

FINANCIAL ACCOUNTING

From Its Basics to Financial
Reporting and Analysis

Simeon Spiteri

Financial Accounting

Financial Accounting:

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By

Simeon Spiteri

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**Dedicated to
my family.
Thanks Marija!
You provided the first critical support!**

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PART 1:

OVERVIEW

CHAPTER 1

INTRODUCTION

Accounting is divided into two main areas, which are financial accounting and management accounting. This book focuses on financial accounting, which mainly comprises the preparation and examination of financial statements in order to help external users like ordinary shareholders, lenders and suppliers to take economic decisions. Management accounting is directed towards management by providing detailed information in order to help them to take routine and non-routine decisions. Financial accounting reflects past events that are portrayed in the financial statements. Management accounting comprises past events present in the management accounts and also forecasts that appear in the functional and master budgets.

The objective of this book is to help individuals understand key aspects of financial accounting, such as recording business transactions, accounting for year-end adjustments, utilising accounting controls, preparing financial reports, understanding the key aspects of the annual report and the financial statements, and interpret the financial statements. A practical perspective is adopted in this book. Techniques used by accountants and financial analysts in practice are unveiled.

This book is ideal for individuals who have very limited knowledge of financial accounting and also for practitioners. Basic principles and techniques of financial accounting are explained, and illustrative examples are used in order to help the reader understand these principles and techniques. Furthermore, exercises are given at the end of each chapter where the reader can test his/her learning. Model answers are provided at the end of the book. Thus, this book facilitates the understanding of basic principles and techniques of financial accounting, which are useful for individuals with very limited knowledge of financial accounting, such as students and entrepreneurs who have not studied accounting.

PART 2:
THE DOUBLE ENTRY SYSTEM

CHAPTER 2

ACCOUNTING FOR THE ORGANISATION'S ASSETS, LIABILITIES AND CAPITAL

Objectives

After you have read this chapter you should be able to:

- Understand the term accounting;
- See the process used in order to record business transactions;
- Know the meaning of assets, liabilities and capital;
- Understand the accounting equation;
- Identify the main users of accounting information and their information needs; and
- Record transactions by using the double entry system for assets, liabilities and capital.

2.1 Definition of the Term Accounting

Accounting can be defined as the process of recording, classifying, reporting and interpreting financial information for interested users in order to help them in their economic decisions. This indicates that accounting is a process of four key stages, which are recording, classifying, reporting and interpreting financial information. In this chapter emphasis is placed on the recording of business transactions and the identification of the main users of accounting information to whom financial information is provided.

2.2 Process of Recording Transactions

Accounting can be considered as a process because the four stages noted above are performed in a sequential operation. These consist of recording business transactions, classifying the transactions in the appropriate accounts, reporting financial information at the end of the year and interpreting the financial information to interested users.

The best method that a lot of organisations utilise to record business transactions is the double entry system. The double entry system is based on the philosophy that every transaction has a give (-) and take (+) situation for the organisation. However, before explaining further this system let us define three important items in accounts.

2.2.1 Meaning of Assets, Liabilities and Capital

The resources owned by the firm are acquired in order to sustain the operations of the business enterprise. Examples of these resources are stock, cash at bank, machinery and motor vehicles. These resources are called Assets. There are two types of assets, which consist of non-current assets and current assets. Non-current assets are assets that are expected to provide economic benefits to the organisation for a long period of time, which is normally in excess of one year. Examples of non-current assets are buildings, plant and machinery, and motor vehicles. Current assets comprise assets whose value alter frequently. Current assets are also in the form of cash or are quickly translated into cash. Examples of current assets consist of stock, trade receivables, bank and cash.

Someone must contribute for the business enterprise to buy these assets. There are two separate individual/entities that provide finance to the organisation. These are the owner of the organisation and third parties. The assets financed by the owner are called Capital, while those financed by third parties comprise Liabilities. For example, the €1,500 cash contributed by the owner will be considered as capital. A loan of €5,000 will be classified as a liability.

There are two types of liabilities, which consist of non-current and current liabilities. Non-current liabilities, such as a loan are liabilities that take more than one financial year to be paid. Current liabilities are liabilities that will be paid in the near future, which is less than the firm's financial year. Examples of current liabilities are trade payables and bank overdraft.

One can derive the following accounting equation from these variables:

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

If we apply the philosophy of the double entry system, the take situation is the assets, while the give situation is the capital and liabilities. Capital and liabilities are debts that the organisation is required to pay in future.

Example: Application of the Accounting Equation

An organisation incurred the following transactions during the month:

1. The owner deposited €10,000 into the business bank account.
2. A motor vehicle was bought costing €5,000 on credit from Muscat Motors.
3. The organisation repaid Muscat Motors the amount due of €5,000 by cheque.
4. The firm purchased stock of €1,500, which were immediately paid by cheque.

Situation	Assets €	Capital €	Liabilities €
1	10,000 (Bank)	10,000 (Owner)	-
2	5,000 (Motor Vehicle)	-	5,000 (Muscat Motors)
3	-5,000 (Bank)	-	-5,000 (Muscat Motors)
4	1,500 (Inventories) -1,500 (Bank)	-	-

The impact of these transactions on assets, capital and liabilities is outlined below:

1. The owner deposited €10,000 into the business bank account.
Take situation: €10,000 deposited in the bank account (+ assets).
Give situation: in the future the firm has to pay the owner €10,000 (+ capital).
2. The firm purchased a motor vehicle costing €5,000 on credit from Muscat Motors.
Take situation: motor vehicle of €5,000 are acquired by the organisation (+ assets).
Give situation: in the future the organisation has to pay Muscat Motors €5,000 (+ liabilities).
3. The firm repaid Muscat Motors the amount due of €5,000 by cheque.
Take situation: the debt with Muscat Motors is settled (- Liabilities).

Give situation: the firm had to use €5,000 from the bank account to settle the debt (- assets).

4. The firm purchased stock of €1,500 paying immediately by cheque.

Take situation: the enterprise purchased stock of €1,500 (+ assets).
Give situation: the organisation had to use €1,500 from the bank account to purchase this stock (- assets).

The key principle is that in every transaction there is a take and give situation. The take situation is either increasing assets or decreasing capital or liabilities. The give situation is either decreasing assets or increasing capital or liabilities.

2.3 Main Users of Accounting Information

There are internal and external users of accounting information. In this section emphasis is placed on external users because the aspects of financial accounting are considered in this book.

The main external users of accounting information and their information needs are stated below:

Investors: investors consist of the individuals who invest in the organisation and become the respective owners. In a company the investors are known as the ordinary shareholders. Investors are interested in the profitability made by the organisation. This shows the direct return that they can get from the firm. Moreover, investors consider the investment risk in the organisation, which is the risk that the firm goes bankrupt or that they are unable to achieve the anticipated return. Thus, attention is given to the liquidity and long term solvency of the organisation.

Lenders: comprise individuals who lend money to the organisation. Such money is repayable after more than one year. Lenders are interested in the liquidity of the organisation in order to assess its ability to pay interest and the loan when it matures. Furthermore, they will consider the long term stability of the organisation to assess the risk that the organisation goes bankrupt.

Trade Payables: consist of individuals who sell goods to the organisation on credit. Like lenders trade payables are interested in the liquidity of the organisation to evaluate the firm's ability to pay the debts on time. They also consider the firm's long term stability to assess the possibility that the

organisation can be a client for the long run. However, lower emphasis is placed on long term stability than lenders because the amount due is payable in the short term.

The Government: the government is interested in the profit generated by the organisation. This helps to examine if the company paid the correct amount of taxation. The government is also interested in the long term solvency of the organisation to evaluate the risk that the company may go insolvent. This affects the unemployment rate especially if it is a large organisation.

Customers: customers are interested in the long term solvency of the firm in order to evaluate the risk that it goes bankrupt. If the company becomes insolvent it can adversely impact the after sales service that the customer is entitled to. Furthermore, the customer may be unable to purchase additional products from the organisation. This is important especially for brand loyal customers.

General Public: the general public is also interested in the long term solvency of the organisation because it influences the rate of unemployment in the community.

2.4 Recording Transactions that affect Assets, Liabilities and Capital

The double entry system is based on the give and take situation, as already remarked. The take situation (+) is called the debit side, while the give situation (-) is called the credit side. Business transactions need to be recorded on the debit side and the credit side in accordance to this principle. Business transactions also lead to the creation of accounts. Different accounts are opened to reflect the asset acquired or disposed and the liabilities incurred. One account is opened only for the assets invested by the owner, which is called the capital account. The drawings account is opened when the owner takes resources from the organisation for his/her personal use.

The layout of an account is as follows:

Name of Account

Date	Debit	€	Date	Credit	€

As you can see the debit is on the left-hand side, while the credit is on the right-hand side.

Example: Recording Business Transactions

Money Deposited by the Owner:

1st January 2019: The owner deposited €15,000 into the business bank account.

Take: the firm received €15,000 in the bank account.

Give: in the future the organisation needs to pay the owner €15,000.

Bank Account

Date	Debit	€	Date	Credit	€
1/1/19	Capital*	15,000			
Capital Account					
			1/1/19	Bank*	15,000

*The narration reflects the other account in order to explain in what account was the other entry passed. Remember that in practice numerous accounts are opened to reflect all the business transactions incurred by the organisation.

Acquisition of Furniture on Credit and Repayment at a Later Date:

18th January 2019: The organisation purchased furniture of €3,500 on credit from Combi Ltd.

Take: the firm received furniture of €3,500.

Give: in the future the organisation needs to pay €3,500 to Combi Ltd.

26th January 2019: The firm paid the debt of Combi Ltd. by cheque.

Take: the debt is settled, which leads to a decline in liabilities of €3,500.

Give: €3,500 from the business bank account had to be used.

Furniture Account

Date	Debit	€	Date	Credit	€
18/1/19	Combi Ltd.	3,500			
Combi Ltd. Account					
26/1/19	Bank	3,500	18/1/19	Furniture	3,500
Bank Account					
			26/1/19	Combi Ltd.	3,500

Purchase of Motor Vehicle by Cheque:

30th January 2019: The firm acquired a motor vehicle of €6,000, which was paid immediately by cheque.

Take: the firm received a motor vehicle of €6,000.

Give: €6,000 from the business bank account had to be used to purchase the motor vehicle.

Motor Vehicle Account

Date	Debit	€	Date	Credit	€
30/1/19	Bank	6,000			
Bank Account					
			30/1/19	Motor Vehicle	6,000

Transferred Money from the Bank Account to the Cash Account:

1st February 2019: Took €250 from the business bank account and deposited it into the cash till.

Take: the firm's cash in hand increased by €250.

Give: the balance in the bank account decreased by €250.

Cash Account

Date	Debit	€	Date	Credit	€
1/2/19	Bank	250			
Bank Account					
			1/2/19	Cash	250

Received a Loan:

3rd February 2019: Alex Smith provided a loan of €20,000, which was deposited in the bank account.

Take: the firm received money of €20,000, which was deposited in the bank account.

Give: there is a liability of €20,000, which is payable to Alex Smith.

Bank Account

Date	Debit	€	Date	Credit	€
3/2/19	Loan: Alex Smith	20,000			
Loan: Alex Smith Account					
			3/2/19	Bank	20,000

Money Taken by the Owner:

8th February 2019: The owner took €1,000 cash from the business bank account.

Take: the liability to the owner decreased by €1,000.

Give: the balance in the bank account declined by €1,000.

Drawings Account

Date	Debit	€	Date	Credit	€
8/2/19	Bank	1,000			
Bank Account					
			8/2/19	Drawings	1,000

Paid Part of the Loan Due to Alex Smith:

26th February 2019: Paid part of Alex Smith's loan of €2,500 by cheque.

Take: the liability payable to Alex Smith decreased by €2,500.

Give: the balance in the bank account diminished by €2,500

Loan: Alex Smith Account

Date	Debit	€	Date	Credit	€
26/2/19	Bank	2,500			
Bank Account					
			26/2/19	Loan: Alex Smith	2,500

Review Questions

Question 1

Complete the following table by using the accounting equation:

	Assets €	Liabilities €	Capital €
1	20,000	5,000	
2	13,500		6,000
3		2,500	12,000
4	18,000	3,000	
5	16,900		10,000
6	11,000	6,000	

Question 2

Identify the assets from the following:

- Motor Vehicles
- Insurance
- Plant and Equipment
- Loan – M. Buttigieg
- Discount Received
- Premises
- Accounts Receivable
- Inventory
- Accounts Payable
- Cash at Bank

Question 3

Distinguish the following items into assets and liabilities:

- Accounts Payable
- Cash in hand
- Building
- Office Equipment
- Bank Overdraft
- Accounts Receivable
- Inventory

Question 4

What is the main difference between capital and a liability?

Question 5

Antoine Vella decided to start a business enterprise. Initially before starting any trading he acquired office equipment costing €3,500 and a motor van costing €6,000. He bought inventory costing €4,000 and paid suppliers €1,000. The remaining was provided on a 30-day credit. Antoine also bought premises costing €100,000. These were financed by capital and a loan of €60,000. Calculate the capital that Antoine invested in the organisation.

Question 6

James Mifsud started a business enterprise and performed the following transactions in the first month:

- The owner deposited €15,000 into the business bank account.
- Transferred €500 from the bank account into the cash till.
- Bought office equipment costing €3,500 by cheque.
- Bought goods for re-sale costing €500 by cheque.
- Bought goods for re-sale on credit from A. Micallef costing €1,000.
- Sold goods to a customer of €600 who paid immediately by cash.
- The owner took €1,000 from the business bank account.
- Sold €2,000 worth of goods to a customer on credit.
- Returned goods to A. Micallef of €20.

Record these transactions in the following table:

Assets	Capital	Liabilities

Question 7

Record the following transactions by using the double entry system:

- Sep. 1 The owner started a business by depositing €4,000 in the bank account.
- Sep. 2 Bought office equipment costing €300 by cheque.
- Sep. 5 Deposited €250 bank into the cash till.
- Sep. 9 Bought motor vehicle €3,000 on credit from Motors Inc.
- Sep. 15 The owner deposited an additional €1,500 in the bank account.
- Sep. 23 Paid Motors Inc. the amount due of €3,000 by cheque.
- Sep. 28 Bought more office equipment of €200 paying by cash.

Question 8

Reflect the following transactions in the respective accounts:

- Oct. 1 Started business with €5,000 in the business bank account.
- Oct. 3 Bought motor vehicle costing €2,200, which was immediately paid by cheque.
- Oct. 4 Bought office furniture costing €400 by cheque.
- Oct. 5 Returned faulty office furniture of €50. A refund was provided, which was deposited in the cash till.
- Oct. 11 Bought machinery costing €950, which was purchased on credit from Novitex.

Oct. 13	Deposited €300 into the cash till from the bank account.
Oct. 15	Sold part of the machinery for €100 cash.
Oct. 17	Took a loan from Felix Blackburn of €3,300, which was deposited in the bank account.
Oct. 20	Bought additional machinery of €120, which was paid by cheque.
Oct. 24	The owner deposited an additional €500 in the cash till.
Oct. 30	Paid Novitex €500 by cheque.

Question 9

Record the transactions below in the respective accounts:

Nov. 1	Started business with €3,500 in the cash account.
Nov. 2	Deposited €3,000 into the bank account from the cash till.
Nov. 4	Purchased office furniture of €500 on credit from Beautiful Furniture Ltd.
Nov. 5	Bought machinery of €1,000 paying by cheque.
Nov. 8	Return faulty office furniture of €100. This was deducted from the amount due to Beautiful Furniture Ltd.
Nov. 10	The owner deposited an additional €1,200 in the bank account.
Nov. 13	The owner took €50 cash for his personal use.
Nov. 19	Sold office furniture of €100 by cash.
Nov. 23	Paid Beautiful Furniture Ltd. the amount due of €400 by cheque.
Nov. 25	Took a loan from Brandon Smith of €4,000, which was deposited in the bank account.
Nov. 28	The owner took €120 money from the business bank account.

CHAPTER 3

ACCOUNTING FOR STOCK

Objectives

After you have read this chapter you should be able to:

- Distinguish between sales and purchases;
- Understand the difference between cash sales and credit sales;
- Differentiate between cash purchases and credit purchases;
- Distinguish between return outwards and returns inwards; and
- Account for stock by using the double entry system.

3.1 Different Types of Inventory Accounts

The inventory account, which is sometimes also referred to as stock is an account affected by following four main types of transactions:

- Purchase of inventory;
- Return of faulty inventory to suppliers;
- Selling of inventory; and
- Receipt of faulty inventory from clients.

These types of transactions have a huge impact on the operating profit made by the enterprise. Thus, it is appropriate that these transactions are not mixed together in the inventory account but are separated to four different accounts. This aids in analysing the main factors that influence the operating profit of the organisation. These are classified as follows:

- Purchase of inventory – Purchases Account
- Return of faulty inventory to suppliers – Returns Outwards Account
- Selling of inventory – Sales Account
- Receipt of faulty inventory from our clients – Returns Inwards Account

3.2 Accounting for Purchases, Sales, Returns Out and Returns In

Goods Bought by Cheque:

10th February 2019: Bought stock of €600 by cheque.

Take: the organisation received inventory of €600.

Give: the firm paid €600 from the business bank account.

Purchases Account

Date	Debit	€	Date	Credit	€
10/2/19	Bank	600			
Bank Account					
			10/2/19	Purchases	600

Goods Bought on Credit:

12th February 2019: Purchased inventory of €2,500 on credit from Extra Supplies.

Take: the firm received inventory of €2,500.

Give: in the future the organisation needs to pay Extra Supplies €2,500.

Purchases Account

Date	Debit	€	Date	Credit	€
12/2/19	Extra Supplies	2,500			
Extra Supplies Account*					
			12/2/19	Purchases	2,500

*Suppliers whom the firm owes money are called trade payable or accounts payable.

Returned Stock to Supplier:

14th February 2019: The firm returned faulty inventory to Extra Supplies of €50.

Take: the amount due to Extra Supplies is decreased by €50.

Give: inventory decreased by €50.

Returns Outwards Account

Date	Debit	€	Date	Credit	€
			14/2/19	Extra Supplies	50
Extra Supplies Account					
14/2/19	Returns Outwards	50			

Goods Sold for Cash:

17th February 2019: Cash sales of €2,000

Take: received cash of €2,000.

Give: inventory diminished by €2,000.

Sales Account

Date	Debit	€	Date	Credit	€
			17/2/19	Cash	2,000
Cash Account					
17/2/19	Sales	2,000			

Goods Sold on Credit:

18th February 2019: Sold inventory on credit to F. Demajo of €3,800.

Take: in the future F. Demajo is required to pay the organisation €3,800.

Give: inventory decreased by €3,800.

Sales Account

Date	Debit	€	Date	Credit	€
			18/2/19	F. Demajo	3,800
F. Demajo Account*					
18/2/19	Sales	3,800			

*F. Demajo represents a client to whom goods are sold on credit. In accounts this is normally referred to as trade receivable or accounts receivable.

Goods Returned by Customer:

19th February 2019: F. Demajo returned inventory of €90.

Take: the firm received inventory of €90.

Give: the amount due to us by F. Demajo decreased by €90.

Returns Inwards Account

Date	Debit	€	Date	Credit	€
19/2/19	F. Demajo	90			
F. Demajo Account					
			19/2/19	Returns Inwards	90

Review Questions

Question 1

Prepare the following table:

	Account to be Debited	Account to be Credited
Bought €300 goods on credit from B. Supplies.		
Cash sales €350.		
Bought goods for cash €200.		
Sold goods on credit of €260 to Alan Clooney.		
Alan Clooney returned faulty goods costing €60.		
Bought goods on credit of €145 from B. Supplies.		
Returned goods to B. Supplies of €45.		

Question 2

Complete the following table:

	Account to be Debited	Account to be Credited
Bought €450 goods on credit from AR Supplies.		
Bought €800 machinery on credit from Volcat.		
Cash sales €330.		
Returned faulty machinery of €500 to Volcat.		
Sold goods on credit to Martin Smith of €350.		
Martin Smith returned faulty goods of €20.		
Bought €150 additional machinery by cheque.		

Question 3

Record the following transactions by using the double entry system:

- Oct. 1: Bought goods on credit from Tiles Supplies costing €800
- Oct. 4: Bought goods of €650 paying by cheque.
- Oct. 6: Cash sales of €300.
- Oct. 12: Sold goods on credit to Antoine New, which amounted to €830.
- Oct. 13: Antoine New returned goods costing €30.
- Oct. 18: Bought goods on credit from Tiles Supplies of €330.
- Oct. 24: Returned faulty goods to Tiles Supplies of €92.

Question 4

Post the following transactions to the respective accounts:

- Nov. 1: Bought goods on credit from Hepsu costing €560.
- Nov. 3: Sold €870 goods on credit to Jennifer Mujis.
- Nov. 6: Jennifer Mujis returned goods costing €90.
- Nov. 7: Bought motor vehicle of €9,000 on credit from Good Vehicles.
- Nov. 8: Cash sales of €260.

- Nov. 11: Bought goods for cash costing €440.
- Nov. 12: Purchased €781 goods on credit from Hesub.
- Nov. 14: Returned goods to Hesub costing €81.
- Nov. 20: Bought machinery costing €2,100 on credit from SA Machinery.
- Nov. 23: Returned machinery of €480 to SA Machinery.
- Nov. 30: Cash sales of €713.

CHAPTER 4

ACCOUNTING FOR REVENUE AND EXPENSES

Objectives

After you have read this chapter you should be able to:

- Distinguish between revenue and expenses;
- Understand the impact of revenue and expenses on the firm's profitability;
- Account for revenue and expenses by using the double entry system; and
- Understand and distinguish between capital expenditure and revenue expenditure.

4.1 Difference between Revenue and Expenses

An enterprise in its normal course of business incurs expenses in the production of the income, such as water and electricity, rent, insurance, salaries, rates and more. However, revenue may also be generated, such as discounts received from suppliers for early payment, commission received and rent received. Revenue leads to an increase in the profit generated by the organisation while expenses decrease the profit made by the firm.

4.2 Recording Revenue and Expenses in the Accounts

Payment of Expenditure by Cheque:

3rd March 2019: The enterprise paid an electricity bill by cheque, which amounted to €250.

Take: electricity helps in the production of the income by allowing machinery and other electrical equipment to be used worth €250.

Give: the bank account decreased by €250.

Electricity Account

Date	Debit	€	Date	Credit	€
3/3/19	Bank	250			
Bank Account					
			3/3/19	Electricity	250

15th March 2019: AJ Supplies provided a discount of €300 for early payment, which was deducted from the amount due of €3,300. The remaining amount was paid by cheque.

In this case there are two transactions, which are the payment of the amount due to AJ Supplies and the discount received from AJ Supplies.

Payment of the Amount Due to AJ Supplies:

Take: the liability is decreased by €3,000.

Give: the bank account diminished by €3,000.

Discount Received from AJ Supplies:

Take: the liability declined by €300.

Give: the discount received will lead to higher profitability and the organisation will be required to pay more taxation on the €300 discount.

Discount Received Account

Date	Debit	€	Date	Credit	€
			15/3/19	AJ Supplies	300
Bank Account					
			15/3/19	AJ Supplies	3,000
AJ Supplies Account					
15/3/19	Bank	3,000			
15/3/19	Discount Received	300			

20th March 2019: A customer, A. Ellis paid the amount due of €2,100 by cheque. A discount of €100 was deducted from the amount due for early payment.

Again, there are two business transactions, which consist of the receipt of money from A. Ellis and the discount provided to A. Ellis for early payment.

Receipt of Money from A. Ellis:

Take: money deposited in the firm's bank account balance of €2,000.

Give: A. Ellis is no longer in debt with the organisation by €2,000.

Discount Allowed to A. Ellis:

Take: the discount allowed encouraged earlier payment, which improves the firm's cash flow by €100.

Give: A. Ellis liability to the organisation declined by €100.

Discount Allowed Account

Date	Debit	€	Date	Credit	€
20/3/19	A. Ellis	100			
Bank Account					
20/3/19	A. Ellis	2,000			
A. Ellis Account					
			20/3/19	Discount Allowed	100
			20/3/19	Bank	2,000

4.3 Capital and Revenue Expenditure

All expenditure incurred by a business needs to be distinguished between capital expenditure and revenue expenditure. One should consider the following factors in order to distinguish between these two types of expenses:

- The nature of the business operations;
- The type of expenditure incurred;
- The materiality of the expenditure; and
- The frequency with which this expenditure takes place.

Capital expenditure can be defined as expenses that comprise the acquisition of non-current assets or adding value to the firm's present non-current assets. Capital expenditure is not frequently performed by the organisation and it is material. Such expenditure is shown in the statement of financial position under non-current assets. Examples of capital expenditure are

improvements to buildings, purchase of machinery, acquisition of motor vehicles and legal costs to acquire buildings.

Revenue expenditure can be defined as expenditure performed in the day-to-day running of the business, which ceases to add value to the business once incurred. The value of revenue expenditure is immaterial in comparison to capital expenditure. Furthermore, such expenditure occurs frequently. This type of expenditure must be treated as an expense in the income statement. Examples of this type of expenditure are rent, advertising, salesman commission and petrol.

Review Questions

Question 1

Record the following transactions by using the double entry system:

Feb. 1: Paid rent by cash of €65.

Feb. 3: Provide €15 discount to B. Camenzuli for early payment.

Feb. 8: Paid electricity of €120 by cheque.

Feb. 10: Paid rates of €70 by cash.

Feb. 17: Received €33 discount from R. Supplies for early payment.

Feb. 20: Received commission of €220, which was deposited in the bank account.

Feb. 27: Paid wages of €3,000 by cheque.

Question 2

Reflect the following transactions in the respective accounts:

Nov. 1: Paid insurance of €78 by cheque.

Nov. 7: Settled motor vehicle repairs of €85 by cash.

Nov. 8: Received rent of €140, which was deposited in the bank account.

Nov. 10: Paid stationery of €12 by cash.

Nov. 11: Received discount of €45 from D. Smith for settling the account 20 days before the credit period allowed.

Nov. 14: Paid water and electricity of €180 by cash.

Nov. 15: Paid rates of €110 by cheque.

Nov. 20: Paid sundry expenses of €89 by cash.

Nov. 23: Received money from R. Saliba of €842. A discount of €18 was given to this customer for earlier payment. This money was deposited in the bank account.

Nov. 28: Paid salaries of €4,880 by cheque.

Nov. 30: The bank charged €24 for services rendered.

Question 3

- a) What is the difference between capital expenditure and revenue expenditure?
 b) Complete the following table by placing the expenditure in its appropriate category:

Expenditure	Capital Expenditure	Revenue Expenditure
Purchase of buildings.		
Legal costs to buy buildings.		
Purchase of motor vehicle.		
Motor vehicle fuel.		
Heating.		
Rates.		
Extension to buildings.		

Question 4

Distinguish the following between capital and revenue expenditure:

- a) Legal costs on collecting money from trade receivables.
- b) Carriage costs on sales.
- c) Carriage expenditure on purchases.
- d) Motor vehicles insurance.
- e) Purchase of machinery.
- f) Transportation paid for machinery purchased.
- g) Cost of rebuilding warehouse.
- h) Salaries of office clerks.
- i) Motor vehicles repaired.
- j) Bank charges.
- k) Purchase of air conditions.
- l) Cost of installing air conditions.
- m) Purchase of new computer equipment.

CHAPTER 5

BALANCING OFF THE ACCOUNTS

Objectives

After you have read this chapter you should be able to:

- Balance the accounts;
- Understand the meaning of the balance b/d; and
- Understand what the balance c/d represents.

5.1 Balancing the Accounts

The last rule that needs to be applied when recording transactions is that a balance needs to be made to the respective account. The approach adopted in order to balance the accounts is shown in the following example:

Capital Account

Date	Debit	€	Date	Credit	€
31/3/19	Balance c/d	<u>3,000</u>	2/3/19	Bank	<u>3,000</u>
			1/4/19	Balance b/d	3,000
Bank Account					
2/3/19	Capital	3,000	19/3/19	Purchases	2,500
28/3/19	Sales	5,000	23/3/19	Wages	1,500
			31/3/19	Balance c/d	<u>4,000</u>
		<u>8,000</u>			<u>8,000</u>
1/4/19	Balance b/d	4,000			

Notes:

- The date of the balance c/d should either be at the end of the month or year. This represents the final balance during such period after reflecting all the respective transactions.
- The date of the balance b/d should be at the beginning of the month or year. It should correspond to the balance c/d of the previous month or year. This indicates the initial value present in the account.

The balance is the difference between the total debit side and the total credit side. In the case of the capital account the total of the credit side is €3,000, while that of the debit side is €0. Thus, a balance c/d of €3,000 needs to be reflected on the debit side for the balances to agree. As regards the bank account, the total of the debit side of this account is €8,000, which is €4,000 higher than the credit side. Therefore, the balance c/d, is the difference between the two, which amounts to €4,000.

Review Questions

Question 1

Charmaine Summers started business on 1st April 2019. The following transactions took place during that month:

April 1	Charmaine deposited €3,900 in the business bank account.
April 2	Bought computer equipment costing €850 by cheque.
April 5	Charmaine deposited €300 bank into the cash till.
April 6	Bought goods on credit from the following persons: AJ Supplies €210 and Refix €280.
April 9	Sold goods on credit to the following individuals: Ismail Smith €450 and Anthony Ferry €800.
April 15	Charmaine took €50 cash for her personal use.
April 23	Paid wages of €1,000 by cheque.
April 28	Bank charges of €30.

Required:

- Reflect the transactions in the respective accounts.
- Balance off the accounts.

Question 2

Enter the following transactions in the respective accounts and balance off the accounts as at 30th November 2019:

Nov. 1	Cash sales €300.
Nov. 2	Bought additional goods on credit from: Joseph Smith €400 and Alfred Maringe €390.
Nov. 3	Returned goods to Alfred Maringe €30.
Nov. 5	Sales on credit to: Mary Seale €500 and Alison Lumby €700.
Nov. 7	Mary Seale returned faulty goods worth €50.
Nov. 8	Paid electricity of €55 by cheque.

- Nov. 12 Mary Seale paid the amount due of €450, which was deposited in the bank account. A discount of €12 was provided for early payment, which was deducted from the €450 due.
- Nov. 15 Paid insurance of €80 by cheque.
- Nov. 23 Alison Lumby paid the amount due of €700, which was deposited in the bank account.
- Nov. 25 Received rent of €380, which was deposited in the bank.
- Nov. 28 Paid €15 stationery by cash.

Question 3

AR Enterprise have been operating for numerous years. The opening balances at 1st January 2019 are:

Capital	€10,000
Bank	€8,800 (Debit Balance)
Cash	€350
Agnes Seguna	€412 (Debit Balance)
RJ Supplies	€300 (Credit Balance)
Jacky Lumby	€516 (Debit Balance)

The following transactions took place in January:

- Jan. 2 The owner took €50 cash for his personal use.
- Jan. 4 Agnes Seguna paid the amount due of €412, which was deposited in the bank account.
- Jan. 5 Bought goods on credit from RJ Supplies of €250.
- Jan. 6 Returned goods to RJ Supplies of €25.
- Jan. 8 Paid rates by cheque €150.
- Jan. 10 Received commission of €68 by cash.
- Jan. 12 Paid RJ Supplies €250 by cheque. A discount of €23 was received.
- Jan. 16 Cash sales of €148.
- Jan. 18 Received money from Jacky Lumby of €200, which was posted in the bank.
- Jan. 21 Paid electricity of €145 by cheque.
- Jan. 22 Credit sales of €400 to Agnes Seguna and €188 to Francis Lumby.
- Jan. 23 Francis Lumby returned goods worth €8.
- Jan. 25 Took €200 from the bank account and deposited it in the cash till.

Jan. 26 Paid wages of €2,300 by cheque.
Jan. 28 Bank charges of €50 were deducted by the bank.
Jan. 31 Paid RJ Supplies €180 by cash.

Required:

- a) Post the opening balances in the appropriate accounts.
- b) Reflect the transactions in the respective accounts.
- c) Balance off the accounts.

CHAPTER 6

ACCOUNTING FOR VAT

Objectives

After you have read this chapter you should be able to:

- Distinguish between Input VAT and Output VAT;
- Calculate the impact of VAT on Assets and Liabilities;
- Determine the impact of VAT on Expenses and Revenue;
- Account for VAT by using the double entry system; and
- Calculate the net VAT payable or recoverable from the government.

6.1 Value Added Tax

Value added tax (VAT) is an indirect tax that is ultimately paid by the customer. VAT is a regressive taxation implying that it has a similar impact on high-income and low-income individuals. However, a regressive tax places a greater financial burden on low-income people because they generate lower income and thus their purchasing power decreases more than high-income people when a regressive tax is introduced. The VAT rate varies according to the legislation present in that country. For example, the VAT rate in Malta is presently at 18%.

6.2 Input VAT and Output VAT

VAT is not directly paid by the customer to the government. An intermediary is used, which is normally the retailer. These firms face two types of VAT, which are the input VAT and the output VAT. The accountant needs to distinguish between these two types of VAT because they have a different impact on the VAT that the organisation needs to pay or receive from the government.

Input VAT consists of VAT that the organisation paid for goods and services received from individuals or firms. Output VAT comprises the VAT that the organisation charges to the customer. The firm can reclaim

the input VAT paid unless it is VAT exempt. VAT exempt organisations are those firms that cannot charge VAT to customers. These are normally small organisations that generate a low amount of sales and thus the law allows them to be exempt from VAT. This provides a price advantage to these organisations because they can charge a lower price to customers.

Example: Computation of VAT and Distinction between Input and Output VAT

During the quarter ending 31st December 2019 an organisation paid input VAT of €10,500. The total sales made by the firm during this quarter amounted to €118,000. This is inclusive of 18% VAT.

Required:

Determine the output VAT and the total VAT that the firm needs to pay to the government.

The input or output VAT can be calculated by using the following formula:

$$\text{Net Amount} + \text{VAT} = \text{Gross Amount (Vat inclusive)}$$

$$100\% + 18\% = 118\%$$

$$\text{Output VAT} = €118,000 \times \frac{18\%}{118\%} = €18,000$$

Output VAT	€18,000
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Input Vat	<u>€10,500</u>
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Vat Payable to the Government	<u>€7,500</u>
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6.3 VAT on Assets and Liabilities

Numerous assets acquired by an organisation are subject to VAT, such as motor vehicles and machinery. Moreover, when the firm acquires goods on credit, the amount payable to the supplier is inclusive of VAT.

Example: Input VAT on Assets Acquired

Peter Muscat purchased a motor van by cheque costing €22,000 on 1st November 2019. This is inclusive of 18% VAT.

Required:

- Determine the input VAT charged on the motor van.
- Reflect this transaction in the respective accounts.

The same equation utilised in the previous example will be used in order to determine the input VAT.

$$\text{Input VAT} = \text{€}22,000 \times \frac{18\%}{118\%} = \text{€}3,356$$

Motor Van Account

Date	Debit	€	Date	Credit	€
1 Nov.	Bank (a)	18,644			
Bank Account					
			1 Nov.	Motor Van (a)	18,644
			1 Nov.	VAT (b)	3,356
VAT Account					
1 Nov.	Bank (b)	3,356			

Notes:

- The amount excluding VAT (€22,000 - €3,356) is reflected in the motor van account.
- The input VAT paid is shown separately in the bank account and it is reflected in the VAT Account. In the VAT account one includes both the input and output VAT.

Example: Input VAT due on Goods Purchased on Credit

On 4th December 2019 an organisation acquired goods worth €10,000 on credit from Walceramics. This amount is net of 18% Vat.

Required:

- Determine the input VAT charged on the goods purchased.
- Reflect this transaction in the respective accounts.

In this case the €10,000 is net of VAT. The same equation is used but one needs to be careful where to place this figure in the equation.

$$\text{Input VAT} = \text{€}10,000 \times \frac{18\%}{100\%} = \text{€}1,800$$

Purchases Account

Date	Debit	€	Date	Credit	€
4 Dec.	Walceramics (a)	10,000			
Walceramics Account					
			4 Dec.	Purchases (a)	10,000
			4 Dec.	VAT (b)	1,800
VAT Account					
4 Dec.	Walceramics (b)	1,800			

Notes:

a) The amount net of VAT (€10,000) is posted in the purchases account. Always the net figure is posted in the revenue or expenditure account.

b) The input VAT is posted in the VAT account. This account serves to determine the net vat payable or recoverable from the government. The gross amount is included in Walceramics account. This shows the total amount payable to this supplier.

6.4 VAT on Expenses and Revenue

The same principle applied in the previous section is used when accounting for expenses and revenue. This principle is that input VAT or output Vat are not reflected in the expense or revenue account. In the income statement one shows all revenue and expenditure net of VAT.

Example: VAT on Expenses and Revenue

An organisation incurred the following expenses and revenue during the month of December:

December 10	Stationery of €100 (net of 18% VAT)
December 12	Fuel of €1,800 (inclusive of 18% VAT)
December 15	Food of €300 (VAT exempt)
December 20	Cash Sales of €3,800 (net of 18% VAT)

All expenditure was paid by cash.

Required:

- a) Determine the input and output VAT.
- b) Post the transactions in the appropriate accounts.

Input VAT:

$$\text{Stationery} = \text{€}100 \times \frac{18\%}{100\%} = \text{€}18$$

$$\text{Fuel} = \text{€}1,800 \times \frac{18\%}{118\%} = \text{€}275$$

Food is VAT exempt and thus no input VAT was charged.

Output VAT:

$$\text{Sales} = \text{€}3,800 \times \frac{18\%}{100\%} = \text{€}684$$

Stationery Account

Date	Debit	€	Date	Credit	€
10 Dec.	Cash	100			
Fuel Account					
12 Dec.	Cash (€1,800 – €275)	1,525			
Food Account					
15 Dec.	Cash	300			
Cash Account					
2 Dec.	Sales	3,800	10 Dec.	Stationery	100
2 Dec.	VAT	684	10 Dec.	VAT	18
			12 Dec.	Fuel	1,525
			12 Dec.	VAT	275
			15 Dec.	Food	300

Sales Account					
			2	Cash	3,800
			Dec.		
VAT Account					
10	Cash	18	2	Cash	684
Dec.			Dec.		
12	Cash	275			
Dec.					
31	Balance c/d (a)	<u>391</u>			—
Dec.					
		<u>684</u>			<u>684</u>

Note:

a) This balance represents the net VAT that the organisation needs to pay to the government. VAT recoverable from the government would have emerged if the balance c/d was on the credit side. This arises when the input VAT is larger than the output VAT. This is often the case when the organisation incurs capital expenditure, such as the purchase of a motor vehicle or the firm buys excessive inventories.

Review Questions

Question 1

Record the following transactions using the double-entry principles:

Date	Business transaction
1 Nov.	The owner deposited €50,000 into the business bank account.
2 Nov.	Bought stock on credit from Supplies Ltd. of €1,180. This amount is inclusive of 18% Vat.
3 Nov.	Bought stock paying immediately by cheque amounting to €295. This amount is inclusive of 18% Vat.
5 Nov.	Paid Supplies Ltd. the amount due of €1,180.
10 Nov.	Sold goods on credit to Evans Smith of €1,416. This amount is inclusive of 18% Vat.
12 Nov.	Cash sales of €354 deposited in the bank account. This amount is inclusive of 18% Vat.
20 Nov.	Paid the following expenses by cheque: Telephone expenses €250 (inclusive of 18% Vat) Bank charges €30 Wages €500

Question 2

Record the following transactions using the double-entry principles:

Date	Business transaction
1 Nov.	The owner deposited €25,000 into the business bank account.
2 Nov.	Bought stock on credit from Extra Stock Ltd. of €1,500. This amount is net of 18% Vat.
3 Nov.	Bought stock paying immediately by cheque amounting to €400. This amount is inclusive of 18% Vat.
5 Nov.	Paid repairs and maintenance of €1,000. This is inclusive of 18% VAT.
10 Nov.	Sold goods on credit to Alex Brincat of €1,680. This amount is net of 18% Vat.
12 Nov.	Cash sales of €480 deposited in the bank account. This amount is net of 18% Vat.
15 Nov.	Bought a motor vehicle costing €10,000 paying immediately by cheque. This amount is net of 18% Vat.
20 Nov.	Paid the following expenses by cheque: Fuel €100 (inclusive of 18% Vat) Bank charges €25 Insurance €700

Question 3

Adrian sells electrical goods and the following information reflects the past quarter ending 31st December 2019:

Sales (inclusive of 18% VAT)	€236,000
Inventory at 1 st October 2019 (excluding VAT)	€15,000
Inventory at 31 st December 2019 (excluding VAT)	€20,500
Purchases (net of 18% VAT)	€115,000
Expenses (excluding VAT)	€80,000
VAT Credit Balance at 1 st October 2019	€560
VAT paid by cash during the quarter	€8,000

Additional information:

- Suppliers provide 2% cash discount for early payment. Adrian took advantage of this discount for all the purchases made.
- One half of the expenditure is subject to 18% VAT.

Required:

- a) The VAT Account.
- b) The income statement for the quarter ended 31st December 2019.
- c) State and justify if the pending Vat balance is an asset or a liability.

PART 3:
PREPARING THE FINAL ACCOUNTS

CHAPTER 7

THE TRIAL BALANCE

Objectives

After you have read this chapter you should be able to:

- Understand why the debit side of the trial balance should agree with the credit side;
- Understand the reasons why a trial balance is prepared;
- Prepare a trial balance; and
- Comprehend the reasons why the trial balance may not agree.

7.1 Introduction

The balances that are presented in the trial balance are generated from the accounts, which are prepared in line to the double entry system. In the double entry system for every debit entry there is a corresponding credit entry. Therefore, the total of the balances on the debit side should agree with those of the credit side in the trial balance. There is a mistake if the totals do not agree and normally a suspense account is opened in order to balance the totals. The suspense account is kept temporary in the books because it is closed after identifying the mistakes and posting the corresponding entries to correct the errors. The suspense account is explained in more detail in chapter 18. However, if the total debit side agrees with the total credit side in the trial balance there is no guarantee that there are no mistakes in the accounts. As explained in chapter 17 there are errors that are not identified by the trial balance.

7.2 Uses of the Trial Balance

Basically, the trial balance is prepared for the following reasons:

- To simplify the accounts in a list of balances and thus help the accountant to prepare the final accounts. The final accounts consist

of the income statement and the statement of financial position, which are explained in more detail in chapter 8.

- To help in the identification of mistakes. However, there may still be mistakes in the accounts even though the trial balance agrees, as already mentioned in the previous section.

Example: Double Entry and the Trial Balance

Record the following transactions by using the double entry system and prepare a trial balance as at 30th November 2019:

- 1st November: The owner deposited €1,500 into the business bank account.
- 2nd November: Transferred €550 from the business bank account to the cash account.
- 4th November: Bought goods for resale costing €500 on credit from BH Supplies.
- 5th November: Returned faulty goods to BH Supplies of €50.
- 7th November: Paid €300 rent by cash.
- 10th November: Sold goods on credit to Jennifer of €250.
- 14th November: Cash sales of €600.
- 18th November: Jennifer returned goods of €30.
- 20th November: Bought a printer costing €100, which was paid by cheque.
- 21st November: Paid BH Supplies the amount due by cheque and received €25 discount for early payment.
- 26th November: Paid wages by cash of €200.
- 27th November: Paid commission by cheque of €30.
- 28th November: Jennifer paid the amount due, which was deposited in the business bank account.
- 30th November: Paid insurance of €100 by cheque.

Bank Account

Date	Debit	€	Date	Credit	€
1/11/19	Capital	1,500	2/11/19	Cash	550
28/11/19	Jennifer	220	20/11/19	Printer	100
			21/11/19	BH Supplies	425
			27/11/19	Commission	30
			30/11/19	Insurance	100
			30/11/19	Balance c/d	<u>515</u>
		<u>1,720</u>			<u>1,720</u>

Cash Account					
2/11/19	Bank	550	7/11/19	Rent	300
14/11/19	Sales	600	26/11/19	Wages	200
			30/11/19	Balance c/d	650
		<u>1,150</u>			<u>1,150</u>
BH Supplies Account					
5/11/19	Returns Out	50	4/11/19	Purchases	500
21/11/19	Bank	425			
21/11/19	Discount Received	<u>25</u>			—
		<u>500</u>			<u>500</u>
Capital Account					
30/11/19	Balance c/d	<u>1,500</u>	1/11/19	Bank	<u>1,500</u>
Purchases Account					
4/11/19	BH Supplies	500	30/11/19	Balance c/d	<u>500</u>
Returns Out Account					
30/11/19	Balance c/d	50	5/11/19	BH Supplies	<u>50</u>
Rent Account					
7/11/19	Cash	<u>300</u>	30/11/19	Balance c/d	<u>300</u>
Sales Account					
30/11/19	Balance c/d	850	10/11/19	Jennifer	250
			14/11/19	Cash	600
		<u>850</u>			<u>850</u>
Jennifer Account					
10/11/19	Sales	250	18/11/19	Returns In	30
			28/11/19	Bank	<u>220</u>
		<u>250</u>			<u>250</u>
Returns In Account					
18/11/19	Jennifer	<u>30</u>	30/11/19	Balance c/d	<u>30</u>
Printer Account					
20/11/19	Bank	<u>100</u>	30/11/19	Balance c/d	<u>100</u>
Discount Received Account					
30/11/19	Balance c/d	25	21/11/19	BH Supplies	<u>25</u>
Wages Account					
26/11/19	Cash	<u>200</u>	30/11/19	Balance c/d	<u>200</u>
Commission Account					
27/11/19	Bank	<u>30</u>	30/11/19	Balance c/d	<u>30</u>
Insurance Account					
30/11/19	Bank	<u>100</u>	30/11/19	Balance c/d	<u>100</u>

Trial Balance as at 30th November 2019	€	€
Bank	515	
Cash	650	
Capital		1,500
Purchases	500	
Returns Out		50
Rent	300	
Sales		850
Returns In	30	
Printer	100	
Discount Received		25
Wages	200	
Commission	30	
Insurance	<u>100</u>	
	<u>2,425</u>	<u>2,425</u>

In the trial balance the figures are included on the opposite side of the balance c/d.

7.3 Why the Trial Balance may not Agree

The following are the reasons why the trial balance may not agree:

1. The transaction is recorded on the same side, such as both on the debit side;
2. The wrong figure is entered in one of the accounts;
3. A balance is calculated incorrectly;
4. The wrong balance is transferred to the trial balance and/or in the wrong side; and
5. The total of the trial balance was calculated incorrectly.

Review Questions

Question 1

Record the following transactions by using the double entry system, balance the accounts and prepare the trial balance as at 30th April 2019:

- 1st April: Started the business with a capital of €3,000 in cash.
 2nd April: The owner opened a business bank account and transferred €2,000 cash to this account.
 4th April: Bought goods on credit from the following suppliers: F. Maringe €500 and B. Jones €650.
 5th April: Sold goods on credit to the following individuals: James €550 and Alex €780.
 9th April: Bought office equipment of €300, which was paid by cheque.
 11th April: Paid F. Maringe the amount due by cheque and received a discount of €5.
 15th April: James paid the amount due and a discount of €10 was provided for quick payment. The money was deposited in the bank account.
 20th April: Paid rent by cheque €100.
 22nd April: Paid B. Jones €350 by cash.
 25th April: Cash sales of €120.
 28th April: Received cash from Alex of €280.

Question 2

Donald Meilaq started a business on 1st May 2019. The following transactions took place in May:

- 1st May: Started the business with €2,000 in the business bank account.
 2nd May: Transferred €200 from the business bank account into the cash account.
 6th May: Bought goods on credit from the following suppliers: K. Allen €800 and Smith Supplies €1,000.
 7th May: Returned goods to Smith Supplies worth €100.
 10th May: Sold goods on credit to Harry €150 and Amanda €320.
 11th May: Paid rates by cheque of €15.
 13th May: Harry returned goods of €50.
 15th May: Donald took €50 cash for his personal use.

- 18th May: Paid the following suppliers by cheque: K. Allen €500 and Smith Supplies €650.
- 20th May: Paid insurance by cheque €90.
- 23rd May: Amanda paid \$200, which were deposited in the cash account. A discount of €8 was given for early payment.
- 24th May: Paid stationery of €30 by cash.
- 25th May: Cash sales of €85.
- 28th May: Paid wages by cash of €110.
- 30th May: The owner deposited an additional €140 in the cash account.
- Required:
- Record these transactions using the double entry system.
 - Balance off the accounts.
 - Prepare a trial balance as at 31st May 2019.

Question 3

Record the following transactions for the month of June by using the double entry system, balance the accounts and prepare the trial balance:

- 1st June: Started the business with €1,500 in the business bank account and €900 cash.
- 2nd June: Bought goods on credit from: R. Smith €660 and B. Hall €500.
- 7th June: Cash sales €350.
- 8th June: Returned goods to R. Smith of €60.
- 9th June: Received rent of €140, which was deposited in the bank account.
- 10th June: Sold goods on credit to Alfred €450 and Richard €290.
- 11th June: The owner took €80 cash for his personal use.
- 12th June: Bought motor vehicle costing €950 paying by cheque.
- 13th June: Richard returned goods of €45.
- 16th June: Received loan from A. Camenzuli of €1,000, which was deposited in the business bank account.
- 18th June: Paid the following suppliers by cheque: R. Smith €260 and B. Hall €450.
- 20th June: Paid stationery by cash €24.
- 23rd June: Cash sales €135.
- 24th June: Bought computer costing €280, which was paid by cheque.
- 25th June: Paid cleaning fees of €65 by cash.
- 27th June: Sold goods on credit to Antoine €560

- 28th June: Received cash from the following customers: Richard €200 and Antoine €260. A discount of €5 was given to Antoine.
- 30th June: Bought goods paying by cash of €410.

CHAPTER 8

THE FINAL ACCOUNTS OF A SOLE TRADER

Objectives

After you have read this chapter you should be able to:

- Prepare the income statement of a sole trader; and
- Prepare the statement of financial position of a sole trader.

8.1 Introduction

In part 2 attention was devoted to the process of recording transactions through the double entry system and calculating the accounts balances. Now emphasis is placed on the preparation of the final accounts of a sole trader, which mainly comprise the income statement and the statement of financial position. The figures reflected in these final accounts are derived from the trial balance.

8.2 The Trading Account and The Income Statement

8.2.1 The Trading Account

The income statement starts with the trading account, which highlights the gross profit made by the organisation. The gross profit figure is important because it shows the profit that the firm is making from the selling of goods in comparison to their purchase cost and other related expenditure, such as transportation costs (carriage inwards). The following is the format of the Trading Account:

Trading Account for the year ended	€	€
Sales		55,000
Less: Returns Inwards		<u>(2,000)</u>
		53,000
<u>Less: Cost of Goods Sold:</u>		
Opening Stock	8,000	
Add: Purchases	40,000	
Less: Returns Outwards	<u>(3,000)</u>	
	45,000	
Less: Closing Stock	<u>(6,000)</u>	39,000
Gross Profit		14,000

Returns inwards are deducted from sales because returns inwards are goods returned by the customer because they are probably faulty or not according to the client's specifications. The same principle applies to returns outwards. Returns outwards should be deducted from purchases because they are goods returned by the organisation to the supplier since they are faulty or not up to the requested specifications.

When calculating the cost of goods sold, one is adding the opening stock with purchases and deducting the closing stock. This is done in order to comply with accounting concepts, which will be covered in more detail in chapter 13. One of these concepts is the accruals concept, which states that revenue incurred in a particular period should be matched with expenses incurred in that period. As a result, the costs of the stock purchased should be matched with the stock sold. Therefore, one must deduct the stock that is not yet sold (closing stock) in order to arrive at the cost of the goods sold figure.

8.2.2 The Income Statement

The other part of the income statement comprises the revenue, which is added to the gross profit. Expenditure is then deducted in order to derive the final figure in the income statement, which is the net profit or loss.

Example: The Income Statement

James, the owner of a small hardware store provided you the following information in order to prepare the income statement for the financial year ended 31st December 2019:

Gross Profit	€14,000
Discount received	€3,500
Rent	€2,000
Water & electricity	€2,000
Sundry expenses	€1,500
Commissions received	€500
Rates	€2,500
Telephone expenses	€1,000

Income Statement for the year ended 31st December 2019	€	€
Gross Profit		14,000
<u>Add: Revenue:</u>		
Discount received	3,500	
Commission received	<u>500</u>	4,000
		18,000
<u>Less: Expenses:</u>		
Rent	2,000	
Water & electricity	2,000	
Sundry expenses	1,500	
Telephone expenses	1,000	
Rates	<u>2,500</u>	9,000
Net Profit		<u>9,000</u>

8.2.3 Carriage Inwards and Carriage Outwards

Carriage inwards consist of transportation costs that are incurred in order to get the goods from the suppliers. Carriage inwards are included in the trading account after the returns outwards. These are added to the cost of sales.

Carriage outwards comprise transportation costs for delivering the goods to customers. These are included with the expenses in the income statement.

Example: The Full Income Statement

The following information is presented by A. Dyson in order to prepare the income statement of the organisation for the financial year ended 31st October 2019:

Stock at 1 st November 2018	€5,000
Purchases	€40,200
Sales	€66,800
Returns Out	€1,400
Carriage In	€550
Rent	€3,000
Water & electricity	€2,220
Carriage Out	€630
Office Expenses	€500
Commissions Received	€800
Rates	€450
Telephone Expenses	€300
Discounts Received	€90
Discounts Allowed	€110
Returns In	€1,020
General Expenses	€1,150

Stock at 31st October 2019 amounted to €6,200.

Income Statement for the year ended 31st October 2019	€	€
Sales		66,800
Less: Returns In		<u>1,020</u>
		65,780
<u>Less: Cost of Goods Sold:</u>		
Opening Stock	5,000	
Add: Purchases	40,200	
Less: Returns Out	1,400	
Add: Carriage In	<u>550</u>	
	44,350	
Less: Closing Stock	<u>6,200</u>	<u>38,150</u>
Gross Profit		27,630
<u>Add: Revenue:</u>		
Discount received	90	
Commission received	<u>800</u>	<u>890</u>
		28,520
<u>Less: Expenses:</u>		
Rent	3,000	
Water & electricity	2,220	
Carriage Out	630	
Office expenses	500	

Telephone expenses	300	
Discounts Allowed	110	
General Expenses	1,150	
Rates	<u>450</u>	<u>8,360</u>
Net Profit		<u>20,160</u>

8.3 The Statement of Financial Position

The statement of financial position is a statement that shows the assets, liabilities and capital of the organisation. The net profit generated by the organisation and the drawings taken by the owner are also shown in the statement of financial position. The statement of financial position is useful to evaluate the liquidity and long term solvency of the organisation. The income statement helps to examine the profitability of the firm. Ratio analysis is normally adopted to analyse the profitability, liquidity and long term solvency of organisations. This technique is explained in depth in chapter 26.

Example: The Statement of Financial Position

The following information is used in order to prepare the statement of financial position for the year ended 31st December 2019:

Net Profit for the year	€6,000
Capital	€20,000
Premises	€10,000
Drawings	€1,000
Motor Vehicles	€6,000
Stock	€5,000
Accounts Receivable	€4,000
Cash at bank	€12,500
Cash in hand	€500
Accounts Payable	€3,000
Loan: B. Oakwood	€10,000

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Premises		10,000
Motor Vehicles		<u>6,000</u>
		16,000
<u>Current Assets:</u>		
Stock	5,000	
Accounts Receivable	4,000	
Bank	12,500	
Cash	<u>500</u>	<u>22,000</u>
Total Assets		<u>38,000</u>
<u>Financed By:</u>		
Capital		20,000
Add: Net Profit		<u>6,000</u>
		26,000
Less: Drawings		<u>1,000</u>
		25,000
<u>Current Liabilities:</u>		
Accounts Payable	3,000	
<u>Non-Current Liabilities:</u>		
Loan: B. Oakwood	<u>10,000</u>	
Total Liabilities		<u>13,000</u>
Total Capital and Liabilities		<u>38,000</u>

From the statement of financial position one can determine the working capital, which is the difference between the total current assets and the total current liabilities. This indicates the value of the capital being used in the daily operations of the business.

Review Questions

Question 1

Prepare the income statement J. Smith by using the following information:

Stock at 1 st January 2019	€7,500
Purchases	€99,000
Sales	€130,000
Rent	€4,000
Water & electricity	€3,300
Office Expenses	€578
Commissions Received	€650
Telephone Expenses	€220
Discounts Received	€18
Discounts Allowed	€198
Repairs	€350

Stock at 31st December 2019 amounted to €17,000.

Question 2

The trial balance of G. Patton is shown below:

Trial Balance as at 31st December 2019	€	€
Sales		240,000
Stock at 1 st January 2019	15,600	
Purchases	195,000	
Discounts Received		350
Returns In	700	
Returns Out		680
General Expenses	1,100	
Motor Expenses	600	
Insurance	1,200	
Discounts Allowed	220	
Rent	540	
Telephone Expenses	180	
Buildings	48,000	
Motor Vehicles	12,000	
Accounts Receivable	7,900	
Accounts Payable		3,200
Cash at Bank	1,450	
Cash in Hand	150	
Drawings	4,590	
Capital		<u>45,000</u>
	<u>289,230</u>	<u>289,230</u>

Stock at 31st December 2019 was €14,450.

Required:

- Income Statement for year ended 31st December 2019.
- Statement of financial position as at 31st December 2019.

Question 3

Use the following trial balance of K. Punch in order to prepare the income statement and statement of financial position for the year ending 30th April 2019:

Trial Balance as at 30th April 2019	€	€
Stock at 1 st May 2018	17,440	
Carriage In	410	
Carriage Out	650	
Sales		287,130
Returns In	1,130	
Purchases	217,000	
Discounts Allowed	1,480	
Returns Out		830
Fuel Costs	980	
Discounts Received		1,450
Motor Vehicles	10,700	
Repairs and Maintenance	2,070	
Office Equipment	4,100	
Buildings	65,000	
Accounts Receivable	12,000	
Accounts Payable		8,900
Cash at Bank	7,400	
Sundry Expenses	720	
Wages and Salaries	7,050	
Drawings	1,200	
Rent Received		7,800
Interest Received		120
Rates	465	
Water and Electricity	755	
Capital		48,200
Office Expenses	<u>3,880</u>	
	<u>354,430</u>	<u>354,430</u>

Stock at 30th April 2019 was €18,100.

Question 4

B. Silverman started a business selling tiles. The following is the trial balance for the financial year ending 30th November 2019:

Trial Balance as at 30th November 2019	€	€
Purchases	94,600	
Rent	1,200	
Insurance	850	
Office Expenses	1,440	
Stock at 1 st December 2018	21,200	
Warehouse	90,000	
Capital		100,000
Sales		147,800
Repairs and Maintenance	300	
Rates	506	
Accounts Payable		14,600
Discounts Received		950
Returns In	1,450	
Motor Vehicles	14,000	
Transportation Expenses	1,760	
Discounts Allowed	1,064	
Commission Received		1,550
Returns Out		1,000
Wages and Salaries	8,560	
Water and Electricity	2,300	
Carriage In	800	
Bank		1,400
Cash in Hand	410	
Interest Expense	70	
Accounts Receivable	18,700	
Drawings	5,400	
General Expenses	740	
Legal Fees	900	
Carriage Out	<u>1,050</u>	
	<u>267,300</u>	<u>267,300</u>

Stock at 30th November 2019 was €24,000.

Required:

- Income Statement for year ended 30th November 2019.
- Statement of financial position as at 30th November 2019.

PART 4:
**THE BOOKS OF ORIGINAL ENTRY
AND ACCOUNTING CONTROLS**

CHAPTER 9

THE BOOKS OF ORIGINAL ENTRY

Objectives

After you have read this chapter you should be able to:

- Identify when transactions are recorded in the books of original entry;
- Understand what each book of original entry is used for;
- Understand the relationship between the books of original entry and the subsidiary ledgers;
- Identify what the sales ledger, purchases ledger and general ledger are used for;
- Understand the difference between personal accounts and impersonal accounts;
- Post transactions in the books of original entry; and
- Understand the whole process of recording transactions.

9.1 Stage when Transactions are Reflected in the Books of Original Entry

Now that you have gained a good idea of the double entry system, attention is given to the books and ledgers in which accounting transactions are recorded.

When a business transaction occurs, it is first recorded in the books of the original entry. Eventually, it is reflected in the subsidiary ledgers by using the double entry system. In this chapter attention is initially given to the books of original entry. These are then linked to the subsidiary ledgers.

9.2 The Books of Original Entry

The books of original entry consist of the following:

Book	Content	Source of information
Sales Journal	Includes details of all the credit sales to customers.	Invoices given to customers.
Purchases Journal	Comprises details of all the credit purchases from suppliers.	Invoices received from suppliers.
Returns Inward Journal	Consists of details of all the returns from customers.	Credit note.
Returns Outwards Journal	Includes details of all the returns to suppliers.	Debit note.
Cash Book	All receipts and payments made by cash or cheque.	Cheques, invoices for expenses or capital expenditure, and receipts given to customers.
General Journal	All other transactions, usually one-off or year-end transactions.	Documents prepared by the accountant.

Key definitions:

Invoice – is a document sent by a supplier to a customer that itemises the goods supplied to the customer, their prices and the total amount of money owed by the customer for these products. There are invoices received from suppliers, which are shown in the purchases day book and invoices sent to our clients, which are included in the sales day book.

Credit note – a credit note is a document sent to a customer showing an allowance given by the enterprise with respect to returned goods.

Debit note – a debit note is a document received from a supplier showing an allowance provided by the supplier with respect to returned goods.

9.3 The Subsidiary ledgers

Once the entries are recorded in the books of original entry, they are transferred to subsidiary ledgers and recorded using the double entry system. A ledger is similar to a book in which the business transactions are recorded by using the double entry system. It contains a number of accounts. There are three different types of ledgers, which consist of:

- **Sales ledger** – this is for customers' (trade receivables) personal accounts.
- **Purchases ledger** – this is for suppliers' (trade payables) personal accounts.
- **General ledger** – all the remaining accounts are recorded in this ledger.

Key definitions:

There are different types of accounts, which are described below:

Personal accounts – these are accounts of the trade receivables and trade payables. These emerge from credit sales and credit purchases.

Impersonal accounts – these are divided into two types of accounts, as follows:

- **Real accounts** – accounts in which assets are recorded. For example, purchase machinery or inventories.
- **Nominal accounts** – accounts in which expenses, revenue and capital are recorded.

9.4 The Sales Journal

The sales journal provides details of credit sales. For credit control purposes one only needs details from trade receivables. Such information may be useful to see the amount of credit sales made by the organisation and who are the most frequent customers who buy on credit. Credit control is a function usually performed by a credit controller to ensure that trade receivables pay the organisation on time.

As already pointed out in section 9.2 the information on credit sales is gained from the invoices issued by the enterprise to the customer. A typical sales invoice would appear as follows:

Busietta Enterprises 12, Marina Street, Pieta, Malta. Vat Reg. No. 1290-1304					
Mr. Donald James Date: 20/11/2019 12, Rockstone Place Code: DJ1324 Southampton System Ref: 00063562					
Invoice 18951					
Stock Code	Description	Quantity	Price	VAT %	Gross
LGS4J6TY	Stationery	12	0.50	20	6.00
CMF685K	Toner	1	60	20	<u>60.00</u>
Subtotal					66.00
VAT					<u>13.20</u>
Total Items: 13				Total	<u>79.20</u>
Payment Terms: Cash on Purchase.					

Example: The Sales Journal

The credit sales incurred by Busietta Enterprises for the month of November were as follows:

2 Nov. 2019: Sold goods on credit to J. Gordon worth €188. The invoice sent to J. Gordon was invoice number 16553. This transaction needs to be reflected in folio SL 10.

16 Nov. 2019: W. Smith bought goods on credit from the firm of €200 and invoice number 16554 was issued. This transaction needs to be cross-referenced to folio SL 11.

20 Nov. 2019: Sold goods on credit to D. James amounting to €140 and invoice number 16555 was issued. This needs to be shown in folio SL 12.

Sales Journal				
Date	Customer	Invoice No.	Folio	Amount (€)
2 Nov. 2019	J. Gordon	16553	SL 10	188
16 Nov. 2019	W. Smith	16554	SL 11	200
20 Nov. 2019	D. James	16555	SL 12	<u>140</u>
Transfer to the Sales Account			GL 22	<u>528</u>

The folio is used in traditional manual bookkeeping. Accountants use the folio column in order to easily identify the ledger and page where the other corresponding entry was made. For example, SL 10 implies: SL = Sales Ledger, 10 = Page number 10.

9.5 Posting Credit Sales to the Subsidiary Ledgers

As already explained in section 9.3, once the transactions are recorded in the book of original entry (in this case the sales journal) they have to be recorded in the subsidiary ledgers by using the double entry system. The transactions are posted in the subsidiary ledgers by using the same example shown in section 9.4.

Sales Ledger

J. Gordon Account							
Date	Debit	Folio	€	Credit	Date	Folio	€
2 Nov.	Sales	SJ 12	188				
W. Smith Account							
16 Nov.	Sales	SJ 12	200				

D. James Account							
20 Nov.	Sales	SJ 12	140				

General Ledger

Sales Account							
Date	Debit	Fo- lio	€	Date	Credit	Folio	€
				2 Nov.	J. Gordon	SJ 12	188
				16 Nov.	W. Smith	SJ 12	200
				20 Nov.	D. James	SJ 12	140

9.6 The Purchases Journal

The purchases journal includes purchases made on credit. The same principle used when doing the sales journal is applied here. Data is collected from suppliers from whom the organisation buys goods on credit.

Example: The Purchases Journal

The credit purchases incurred by Busietta Enterprises for the month of November were as follows:

10 Nov. 2019: Busietta Enterprises bought goods on credit from Supplies Ltd. of €150 and invoice number 97825 was received. The transaction needs to be referenced to folio PL 12.

18 Nov. 2019: Bought goods on credit from Hamilton Supplies amounting to €189 and invoice number 34067 was issued by the supplier. The corresponding folio is PL 16.

27 Nov. 2019: K. Camenzuli sold the organisation goods on credit of €725. This needs to be cross-referenced to folio PL 23. Invoice number 54925 was received from K. Camenzuli

Purchases Journal				
Date	Customer	Invoice No.	Folio	Amount (€)
10 Nov. 2019	Supplies Ltd.	97825	PL 12	150
18 Nov. 2019	Hamilton Supplies	34067	PL 16	189

27 Nov. 2019	K. Camenzuli	54925	PL 23	<u>725</u>
Transfer to the Purchases Account			GL 50	<u>1,064</u>

9.7 Posting Credit Purchases to the Subsidiary Ledgers

Once postings are made to the purchases journal one needs to reflect the transactions in the appropriate ledgers. The same example used above is utilised in order to show how this is done.

Purchases Ledger

Supplies Ltd. Account							
Date	Debit	Folio	€	Date	Credit	Folio	€
				10 Nov.	Purchases	PL 14	150
Hamilton Supplies Account							
				18 Nov.	Purchases	PL 14	189
K. Camenzuli Account							
				27 Nov.	Purchases	PL 14	725

General Ledger

Purchases Account							
Date	Debit	Folio	€	Date	Credit	Folio	€
10 Nov.	Supplies Ltd.	PB 14	150				
18 Nov.	Hamilton Supplies	PB 14	189				
27 Nov.	K. Camenzuli	PB 14	725				

9.8 The Returns Journal

As already noted in section 9.2 there are two types of returns journals, which consist of the returns inwards journal and the returns outward journal. The sources of information used for these journals consist of the following:

Credit notes for the Returns Inwards Journal

Debit notes for the Returns Outwards Journal

Example: The Returns Inwards and the Returns Outwards Journals

The returns incurred by Busietta Enterprises for the month of November were as follows:

Returns to Suppliers:

11 Nov. Supplies Ltd.	Debit note No. 111 (PL 12)	€15
20 Nov. Hamilton Supplies	Debit note No. 34120 (PL 16)	€20
30 Nov. K. Camenzuli	Debit note No. 4523 (PL 23)	€125

Returns from Customers:

10 Nov. J. Gordon	Credit note No. 676 (SL 10)	€100
18 Nov. W. Smith	Credit note No. 2468 (SL 11)	€50
25 Nov. D. James	Credit note No. 1093 (SL 12)	€120

Returns Outwards Journal				
Date	Supplier	Debit Note No.	Folio	Amount (€)
11 Nov. 2019	Supplies Ltd.	111	PL 12	15
20 Nov. 2019	Hamilton Supplies	34120	PL 16	20
30 Nov. 2019	K. Camenzuli	4523	PL 23	<u>125</u>
Transfer to the Returns Outwards Account			GL 55	<u>160</u>

Returns Inwards Journal				
Date	Customer	Credit Note No.	Folio	Amount (€)
10 Nov. 2019	J. Gordon	676	SL 10	100
18 Nov. 2019	W. Smith	2468	SL 11	50
25 Nov. 2019	D. James	1093	SL 12	<u>120</u>
Transfer to the Returns Inwards Account			GL 22	<u>270</u>

9.9 Posting Returns to the Subsidiary Ledgers

Again, once the transactions are reflected in the books of original entry like the returns outwards journal, they need to be posted in the subsidiary ledgers. The example of the previous section is used to illustrate this.

Purchases Ledger

Supplies Ltd. Account							
Date	Debit	Folio	€	Date	Credit	Folio	€
11 Nov.	Returns Out	RO 17	15				
Hamilton Supplies Account							
20 Nov.	Returns Out	RO 17	20				
K. Camenzuli Account							
30 Nov.	Returns Out	RO 17	125				

Sales Ledger

J. Gordon Account							
Date	Debit	Folio	€	Date	Credit	Folio	€
				10 Nov.	Returns In	RI 12	100
W. Smith Account							
				18 Nov.	Returns In	RI 12	50
D. James Account							
				25 Nov.	Returns In	RI 12	120

The returns outwards were posted in the Purchases Ledger because returns outwards consist of returns made to suppliers (trade payables). The returns inwards were posted in the Sales Ledger because these returns are received from customers (trade receivables).

General Ledger

Returns Outwards Account							
Date	Debit	Folio	€	Date	Credit	Folio	€
				11 Nov.	Supplies Ltd.	RO 17	15
				20 Nov.	Hamilton Supplies	RO 17	20
				30 Nov.	K. Camenzuli	RO 17	125

Returns Inwards Account							
Date	Debit	Folio	€	Date	Credit	Folio	€
10 Nov.	J. Gordon	RI 12	100				
18 Nov.	W. Smith	RI 12	50				
25 Nov.	D. James	RI 12	120				

9.10 The Journal

The Journal is the book of original entry which reflects unusual transactions. This book of original entry is usually used by the accountant to reflect the following transactions:

- Purchase and sale of non-current assets on credit.
- Correction of errors.
- Year-end adjustments, which are bad debts, provision for doubtful debts, provision for depreciation, accruals and prepayments.
- Opening entries, which are entries needed to open a new set of books.

9.10.1 Purchase and Sale of Non-Current Assets on Credit

Example: Acquisition of Machine on Credit

A machine was bought on credit from Aquilina Supplies Ltd. for €1,200 on 1st December 2018.

This transaction will be recorded in the Journal as follows:

Date	Details	Folio	Debit	Credit
1 Dec.	Machine	GL 12	1,200	
1 Dec.	Aquilina Supplies Ltd.	GL 24		1,200
Being the purchase of a machine on credit recorded in the accounts.				

Date: in the date column you enter the date the transaction took place.

Details: in this column you enter the name of the accounts found in the subsidiary ledgers in which the transaction will be posted.

Folio: in this column you enter the name and page number of the subsidiary ledgers, in which the transaction will be recorded. In this case both accounts are in the General Ledger. Therefore, GL is posted in the folio to reflect the General ledger and the appropriate page number of this ledger.

Debit and Credit: the same double entry principle is applied (give and take) to reflect the transaction.

Take (Debit side) – bought a machine.

Give (Credit side) – machine was bought on credit. Therefore, in the future the organisation is required to pay Aquilina Supplies Ltd.

Narration: at the end of the journal you can see an explanation of the transaction “Being the purchase of a machine on credit recorded in the accounts”. This explanation is called narration and is required at the end of each transaction entered in the journal. This serves to better explain the transaction and is helpful for future reference.

The disposal of non-current assets will be explained in chapter 14. The bad debts and provision for doubtful debts will be illustrated in chapter 15. The accruals and prepayments will be described in chapter 16. The correction of errors will be explained in chapters 17 and 18. These factors all include transactions that are posted in the journal.

9.10.2 Opening Entries

Example: Reflecting Opening Entries in the Journal

James Sultana have been operating a small retail shop for three years and he has never recorded transactions by utilising the double entry system. The

value of the firm's assets and liabilities on 1st December 2019 were as follows:

Assets:	Office fixtures	€1,200
	Motor van	€1,000
	Stock	€400
	Receivables: B. Smith	€250
	J. Cassar	€500
Liabilities:	Payables: Supplies Ltd.	€450
	Office extra	€900

Required:

Record these opening balances in the journal.

Date	Details	Folio	Debit	Credit
1 Dec.	Office fixtures	GL 1	1,200	
1 Dec.	Motor van	GL 1	1,000	
1 Dec.	Stock	GL 1	400	
1 Dec.	Receivables - B. Smith	SL 1	250	
1 Dec.	J. Cassar	SL 1	500	
1 Dec.	Payables - Supplies Ltd.	PL 1		450
1 Dec.	Office extra	PL 1		900
1 Dec.	Capital	GL 1		<u>2,000</u>
			<u>3,350</u>	<u>3,350</u>
Being assets, liabilities and capital recorded in the books.				

Folio: in this column one reflects the name and page number of the subsidiary ledgers in which the transaction will be recorded. In this case receivables which represent credit sales will be entered in the Sales Ledger (SL), while payables which represent credit purchases will be entered in the Purchases Ledger (PL). All the other accounts will be posted in the General Ledger (GL).

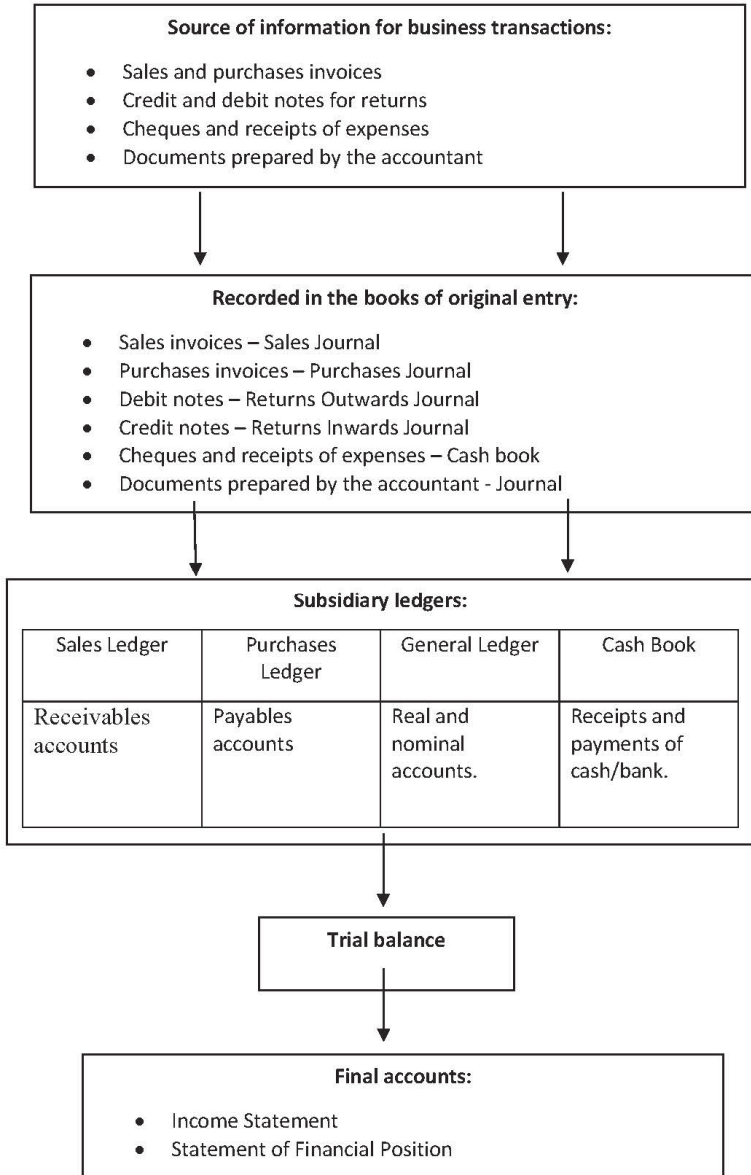
Debit and Credit: double entry (give and take) principle applied here:

(Take) Debit side – all assets of the company (office fixtures, motor van, stock and debtors).

(Give) Credit side – all liabilities of the company (payables) and capital (money owed to owner).

Capital: this figure is found by using the formula: Assets = Capital + Liabilities, which was illustrated in chapter two.

9.11 Process of Recording Transactions



Review Questions

Question 1

Post the relevant transactions in the Sales Journal:

- April 1 Sold goods on credit to E. Micallef of €152.
- April 14 Credit sales: E. Mendoza €220; R. Aquilina €300.
- April 16 Returns from E. Mendoza €20.
- April 20 Cash sales of €350.
- April 24 Sold goods on credit to F. Felix €361.
- April 28 F. Felix returned faulty goods of €21.
- April 30 Credit sales of €80 to N. Magrin.

Question 2

Reflect the relevant transactions in the Purchases Journal:

- May 1 Bought goods on credit from Supplies Ltd. of €170.
- May 9 Returned goods to Supplies Ltd. of €25.
- May 12 Purchases paid by cash of €210.
- May 19 Credit Purchases: E. Poulton €190; R. Spiteri €310
- May 23 Bought goods on credit from D. Valencia of €400.
- May 26 Returned faulty goods to D. Valencia of €36.
- May 31 Credit purchases of €110 from AK Supplies.

Question 3

Post the relevant transactions in the Returns Inwards Journal and Returns Outwards Journal:

- June 1 Credit purchases: L. Smith €135; H. Mendez €330.
- June 3 Credit sales: B. Lumby €250; R. Debono €500.
- June 8 R. Debono returned goods of €20.
- June 11 Received faulty goods from B. Lumby of €20.
- June 13 Credit purchases from H. Mendez €315.
- June 14 Returned goods to H. Mendez of €20.
- June 18 Received goods from R. Debone €36.
- June 21 Credit sales to B. Lumby of €80.
- June 24 Received goods from B. Lumby of €23.
- June 29 Good returned of €40 to L. Smith.

Question 4

Reflect the following transactions in the Sales Journal, Purchases Journal, Returns Inwards Journal and Returns Outwards Journal:

- July 1 Credit purchases: K. Camilleri €420; Supplies Ltd. €350.
- July 3 Credit sales: T. Kelly €300; H. Taylor €178.
- July 5 Returns: T. Kelly €30; H. Taylor €8.
- July 8 Cash sales of €155.
- July 9 Credit purchases: Supplies Ltd. €500; B. Mohammed €418; T. Buhagiar €40
- July 11 Returns: Supplies Ltd. €80; B. Mohammed €18.
- July 18 Credit sales of €250 to T. Kelly.
- July 23 T. Kelly returned goods worth €45.
- July 24 Purchases of €154 paid by cash.
- July 30 Credit purchases: K. Camilleri €402; S. Kumar €47.

CHAPTER 10

THE CASH BOOK AND THE PETTY CASH BOOK

Objectives

After you have read this chapter you should be able to:

- Understand the role of the cash book;
- Record transactions in the two-column cash book;
- Post transactions in the three-column cash book;
- Reflect transactions in the discount allowed and discount received accounts;
- Understand the imprest system of the petty cash book; and
- Reflect transactions and balance the petty cash book by using the imprest system.

10.1 The Importance of Cash and the Role of the Cash Book

Apart from the profits made by a firm, a businessman is also interested in the cash position of the organisation. The cash and bank accounts are the key accounts that highlight the firm's cash position. These accounts are entwined together in the two-column cash book. Therefore, a key role of the two-column cash book is to provide information to interested users about the liquidity of the organisation. This helps in the decision making process and aids to assess the liquidity risk of the firm. For example, the cash and bank balance present in the two-column cash book need to be analysed in order to see if enough cash is kept in the firm. Additional cash should be generated in the organisation if there is insufficient cash and if there is excessive cash this needs to be invested in feasible projects.

10.2 Recording Transactions in the Two-Column Cash Book

The double entry system that was explained in part 2 is applied in the two-column cash book. The following illustrative example further explains how transactions are recorded in the two-column cash book.

Example: The Two-Column Cash Book

Here is a list of transactions, which took place in June 2019, which affect the cash account or bank account:

- 1st June Balance brought down: Bank €7,000, Cash €1,500;
- 2nd June Cash Sales €500.
- 5th June Bought goods paying by cheque amounting to €500.
- 10th June D. Camenzuli a trade receivable paid us the amount due of €1,000, which was deposited in the bank account.
- 16th June Paid €800 to R. Smith by cheque.
- 20th June Took €50 out of the cash till and deposited it in the business bank account.
- 28th June Paid water and electricity bill of €150 by cash.

Cash Book

Date	Debit	Bank	Cash	Date	Credit	Bank	Cash
1 June	Balance b/d	7,000	1,500	5 June	Purchases	500	
2 June	Sales		500	16 June	R. Smith	800	
10 June	D. Camenzuli	1,000		20 June	Bank		50
20 June	Cash	50		28 June	Water and electricity		150
		_____	_____	30 June	Balance c/d	<u>6,750</u>	<u>1,800</u>
		<u>8,050</u>	<u>2,000</u>			<u>8,050</u>	<u>2,000</u>

The transaction reflected on 20th June is known as a contrary entry. It arises either when money is taken from cash and deposited in the bank account or when money is taken from the bank account and placed in the cash account.

10.3 The Three-Column Cash Book

This type of cash book contains two discount columns in addition to the cash and bank columns, which are:

- **The Discounts Allowed:** This is shown on the debit side of the cash book. The discounts allowed consist of discounts given to customers to stimulate early payment. This is done in order to enhance the liquidity of the organisation. This type of discount is considered as an expense.
- **The Discounts Received:** This is outlined on the credit side of the cash book. Such discount is provided by suppliers to encourage early payment. This type of discount is considered as a gain.

There is also the trade discount, which is a discount granted by a manufacturer or wholesaler to a retailer. The trade discount is usually given in order to allow the retailer to make a reasonable profit. The trade discount should never be recorded in the accounts. It should be deducted from the list price and only the net figure should be reflected in the cash book and other corresponding accounts.

Example: The Three-Column Cash Book

The following transactions which occurred in July 2019 should be recorded in the Three-Column Cash Book:

1 st July	Balance from previous month: Bank €3,200, Cash €500.
5 th July	A debtor P. Smith paid the firm the amount due in cash of €100. A cash discount of 2% was allowed.
11 th July	Paid R. Spiteri by cheque the amount of €500. He gave a 3% cash discount, which was deducted from the amount due.
25 th July	Paid a creditor by cheque, RX Limited the amount of €300. The supplier provided a 30% trade discount.

Three-Column Cash Book

Date	Debit	Disc. allowed	Bank	Cash	Date	Credit	Disc. received	Bank	Cash
1 July	Balance b/d		3,200	500	11 July	R. Spiteri	15	485	
5 July	P. Smith	2		98	25 July	RX Ltd.		210	
		—	—	—	31 July	Balance c/d	—	<u>2,505</u>	<u>598</u>
		<u>2</u>	<u>3,200</u>	<u>500</u>			<u>15</u>	<u>3,200</u>	<u>500</u>

Workings:

1. Discount allowed to P. Smith:

Total Due €100 (100%) (Note: The total due is always 100%)
Discount € 2 (2%) = 100 x 2%
Money received € 98

2. Discount received from R. Spiteri:

Total Due €500 (100%)
Discount € 15 (3%) = 500 x 3%
Money paid €485

3. Trade discount from RX Ltd:

Total Due €300 (100%)
Discount € 90 (30%) = 300 x 30%
Money paid €210

Unlike the discounts allowed and received, the trade discount is not recorded in the accounts. Only the net figure of €210 is reflected in the accounts.

The discount allowed and discount received accounts are not balanced in the cash book because in the cash book they are considered as memorandum accounts.

10.3.1 The Subsidiary Accounts

The subsidiary accounts basically consist of the accounts that are kept in the subsidiary ledgers. These do not form part of the books of original entry, which were outlined in chapter 9. These are the accounts covered in part 2 of this book. In this subsection emphasis is placed on the discounts allowed

and discounts received. The same example of section 10.3 is used to illustrate the subsidiary accounts. It is also assumed that on 1st July P. Smith had an amount due of €100 and the organisation had outstanding payments of €500 to R. Spiteri and €210 to RX Ltd.

Bank Account

Date	Debit	€	Date	Credit	€
01/7/19	Balance b/d	3,200	11/7/19	R. Spiteri	485
			25/7/19	RX Ltd.	210
			31/7/19	Balance c/d	<u>2,505</u>
		<u>3,200</u>			<u>3,200</u>
Cash Account					
01/7/19	Balance b/d	500	31/7/19	Balance c/d	598
05/7/19	P. Smith	<u>98</u>			
		<u>598</u>			<u>598</u>
P. Smith Account					
01/7/19	Balance b/d	100	05/7/19	Cash	98
		—	05/7/19	Discounts Allowed	<u>2</u>
		<u>100</u>			<u>100</u>
Discounts Allowed Account					
05/7/19	P. Smith	<u>2</u>	31/7/19	Income Statement	<u>2</u>
R. Spiteri Account					
11/7/19	Bank	485	01/7/19	Balance b/d	500
11/7/19	Discounts Received	<u>15</u>			—
		<u>500</u>			<u>500</u>
RX Ltd. Account					
25/7/19	Bank	<u>210</u>	01/7/19	Balance b/d	<u>210</u>
Discounts Received Account					
31/7/19	Income Statement	<u>15</u>	11/7/19	R. Spiteri	<u>15</u>

10.4 The Petty Cash Book

Small expenditure like coffee, stamps and cleaning are included in the petty cash book. The cash book focuses on the receipts and payments of significant items, while the petty cash book records payments of small expenses.

10.4.1 The Imprest System

The imprest system is used by organisations to withdraw money from the cash book and transfer it to the petty cash book. Normally the transfer happens at the end of the month. However, instances may arise where transfers from the cash book are made before the end of the month due to unforeseen expenses. The money transferred from the Cash Book would lead to the original balance held in the petty cash book. For example, the original petty cash book balance amounted to €100. During the month of July, a total of €70 expenses were paid from the petty cash book. Therefore, the resulting balance amounts to €30. Thus, at the end of July in accordance to the imprest system, €70 are transferred from the cash book in order to restore the balance of €100, which will be used for the month of August.

The imprest system can be explained in more depth by looking at the following six steps:

Step One – the finance director or financial controller decides on the appropriate amount that should be transferred from the cash book to the petty cash book on a monthly basis.

Step Two – the first balance is transferred from the cash book to the petty cash book. This transaction is credited from the cash book (cash or bank column) and posted to the receipts side of the petty cash book.

Step Three – the petty cashier can pay out small expenses incurred by the business out of the money that was transferred from the cash book. The invoices of the corresponding expenses should be kept in the petty cash box. The petty cashier is the clerk responsible for the petty cash book. His main responsibilities are posting transactions in the petty cash book and filing the corresponding documents supporting such expenditure.

Step Four – at the end of the month the petty cashier requests the sum of money necessary to restore the petty cash balance from the financial controller. The amount requested is evaluated by looking at the expenditure incurred and transferred accordingly.

Step Five – during the month petty cash expenses should be recorded in the subsidiary ledgers.

Step Six – an internal control should be implemented at the end of the financial year where the petty cashier counts the money in the petty cash box in front of a witness, who is normally the financial controller. Such

amount is reconciled to the figure highlighted in the petty cash book. This ensures that no money was stolen during the year and also helps in identifying accounting errors. Such an internal control can also be adopted during the year if the financial controller or supervisor suspects that fraud is being committed.

Example: The Petty Cash Book

Record the following transactions in Albert’s petty cash book for the month of October. The petty cash book should be categorised in the following expenses: Travel, Postage and Stationery.

1 st October	Petty Cash Balance	€6
5 th October	Paid bus fares	€1.75
9 th October	Paid for envelopes	€2.00
13 th October	Paid for postage stamps	€0.75

Petty Cash Book

Dr		Cr				
Receipts	Date	Details	Total	Travel	Postage	Stationery
€			€	€	€	€
6.00	1 Oct.	Balance b/d				
	5 Oct.	Bus fares	1.75	1.75		
	9 Oct.	Envelopes	2.00			2.00
	13 Oct.	Stamps	<u>0.75</u>	—	<u>0.75</u>	—
			4.50	<u>1.75</u>	<u>0.75</u>	<u>2.00</u>
	31 Oct.	Balance c/d	1.50			
<u>6.00</u>			<u>6.00</u>			
1.50	1 Nov.	Balance b/d				
4.50	1 Nov.	Imprest: Cash Book				

Notes:

1. The petty cash book like any other account contains a debit side (receipts) and a credit side (expenses paid). The debit side records all the money transferred from the cash book, while the credit side reflects all the expenses paid.
2. There are no rules to the number of expense columns that should be made.

In this example the petty cash float is of €6.00. During the month of October €4.50 was paid for expenses. The imprest system was applied and as a result at the beginning of November €4.50 were transferred from the cash book to bring the petty cash float back to €6.00.

Review Questions

Question 1

The following transactions took place in the month of June 2019 for Rise Furniture Ltd:

- June 1 Opening balances: Bank €8,100 and Cash €590.
- June 2 Cash sales of €201.
- June 8 Bought machinery on credit from Ferramenta of €1,900.
- June 13 Sold goods on credit worth €360 to Lucas Azzopardi.
- June 14 Paid stationery of €80 by cash.
- June 17 Lucas Azzopardi paid €260 by cheque.
- June 19 Lucas Azzopardi returned goods worth €30.
- June 21 Paid Ferramenta the amount due of €1,900 by cheque.
- June 26 Paid electricity of €110 by cash.
- June 30 Paid wages of €1,050 by cheque.

Required:

Prepare the two-column cash book for Rise Furniture Ltd.

Question 2

- a) What is the purpose of a cash book?
- b) Distinguish between a two-column cash book and a three-column cash book.
- c) Record the following transactions in a three-column cash book:

- July 1 Balances from previous month: Bank €14,600 and Cash €350.
- July 3 Paid Rent by cheque of €600.
- July 5 Received a cheque €180 from B. Jones in full settlement of the amount due of €200.
- July 7 Settled the amount due to Andor Supplies of €480 by cheque less 2% cash discount.
- July 10 Cash sales €250.
- July 13 Sold goods on credit to R. Mangion of €390.
- July 15 Paid office expenses of €60 by cash.
- July 18 Transferred €812 from the bank account to the cash till.

- July 20 R. Mangion settled the €390 due by cash less 5% cash discount.
 July 21 The owner took €125 cash for personal use.
 July 28 Paid J. Garreth €500 by cheque, in settlement of the amount due of €512.

Question 3

Robert Mifsud uses the imprest system for the petty cash book with a floating balance of €100. The petty cash transactions during November 2019 are shown below:

Date		€
1 November	Petty Cash Balance	12
1 November	Financial controller transferred money to restore the petty cash float.	88
4 November	Purchased stationery	5
5 November	Paid cleaning expenses	24
6 November	Bought plastic folders	3
8 November	Paid petrol	20
11 November	Bought pencils	2
17 November	Paid parking fee	5
23 November	Motor repairs	15
29 November	Paid cleaning expenses	24

Required:

- Record the transactions in the petty cash book. Do not use more than three analysis columns for expenditure.
- Balance the petty cash book and restore the petty cash float on 1st December 2019.

CHAPTER 11

THE BANK RECONCILIATION STATEMENT

Objectives

After you have read this chapter you should be able to:

- Link the preparation of the bank reconciliation statement with that of the cash book;
- Understand the purpose of the bank reconciliation statement as an internal control;
- Understand the key terms used in the banking system;
- Identify factors that need to be recorded in the updated cash book and the bank reconciliation statement;
- Prepare the updated cash book; and
- Prepare the bank reconciliation statement.

11.1 Introduction

Nowadays, organisations keep a high proportion of their cash and cash equivalents in the bank accounts. So, cash at bank is a central resource for an organisation. Without cash at bank an organisation will face bankruptcy in a few months because it will be unable to pay operating costs and liabilities that need to be settled. Thus, it is important that appropriate controls are set in the organisation in order to ensure that cash at bank is not stolen and accounting errors are identified as soon as possible.

The bank reconciliation statement helps to prevent fraud and identify accounting errors because during its preparation one needs to compare the cash book with the bank statement. The bank statement comprises a document provided by the bank. The reliability of such document is greater than documents developed within the organisation because if an individual is committing fraud he/she is able to manipulate internal documents. This implies that the preparation of the bank reconciliation statement can be an appropriate internal control for the organisation. Such internal control can

be strengthened if there is segregation of duties. Segregation of duties means that the individual responsible for making the entries in the cash book is not the same person who prepares the bank reconciliation statement. For example, the entries in the cash book may be performed by a clerk, while the bank reconciliation statement is prepared by the accountant.

11.2 Main Features of a Bank Statement

A bank statement usually contains the following main features:

- Name of bank and its address;
- Name of client and address;
- Transaction dates covered in the bank statement;
- Card number, if the bank statement reflects a credit card;
- Statement number;
- Page number, if there is more than one page in the bank statement;
- Statement date;
- Currency;
- Type of account (examples: current, savings, term deposit); and
- Account number.

In the bank statement transactions are recorded in a running balance format as follows:

Date	Transaction Description	Withdrawals	Deposits	Balance
1 Nov.	Opening balance			€3,000
2 Nov.	Cheque 142	€200		€2,800
9 Nov.	Deposit		€300	€3,100

It should be noted that in a bank statement the transaction entries will always appear on the opposite side of the cash book. For example, if in the cash book an entry is on the debit side, in the bank statement it will be on the credit side because the bank will look at the transaction from the opposite point of view when compared with that of the organisation. Suppose the firm pays cash into the bank. In the organisation's accounts one will credit the cash account (give) and debit the bank account (take). In other words, the bank becomes a debtor of the enterprise because the organisation has given money to the bank. From the point of view of the bank, cash is

received and is payable to the firm. Therefore, the organisation in the bank's books is seen as a creditor.

11.3 Definition of Main Terms

Standing order – an authorisation by a client to a bank to make regular periodic payments (usually monthly) to a specific individual/enterprise. For example, a standing order of €50 per month is set for an accounts payable in order to settle the amounts outstanding for goods ordered on credit from this supplier.

Direct debit – when the organisation gives authority to an individual/entity to withdraw money from the firm's bank account for the payment of insurance, rent and other similar expenditure. The difference between a standing order and a direct debit is that instructions are given to the individual/entity to get the money and not to the bank, as is performed in a standing order.

Bank charges – comprise charges made by the bank to the organisation for services offered. For example, if a client instructs the bank to pass a standing order, the bank will charge money for this service.

Dishonoured cheque – is a cheque that cannot be settled by the bank because the drawer of the cheque does not have sufficient money.

Bank deposit – consists of a sum of money held on deposit with a commercial bank. Bank deposits are of two main types, which consist of sight deposits (current account) which are withdrawable on demand; and time deposits (deposit account) which can be withdraw provided that some notice is given to the bank. Sight deposits represent instant liquidity for the organisation. They are used to finance daily transactions through regular payments either in the form of currency withdrawal or a cheque payment. Time deposits are usually held for longer periods of time to meet irregular payments and also as a form of savings.

11.4 Differences between the Cash Book and the Bank Statement

Ideally, the bank balance present in the cash book should agree with the bank statement balance. However, in practice they rarely agree for different reasons, such as:

- The bank may have deducted bank charges of which the organisation was unaware until receipt of the bank statement.
- Cheques sent to individuals/entities may not have been presented for payment. Therefore, they will appear in the customer's cash book but not on the bank statement.
- The bank often makes regular payments on behalf of an organisation by means of a standing order. It is easy for the account to forget that they have given out such orders and therefore the appropriate entries in the cash book are not made.
- Banks may receive deposits on behalf of customers of which the organisation may be unaware.

Due to these differences the accountant or the person in charge has the duty that at the end of every month, he/she reconciles the balance as per cash book with the balance as per bank statement. This helps in the identification of the permanent and temporary differences that are leading to different balances.

11.5 Procedure for preparing the Bank Reconciliation Statement

The steps below should be taken when preparing a bank reconciliation statement:

Step 1 – tick off similar amounts that appear on the debit side of the cash book (bank column) to those on the credit side of the bank statement.

Step 2 – tick off similar amounts which appear on the credit side of the cash book (bank column) to those on the debit side of the bank statement.

Note: the unticked items both on the debit and credit side of the cash book (bank column) and bank statement represent the items which are causing the difference between the two balances. These are the items that need to appear in the cash book or bank reconciliation statement.

Step 3 – update the bank balance present in the cash book by reflecting the unticked items that are shown in the bank statement. The items on the credit side of the bank statement should be posted on the debit side of the cash book, while the items on the debit side of the bank statement should be

recorded on the credit side of the cash book. Transactions are considered on the opposite side because the bank and the organisation view them from different perspectives, as already noted in section 11.2.

Step 4 – prepare the bank reconciliation statement by starting with the balance as per updated cash book (bank balance).

Step 5 – add the following in the bank reconciliation statement:

Items which have been deducted in the cash book, but which have not been deducted in the bank statement (that is the unticked items on the credit side of the cash book). These are commonly known as unrepresented cheques.

Step 6 – subtract the following in the bank reconciliation statement:

Items which have been added to the cash book, but which have not been included in the bank statement (that is unticked items on the debit side of the cash book). These are normally referred to as bank lodgements.

Step 7 – the resulting figure, which is known as the balance as per bank statement should correspond to the last balance present in the bank statement.

Example: Update the Bank Account and Prepare the Bank Reconciliation Statement

Bank Account

Date	Debit	€		Date	Credit	€	
1 Dec.	Balance b/d	1,800		10 Dec.	Armani	300	√
5 Dec.	J Masters	200	√	15 Dec.	R Yin	67	√
18 Dec.	B. Lumby	93	√	29 Dec.	G Smith	145	
29 Dec.	K. Muscat	187		31 Dec.	Balance c/d	1,998	
29 Dec.	R. Sammut	<u>230</u>				—	
		<u>2,510</u>				<u>2,510</u>	

Bank Statement

Date		Dr (€)		Cr (€)		Balance (€)
1 Dec.	Balance b/d					1,800
10 Dec.	Cheque: J. Masters			200	√	2,000
12 Dec.	Armani	300	√			1,700
23 Dec.	R. Yin	67	√			1,633
24 Dec.	Cheque: B. Lumby			93	√	1,726
31 Dec.	Credit transfer: Alex			104		1,830
31 Dec.	Bank Charges	31				1,799

Required:

- Prepare the updated bank account.
- Draw up a bank reconciliation statement.

These are prepared in accordance to the steps outlined above.

Steps 1 and 2 - tick the amounts which appear on the bank account and the bank statement.

Step 3 - the transactions which are on the bank statement but are not on the bank account should be entered in the updated bank account as at 31st December (question a). This is shown below:

Bank Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance b/d	1,998	31 Dec.	Bank Charges	31
31 Dec.	Alex	<u>104</u>	31 Dec.	Balance c/d	<u>2,071</u>
		<u>2,102</u>			<u>2,102</u>

Step 4 - once the bank account is updated one can prepare the bank reconciliation statement and enter the amounts entered in the bank account

but not entered in the bank statement. The bank reconciliation statement is outlined below:

Bank reconciliation statement as at 31st December 2019	€
Balance as per cash book	2,071
<u>Add back: Unpresented cheques (step 5):</u>	
G. Smith	145
<u>Less: Bank Lodgements (step 6):</u>	
K. Muscat	187
R. Sammut	<u>230</u>
Balance as per bank statement (step 7)	<u>1,799</u>

Key Principle:

In the bank reconciliation statement, the amounts on the credit side of the cash book which are not recorded in the bank statement should be added with the balance as per cash book, while the amounts on the debit side of the cash book should be subtracted.

Example: Bank Overdraft

Bank Account

Date	Debit	€		Date	Credit	€	
15 May	S. Smith	220	√	1 May	Balance b/d	350	√
30 May	D. Gray	390		2 May	R. Valencia	200	√
31 May	Balance c/d	227		3 May	A. Herbert	50	√
				5 May	B. Micallef	62	√
				12 May	K. Johnson	70	
		—		26 May	G. Taylor	<u>105</u>	
		<u>837</u>				<u>837</u>	

Bank Statement

Date		Dr (€)		Cr (€)		Balance (€)
1 May	Balance b/d					350 O/D
3 May	Cheque 135	200	√			550 O/D
6 May	Cheque 136	50	√			600 O/D
15 May	Deposit			220	√	380 O/D
21 May	Standing Order: A&J Ltd.	55				435 O/D
24 May	Cheque 137	62	√			497 O/D
31 May	Bank Charges	23				520 O/D
31 May	Interest	26				546 O/D

Required:

- Prepare the updated bank account.
- Draw up a bank reconciliation statement.

In this case the balance b/d will be on the credit side of the updated cash book since there is a bank overdraft. This is shown below:

Bank Account

Date	Debit	€	Date	Credit	€
31 May	Balance c/d	331	31 May	Balance b/d	227
			31 May	A&J Ltd.	55
			31 May	Bank Charges	23
		—	31 May	Interest	<u>26</u>
		<u>331</u>			<u>331</u>

Similarly, for the bank reconciliation statement the balance as per cash book should be negative in order to reflect that it is a bank overdraft. This is outlined below:

Bank reconciliation statement as at 31st May 2019	€	€
Balance as per cash book		(331)
<u>Add back: Unpresented cheques:</u>		
K. Johnson	70	
R. Taylor	<u>105</u>	175
<u>Less: Bank Lodgements:</u>		
D. Gray		(390)
Balance as per bank statement		<u>(546)</u>

Review Questions

Question 1

From the following information prepare an updated cash book and a bank reconciliation statement for the month of June 2019:

Bank Account

Date	Debit	€	Date	Credit	€
1 June	Balance b/d	1,200	2 June	I. Kalwant	200
12 June	F. Northouse	145	3 June	Q. Bhopal	100
29 June	B. Yukl	230	8 June	A. Brincat	55
			11 June	C. Taylor	110
		_____	30 June	Balance c/d	<u>1,110</u>
		<u>1,575</u>			<u>1,575</u>

Bank Statement

Date		Dr (€)	Cr (€)	Balance (€)
1 June	Balance b/d			1,200
5 June	Cheque 80	200		1,000
10 June	Cheque 81	100		900
12 June	Cheque 82	55		845
13 June	Deposit		145	990
30 June	Bank Charges	28		962

Question 2

From the following information prepare the updated cash book and the bank reconciliation statement for A&R Ltd. for the month of July 2019:

Bank Account

Date	Debit	€	Date	Credit	€
1 July	Balance b/d	880	4 July	J. Masters	50
11 July	A. Woods	300	5 July	Q. Swift	130
19 July	T. Mujis	150	13 July	K. Brown	180
29 July	R. Lumby	98	18 July	B. Taylor	88
			22 July	J. Masters	55
			26 July	U. Green	105
		_____	31 July	Balance c/d	<u>820</u>
		<u>1,428</u>			<u>1,428</u>

Bank Statement

Date		Dr (€)	Cr (€)	Balance (€)
1 July	Balance b/d			880
7 July	Standing Order: K. Brown	180		700
10 July	Cheque 270	50		650
11 July	Cheque 271	130		520
12 July	Deposit		300	820
13 July	Standing Order: P. Taylor	135		685
20 July	Deposit		150	835
23 July	Cheque 272	88		747
29 July	Bank Charges	31		716

Question 3

Ralph Woods, the accountant of Electronics Ltd. is in the process of preparing the bank reconciliation statement of the organisation for the month of July 2019. The balance as per the bank column of the cash book amounted to €660.

While investigating the bank statement Ralph noted that there is a standing order to R. Marcus of €57 and bank charges of €28, which have not yet been reflected in the cash book. Furthermore, the cheque received from K. Allen of €70 has been dishonoured and needs to be adjusted in the cash book.

Ralph also identified temporary transactions that have not yet been reflected in the bank statement. These are unrepresented cheques from R. Smith €83 and B. Maringe €24, and a bank lodgement of €63.

Prepare the updated cash book (bank column) and the bank reconciliation statement for the month of July 2019.

Question 4

The bank column of the cash book and the bank statement of BP Electronics are shown below:

Bank Account

Date	Debit	€	Date	Credit	€
21 Sep.	F. Fenech	400	1 Sep.	Balance b/d	590
24 Sep.	V. Seale	202	10 Sep.	B. Daft	123
30 Sep.	V. Seale	100	10 Sep.	K. Spencer	210
30 Sep.	Balance c/d	439	12 Sep.	Y. Yukl	88
		—	21 Sep.	D. Atrill	<u>130</u>
		<u>1,141</u>			<u>1,141</u>

Bank Statement

Date		Dr (€)	Cr (€)	Balance (€)
1 Sep.	Balance b/d			590 O/D
8 Sep.	Standing Order: JR Supplies	230		820 O/D
16 Sep.	Cheque 383	123		943 O/D
17 Sep.	Cheque 384	210		1,153 O/D
21 Sep.	Deposit		400	753 O/D
24 Sep.	Standing Order: Toshi Supplies	48		801 O/D
25 Sep.	Deposit		202	599 O/D
26 Sep.	Dishonoured Cheque - 382	51		650 O/D
29 Sep.	Bank Charges	33		683 O/D
29 Sep.	Interest	38		721 O/D

Required:

- Prepare the updated bank column of the cash book.
- Prepare the bank reconciliation statements for the month of September 2019.

CHAPTER 12

THE CONTROL ACCOUNTS

Objectives

After you have read this chapter you should be able to:

- Understand the nature of a control account;
- Understand the advantages of control accounts;
- Prepare the sales ledger control account; and
- Post transactions in the purchases ledger control account.

12.1 Introduction

A control account serves as an internal control over a section of the ledger. The balance on the control account should be equal to the total of the balances in the ledger it is controlling. A sales ledger control account controls the sales ledger, while a purchases ledger control account controls the purchases ledger. The control accounts are kept in the general ledger and not in the ledgers they are controlling.

12.2 Advantages of the Control Accounts

The control accounts provide an independent check of the arithmetical accuracy present in the balances of the sales and purchases ledgers. This is particularly useful when one is preparing the trial balance. Indeed, if there is a difference in the trial balance, the control accounts will help the accountant to see whether or not any of the difference is in the sales or purchases ledgers. If the control accounts agree with the ledgers, then the difference in the trial balance must lie in another account/s in the general ledger. The control accounts also help to provide a quick total of the accounts receivable and accounts payable.

The control account acts as an accounting control for the organisation. Thus, it also helps in detecting and preventing fraud. It is essential that there

is segregation of duties in order to ensure that the accounting controls are effective. This implies that the individual preparing the control account is not the same person who prepares the sales or purchases ledger. There should be a clerk responsible for the sales ledger, another clerk for the purchases ledger and another person, normally the accountant who is responsible for the control accounts.

12.3 Form of the Control Accounts

The control accounts contain all transactions which have been posted as individual items to the sales and purchases ledgers. The periodic totals of each type of transaction are obtained from the books of original entry.

The usual contents of the ledger accounts and the sources of the entries (shown in brackets) are as follows:

Sales Ledger Control Account	
Debit Side	Credit Side
The total of the sales ledger debit balances brought forward from previous period. This represents the opening balance of the accounts receivable.	The total of the sales ledger credit balances brought forward from previous period, if any.
The credit sales for the period (sales journal).	The sales returns for the period (returns inwards journal).
The refunds provided to customers (cash book).	The cash received from accounts receivable (cash book).
The dishonoured cheques (cash book).	The cash discounts allowed (three-column cash book; include discount allowed column).
The interest charged to customers on overdue accounts (journal).	The bad debts written off (journal).
The bad debts recovered (journal).	The cash received in respect of bad debts previously written off (cash book).
The total of the sales ledger credit balances carried forward at end of the period, if any.	The sales ledger balance set off against balances in the purchases ledger (journal).
	The total of the sales ledger debit balances carried forward at end of the period.

Cash sales are not recorded in the sales ledger control account. The provision for doubtful debts is not shown in the sales ledger control account because this account is kept in the general ledger and not in the sales ledger.

Purchases Ledger Control Account	
Debit Side	Credit Side
The total of the purchases ledger debit balances brought forward from previous period, if any.	The total of the purchases ledger credit balances brought forward from previous period. This shows the opening balance of the accounts payable.
The total of the goods returned to suppliers (returns outwards journal).	The total credit purchases (purchases journal).
The total of the cash paid to accounts payable (cash book).	The refunds received from suppliers (cash book).
The cash discounts received (three-column cash book; include discount received column).	The interest charged by suppliers on overdue invoices (journal).
The purchases ledger balances set off against balances in sales ledger (journal).	The total of the debit balances carried forward at the end of the period, if any.
The total of the credit balances carried forward at the end of the period.	

Cash purchases do not feature in the purchases ledger control account.

The double entry system is applied for the preparation of the sales and purchases ledger control accounts. However, these accounts do not feature in the trial balance because these are memorandum accounts.

12.3.1 The Control Accounts, Trade Discount and Cash Discounts

The trade discount is not recorded in the accounts. Examiners may introduce the trade discount into control account questions. In this case one is required to reflect the figure that is net of trade discount in the purchases ledger control account. For example, a supplier provided a 20% trade discount for an invoice of €100. The net figure of €80 should be posted in the purchases ledger control account. On the other hand, cash discounts, which can be discounts allowed or discounts received should be posted in the control accounts.

Example: Sales and Purchases Control Accounts

On 1st January 2019, the following balances appeared in the Books of Loretu Cefai:

	Debit €	Credit €
Sales Ledger Control	17,300	73
Purchases Ledger Control	51	10,500

During the year ended 31st December 2019 the following transactions (in total) were recorded:

Items	€
Credit Sales	135,000
Credit Purchases	92,000
Discounts Received	2,820
Discounts Allowed	3,910
Bad Debts	520
Receipts from Accounts Receivable	82,000
Payments to Accounts Payable	67,000
Returns Inwards	1,490
Returns Outwards	1,525
Dishonoured Cheques	399

Additional information:

1. The discounts allowed of €100 were later cancelled.
2. An amount of €150 owing to H. Spencer was set off against an amount of €250 owed by him.
3. The balances on 31st December 2018 were as follows:

Sales Ledger Control (credit balance)	€43
Purchases Ledger Control (debit balance)	€60

Required:

Prepare the Sales Ledger Control Account and the Purchases Ledger Control Account.

Sales Ledger Control Account

Date	Debit	€	Date	Credit	€
1 Jan	Balance b/d	17,300	1 Jan	Balance b/d	73
31 Dec	Sales	135,000	31 Dec	Discounts allowed	3,910
31 Dec	Dishonoured cheque	399	31 Dec	Bad debts	520
31 Dec	Discount cancelled	100	31 Dec	Bank	82,000
31 Dec	Balance c/d	43	31 Dec	Returns in	1,490
			31 Dec	Set off	150
		_____	31 Dec	Balance c/d	<u>64,699</u>
		<u>152,842</u>			<u>152,842</u>

Purchases Ledger Control Account

1 Jan	Balance b/d	51	1 Jan	Balance b/d	10,500
31 Dec	Discounts received	2,820	31 Dec	Purchases	92,000
31 Dec	Bank	67,000	31 Dec	Balance c/d	60
31 Dec	Returns out	1,525			
31 Dec	Set off	150			
31 Dec	Balance c/d	<u>31,014</u>			_____
		<u>102,560</u>			<u>102,560</u>

When you are doing a set off, it is important that you record the lowest number given, which in this case amounts to €150 and not €250.

Review Questions

Question 1

From the following information prepare the sales ledger control account:

2019		€
1 st June	Sales Ledger Balance	5,100
	Totals for the month of June:	
	Sales Journal	37,100
	Returns Inwards Journal	450
	Cash Book	34,800
	Journal – Discounts Allowed	120

Question 2

By using the following information prepare the purchases ledger control account:

2019		€
1 st June	Purchases Ledger Balance	3,800
	Totals for the month of June:	
	Purchases Journal	29,900
	Returns Outwards Journal	284
	Cash Book	21,450
	Journal – Discounts Received	86

Question 3

Prepare the sales ledger control account and purchases ledger control account from the following information:

2019		€
1 st July	Sales Ledger Balance	8,900
	Purchases Ledger Balance	6,100
	Totals for the month of July:	
	Sales Journal	40,400
	Purchases Journal	36,750
	Returns Inwards Journal	410
	Returns Outwards Journal	312
	Cash Book – Accounts Receivable	36,100
	Cash Book – Accounts Payable	30,220
	Journal – Discounts Allowed	135
	Journal – Discounts Received	97
	Journal – Bad Debts	120
	Journal – Provision for Doubtful Debts	289
	Cash Book – Dishonoured Cheque	55
31 st July	Sales Ledger Credit Balance	89
	Purchases Ledger Debit Balance	67

Additional Information:

1. An amount of €75 owing to B. Armstrong was set off against an amount of €91 owed by him.
2. During the year there was a bad debt recovered of €170. This was not posted in the accounts.

Question 4

Review the following information and prepare the sales ledger control account and purchases ledger control account:

2019		€
1 st August	Sales Ledger Debit Balance	10,000
	Sales Ledger Credit Balance	55
	Purchases Ledger Credit Balance	8,770
	Purchases Ledger Debit Balance	91
	Totals for the month of August:	
	Sales Journal	38,800
	Cash Book – Cash Sales	7,800
	Purchases Journal	29,100
	Returns Inwards Journal	189
	Returns Outwards Journal	106
	Cash Book – Accounts Receivable	25,600
	Cash Book – Accounts Payable	15,150
	Journal – Discounts Allowed	201
	Journal – Discounts Received	113
	Journal – Bad Debts	201
	Journal – Provision for Doubtful Debts	338
	Cash Book – Dishonoured Cheque	48
31 st August	Sales Ledger Credit Balance	76
	Purchases Ledger Debit Balance	37

PART 5:
YEAR-END ADJUSTMENTS

CHAPTER 13

THE ACCOUNTING CONCEPTS

Objectives

After you have read this chapter you should be able to:

- Understand the key accounting concepts of prudence, accruals, materiality, consistency, substance over form and going concern;
- Know that there are International Financial Reporting Standards that need to be followed by organisations; and
- Distinguish between objectivity and subjectivity.

13.1 The Key Accounting Concepts

13.1.1 The Prudence Concept

Prudence is the inclusion of a degree of caution in the exercise of judgements that occurs when estimates are taken under conditions of uncertainty. For example, the accountant may identify the possibility that additional income will be generated by the organisation. The prudence concept states that such estimated additional income cannot be reflected in the accounts until it is realised. On the contrary, the accountant is required to be prudent and include any envisaged additional expenditure in the accounts. Thus, in adherence to this concept inventory needs to be valued at the lower of cost or net realisable value.

13.1.2 The Accruals Concept

The main premise of the accruals concept is that income and expenditure need to be reflected in the income statement when they occur and not when cash is received or paid. For example, an organisation may have paid water and electricity till the end of November. The next payment of water and electricity is envisaged to occur at the end of January. The financial year end of the firm is 31st December. Thus, an estimate is required in order to

determine the water and electricity incurred in December. This will be reflected as an accrual in the financial statements by adding it to the water and electricity account (expense in the income statement) and include the accrual as a current liability (statement of financial position). On the contrary, the opposite is done for prepaid expenditure. For example, motor vehicle insurance is paid in 1st November 2019 for a whole year. In this case only the motor vehicle insurance of November and December needs to be reflected in the financial statements of 2019. Thus, the prepaid insurance needs to be deducted from the insurance account and reflected as a current asset in the statement of financial position.

13.1.3 The Materiality Concept

The materiality concept states that each material item needs to be shown separately in the financial statements. An item is material if its non-disclosure will influence the economic decision of users. The level of materiality depends on the type of organisation and its respective size. For example, a material item in a large organisation may be more than €100,000, while for a small firm it may exceed €1,000. Immaterial amounts need to be aggregated together. For example, loose tools are aggregated together in the financial statements rather than shown separately in the statement of financial position.

13.1.4 The Consistency Concept

The consistency concept states that the accountant is required to comply with the accounting policies set. For example, the accounting policy of machinery may state that the useful life of machinery is 7 years and the straight-line method of depreciation is adopted. In this case the accountant cannot change the useful life of machinery or the depreciation method unless there is a proper justification. Such justification is normally based on the premise that a more realistic figure of machinery will be shown in the accounts. This will more truthfully represent the financial position of the organisation to shareholders and stakeholders.

13.1.5 Substance over Form

There are instances where the legal form of a business transaction differs from its substance. In this case the accountant is required to show this item in accordance to its substance rather than its legal form. A typical example can be derived by referring to International Financial Reporting Standard

number 16, which is titled Leases. The International Financial Reporting Standards comprise a set of principles prepared by the International Accounting Standards Board and the International Financial Reporting Standards Foundation, which act as a common global language used to prepare the financial statements. The purpose of these standards is to enhance the understandability, comparability, reliability and relevance of the financial statements.

International Financial Reporting Standard number 16 distinguishes between finance and operating leases. A finance lease needs to be reflected with the assets of the organisation even though the asset is not legally owned by the firm. This is because the substance of the asset is practically owned by the organisation since the risks and rewards of ownership are mainly transferred to the firm.

13.1.6 The Going Concern Concept

The board of directors are required to take the going concern assumption every year, which needs to be reflected as a note in the financial statements. The going concern concept basically reflects an assumption that the organisation will continue operating in the future. Typical situations where management cannot take the going concern assumption are: intention to close the business enterprise in the future; there are significant doubts about the ability of the organisation to keep its main client/s; and the firm has a shortage of cash and thus it will be very difficult to cover its liabilities in the future.

13.2 Objectivity and Subjectivity

Objectivity implies that the value of an item in the financial statements is based on facts. For example, premises are valued at their original cost by looking at the contract where the purchase price is outlined. Objectivity is ideal because it decreases any bias that can be made in the valuation of assets, liabilities, capital, expenses and revenues.

Nevertheless, subjective estimates are sometimes necessary in order to comply with accounting concepts. For example, the prudence concept requires that doubtful losses are reflected in the financial statements. Thus, the accountant is required to estimate the loss in the value of tangible non-current assets (provision for depreciation) and the anticipated bad debts that will occur in the future of accounts receivables (provision for doubtful debts). In such case subjective estimates are made by the accountant.

Review Questions

Question 1

- a) Describe the prudence concept.
- b) Give one example where the prudence concept is applied.
- c) Explain the consistency concept.
- d) What is the difference between objectivity and subjectivity.

Question 2

- a) Describe the accruals concept.
- b) Give one example where the accruals concept is applied.
- c) State and briefly explain three factors why International Financial Reporting Standards are prepared.
- d) Explain the materiality concept.

Question 3

- a) Describe the substance over form concept.
- b) Give one example where the substance over form concept is applied.
- c) Explain the going concern concept.
- d) State two situations where the going concern of the organisation cannot be taken.

CHAPTER 14

ACCOUNTING FOR DEPRECIATION

Objectives

After you have read this chapter you should be able to:

- Understand the causes of depreciation;
- Compute depreciation by using the straight-line method, reducing balance method and revaluation method;
- Account for the provision for depreciation; and
- Account for the disposal and/or part-exchange of non-current assets.

14.1 Introduction

Before closing off the books and preparing the final accounts at the end of the year, the accountant needs to pass some bookkeeping entries, which are commonly known as year-end adjustments. These are done in order to comply with the prudence and accruals concepts. These accounting concepts were explained in chapter 13. A brief explanation is again provided of these concepts in this chapter where applicable. The year-end adjustments consist of the following:

- Depreciation of the non-current assets;
- Bad debts and provision for doubtful debts; and
- Accruals and prepayments.

In this chapter attention is given to the depreciation of the non-current assets. The other year-end adjustments are explained in the preceding chapters.

14.2 Depreciation of the Non-Current Assets

Every non-current asset that the organisation possess loses its value over time. Thus, the prudence concept states that any doubtful losses should be recorded in the accounts. Therefore, the loss in value of the non-current assets should be reflected in the accounts by providing a provision for depreciation. This accounting concept also states that doubtful profits should not be reflected in the accounts.

14.3 The Causes of Depreciation

The following are the main reasons why non-current assets lose value:

- **Wear and tear** – this reflects the physical deterioration that occurs when the non-current asset is used.
- **Obsolescence** – this arises when a non-current asset becomes outdated. For example, a computer may become obsolete when a more advanced computer is introduced in the market.
- **Time factor** – stems from the passage of time. For example, if the building is rented for 10 years, with the passage of time the building will lose its value because after 10 years the building will no longer be in the possession of the enterprise. Thus, in this case depreciation reflects the legal life of the non-current asset.
- **Depletion** – arises when the resource is used. For example, an enterprise engaged in the extraction of oil will lose this asset as oil is extracted from earth.

The loss in value of the non-current asset (depreciation) should be calculated by the accountant and posted in the books. An accounting policy is set in the organisation that reflects the depreciation method used and the anticipated useful life of the non-current asset.

14.4 Depreciation Methods

Three depreciation methods will be covered in this chapter, which are the straight-line method, the reducing balance method and the revaluation method.

14.4.1 The Straight-Line Method

The straight-line method of depreciation relies on the assumption that the loss in value of the non-current asset is the same each year. The following steps are conducted in order to determine the depreciation of the non-current asset when using the straight-line method:

1. Estimate the useful life of the non-current asset.
2. Assess its scrap value at the end of that period.
3. Deduct the scrap value from the original cost; and
4. Divide the cost of the non-current asset net of scrap value by its useful life.

Scrap value can be defined as the remaining value of a non-current asset after all depreciation has been charged.

These steps can be summarised in the following formula:

$$\text{Depreciation Charge} = \frac{\text{Original cost of non-current asset} - \text{Scrap value}}{\text{Number of years}}$$

Example: The Straight-Line Method

A machine costing €12,000 was purchased on 1st January 2016 by cheque. Its estimated useful life is of five years. The scrap value is €2,000.

Required:

- a) Record these transactions in the subsidiary accounts for 2016, 2017 and 2018.
- b) Record these transactions in the journal for 2016, 2017 and 2018.
- c) Prepare the income statement extracts for 2016, 2017 and 2018.
- d) Prepare the statement of financial position extracts for 2016, 2017 and 2018.

Transactions to record:

2016:

- a) Purchase of the non-current asset (machinery account, bank account)
- b) Depreciation of the non-current asset (provision for depreciation account)

2017:

c) Depreciation of the non-current asset (provision for depreciation account)

2018:

d) Depreciation of the non-current asset (provision for depreciation account)

$$\text{Calculation of Depreciation} = \frac{\text{€}12,000 - \text{€}2,000}{5} = \text{€}2,000$$

Machinery Account

Date	Debit	€	Date	Credit	€
1-Jan-16	Bank	<u>12,000</u>	31-Dec-16	Balance c/d	<u>12,000</u>
Bank Account					
			1-Jan-16	Machinery	12,000
Provision for Depreciation Account					
31-Dec-16	Balance c/d	<u>2,000</u>	31-Dec-16	Income Statement	<u>2,000</u>
31-Dec-17	Balance c/d	4,000	1-Jan-17	Balance b/d	2,000
		—	31-Dec-17	Income Statement	<u>2,000</u>
		<u>4,000</u>			<u>4,000</u>
31-Dec-18	Balance c/d	6,000	1-Jan-18	Balance b/d	4,000
		—	31-Dec-18	Income Statement	<u>2,000</u>
		<u>6,000</u>			<u>6,000</u>

Notes:

- As you can see the straight-line method of depreciation charges the same amount of depreciation every year, which in this example amounts to €2,000.
- Expenses are recorded on the debit side of the income statement. Therefore, by using the double entry system, the corresponding entry should be on the credit side of the provision for depreciation account, as indicated above.

b) Journal Entries:

Journal as at 31st December 2016	Debit	Credit
Machinery account	€12,000	
Bank account		€12,000
Being machinery purchased recorded in the accounts.		
Income Statement	€2,000	
Provision for depreciation on machinery		€2,000
Being depreciation charge for 2016 recorded in the books.		

Journal as at 31st December 2017	Debit	Credit
Income Statement	€2,000	
Provision for depreciation on machinery		€2,000
Being depreciation charge for 2017 recorded in the books.		

Journal as at 31st December 2018	Debit	Credit
Income Statement	€2,000	
Provision for depreciation on machinery		€2,000
Being depreciation charge for 2018 recorded in the books.		

c) Income Statement Extracts:

Income Statement Extract for the year ended 31st December 2016	€
<u>Expenses:</u>	
Depreciation: Machinery	2,000
Income Statement Extract for the year ended 31st December 2017	€
<u>Expenses:</u>	
Depreciation: Machinery	2,000
Income Statement Extract for the year ended 31st December 2018	€
<u>Expenses:</u>	
Depreciation: Machinery	2,000

d) Statement of Financial Position Extracts:

Statement of Financial Position Extract as at 31st December 2016	€
<u>Non-Current Assets:</u>	
Machinery	12,000
Less: Depreciation	<u>2,000</u>
Total Non-Current Assets	<u>10,000</u>

Statement of Financial Position Extract as at 31st December 2017	€
<u>Non-Current Assets:</u>	
Machinery	12,000
Less: Depreciation	<u>4,000</u>
Total Non-Current Assets	<u>8,000</u>

Statement of Financial Position Extract as at 31st December 2018	€
<u>Non-Current Assets:</u>	
Machinery	12,000
Less: Depreciation	<u>6,000</u>
Total Non-Current Assets	<u>6,000</u>

Note:

In the statement of financial position, one needs to deduct the depreciation shown in the balance c/d and not the depreciation charged to the income statement. By using this approach one is reflecting the cumulative (total) impact of depreciation on the non-current asset.

14.4.2 The Reducing Balance Method

Under this method the depreciation will be calculated on the net book value of the non-current asset instead of its original cost. The net book value is calculated as follows:

Cost – Accumulated Depreciation

The net book value is the net amount that is present in the statement of financial position under the heading of the non-current assets. Therefore, the actual depreciation charged will be high at first, but will reduce year by year.

Note: in the example that follows the same entries will be applied as in the straight-line method. The only difference will be that the depreciation (in percentage) will be calculated on the net book value.

Example: The Reducing Balance Method

A machine costing €15,000 was purchased on 1st January 2016 by cheque. The management of the company decided to depreciate the non-current asset by the reducing balance method at the rate of 10% per annum. The scrap value of the asset is assumed to be €0.

Required:

- Record these transactions in the journal for 2016, 2017 and 2018.
- Prepare the income statement extracts for 2016, 2017 and 2018.
- Prepare the statement of financial position extracts for 2016, 2017 and 2018.

Calculation of Depreciation:

2016: Depreciation: €15,000 x 10% = €1,500

Original cost	€15,000
Less: Depreciation	<u>€1,500</u>
Net book value at 31-Dec-2016	<u>€13,500</u>

2017: Depreciation: €13,500 x 10% = €1,350

Net book value at 1-Jan-2017	€13,500
Less: Depreciation	<u>€1,350</u>
Net book value at 31-Dec-2017	<u>€12,150</u>

2018: Depreciation: €12,150 x 10% = €1,215

Net book value at 1-Jan-2018	€12,150
Less: Depreciation	<u>€1,215</u>
Net book value at 31-Dec-2018	<u>€10,935</u>

The Journal Entries will be prepared according to the same principle adopted for the straight-line method. This is shown below:

Journal as at 31st December 2016	Debit	Credit
Machinery account	€15,000	
Bank account		€15,000
Being machinery purchased recorded in the accounts		
Income Statement	€1,500	
Provision for depreciation on machinery		€1,500
Being depreciation charge for 2016 recorded in the books.		

Journal as at 31st December 2017	Debit	Credit
Income Statement	€1,350	
Provision for depreciation on machinery		€1,350
Being depreciation charge for 2017 recorded in the books.		

Journal as at 31st December 2018	Debit	Credit
Income Statement	€1,215	
Provision for depreciation on machinery		€1,215
Being depreciation charge for 2018 recorded in the books.		

b) Income Statement Extracts:

Income Statement Extract for the year ended 31st December 2016	€
<u>Expenses:</u>	
Depreciation: Machinery	1,500
Income Statement Extract for the year ended 31st December 2017	€
<u>Expenses:</u>	
Depreciation: Machinery	1,350
Income Statement Extract for the year ended 31st December 2018	€
<u>Expenses:</u>	
Depreciation: Machinery	1,215

c) Statement of Financial Position Extracts:

Statement of Financial Position Extract as at 31st December 2016	€
<u>Non-Current Assets:</u>	
Machinery	15,000
Less: Depreciation	<u>1,500</u>
Total Non-Current Assets	<u>13,500</u>

Statement of Financial Position Extract as at 31st December 2017	€
<u>Non-Current Assets:</u>	
Machinery	15,000
Less: Depreciation	<u>2,850</u>
Total Non-Current Assets	<u>12,150</u>

Statement of Financial Position Extract as at 31st December 2018	€
<u>Non-Current Assets:</u>	
Machinery	15,000
Less: Depreciation	<u>4,065</u>
Total Non-Current Assets	<u>10,935</u>

14.4.3 The Revaluation Method

Some firms have many low cost non-current assets. For example, a garage will have a lot of spanners, screwdrivers and other small tools. The revaluation method is suggested because these types of assets differ in value and it is difficult to calculate depreciation on each asset. Under this method, the non-current assets are valued at the end of the year and the decrease in value is considered as depreciation.

Example: The Revaluation Method

Tonio Abdilla operates as a mechanic. The stock of loose tools for 2018 was valued as follows:

Value of loose tools at 1 st Jan. 2018	€1,200
Loose tools purchased by cheque on 15 th Feb. 2018	€2,500
Value of loose tools at 31 st Dec. 2018	€3,000

Required:

- Prepare the loose tools account.
- Prepare the income statement extract for 2018.
- Prepare the statement of financial position extract for 2018.

Loose Tools Account

Date	Debit	€	Date	Credit	€
1 Jan.	Balance b/d	1,200	31 Dec.	Income Statement	700
15 Feb.	Bank	<u>2,500</u>	31 Dec.	Balance c/d	<u>3,000</u>
		<u>3,700</u>			<u>3,700</u>

Note: the decrease in value of loose tools of €700 is transferred to the income statement as an expense. This represents the depreciation of loose tools for the year.

b) Income Statement Extract:

Income Statement Extract for the year ended 31st December 2018	€
<u>Expenses:</u>	
Depreciation: Loose Tools	700

c) Statement of Financial Position Extract:

Statement of Financial Position Extract as at 31st December 2018	€
<u>Non-Current Assets:</u>	
Loose Tools	3,700
Less: Depreciation	<u>700</u>
Total Non-Current Assets	<u>3,000</u>

14.5 Disposal (Selling) of Non-Current Assets

A business enterprise might sell its non-current assets for a variety of reasons, such as disposing of old non-current assets that are no longer needed for the firm's operations or replace old non-current assets with new ones.

A disposal account is opened when a non-current asset is sold. This account will show the profit or loss made on the disposal of the non-current asset.

The profit or loss made on the disposal of the non-current asset can be calculated as follows:

$$\text{Profit/(Loss)} = \text{Cost of the non-current asset} - \text{Total depreciation} - \text{Cash received}$$

A loss will be incurred if the cost of the non-current asset is greater than the total depreciation and cash received.

A profit is generated if the cost of the non-current asset is lower than the total depreciation and cash received.

Example: Selling a Non-Current Asset at a Profit

Joseph operates a car hire garage. On 1st January 2015, he bought a new motor van costing €6,000, paying for it immediately by cheque. This car was depreciated by the reducing balance method at the rate of 20% per annum. Joseph sold the van on 31st December 2018 for €3,000 cash.

Required:

- The motor van account and the provision for depreciation account for 2018.
- The asset disposal account.
- Reflect the disposal of the asset in the journal.

First Step: one needs to calculate the provision for depreciation charged before 2018 (from 2015 to 2017):

Cost of motor van	€6,000
Depreciation (€6,000 x 20%)	<u>€1,200</u>
Net book value as at 31 st December 2015	€4,800
Depreciation (€4,800 x 20%)	<u>€960</u>
Net book value as at 31 st December 2016	€3,840
Depreciation (€3,840 x 20%)	<u>€768</u>
Net book value as at 31 st December 2017	<u>€3,072</u>

With the help of the above working one can calculate the total depreciation charged from 2015 to 2017 on this non-current asset, which is as follows:

Depreciation 2015	€1,200
Depreciation 2016	€960
Depreciation 2017	<u>€768</u>
Total depreciation	<u>€2,928</u>

Second Step: open the motor vehicle account and depreciation account and enter the balance brought down at 1st January 2018 for both accounts.

Motor Vehicle Account

Date	Debit	€	Date	Credit	€
1 Jan.	Balance b/d	<u>6,000</u>	31 Dec.	Disposal	<u>6,000</u>
Provision for Depreciation on Motor Vehicle Account					
31 Dec.	Disposal	3,542	1 Jan.	Balance b/d	2,928
		—	31 Dec.	Income Statement	<u>614</u>
		<u>3,542</u>			<u>3,542</u>
Motor Vehicle Disposal Account					
31 Dec.	Motor vehicle	6,000	31 Dec.	Depreciation	3,542
31 Dec.	Income Statement	<u>542</u>	31 Dec.	Cash	<u>3,000</u>
		<u>6,542</u>			<u>6,542</u>

Third Step: since the motor vehicle will be sold at the end of the year one needs to calculate the depreciation for 2018 and reflect it in the accounts.

Depreciation = Net book value as at 31st December 2017 x 20%

Depreciation: €3,072 x 20% = €614

Fourth Step: one needs to open the disposal account to determine the profit or loss derived from the sale of the non-current asset.

The cost of the asset will be reflected on the debit side of the disposal account. This will permit the removal of the balance b/d present in the motor vehicle account. Similarly, the total depreciation of the asset sold will be posted to the credit side of the disposal account. The cash generated from the disposal is also debited in the cash account and credited in the disposal account. This reflects a simple double entry that has already been discussed in chapter two. The difference between the two sides of the disposal account will result in the profit or loss from the disposal. In this case the credit side is greater than the debit side implying that a profit from disposal was generated.

Note: Since in this example there is only one motor vehicle, the depreciation account will be closed because the motor vehicle was sold. If in a question you have more than one non-current asset, then you have to transfer only the total depreciation of the non-current asset sold to the disposal account.

Journal as at 31st December 2018	Debit	Credit
Depreciation on motor vehicle account	€3,542	
Cash account	€3,000	
Motor vehicle account		€6,000
Income Statement (profit on disposal)		€542
	<u>€6,542</u>	<u>€6,542</u>
Being disposal of motor vehicle recorded in the accounts.		

Example: Selling a Non-Current Asset at a Loss

Car Hire Enterprises had the following non-current assets at 1st January 2018:

Car type	Cost (€)	Date of purchase	Depreciation method
Motor vehicle no. 1	10,000	1 st January 2016	10% Straight line
Motor vehicle no. 2	12,000	1 st January 2017	15% Straight line

On 1st October 2018 motor vehicle number 1 was sold and €6,000 cash were received from the buyer.

Required:

- The motor van account and the provision for depreciation account for 2018.
- The asset disposal account.
- The journal entry to reflect the disposal of the non-current asset.

Step 1 – Calculate the depreciation of the motor van of prior years:

2016

Motor vehicle no. 1: €10,000 x 10%

€1,000

2017

Motor vehicle no. 1: €10,000 x 10%	€1,000
Motor vehicle no. 2: €12,000 x 15%	<u>€1,800</u>
Total depreciation as at 1 st January 2018	<u>€3,800</u>

Step 2 – Open the motor vehicle and the depreciation accounts, and enter the balance brought down for both accounts.

Motor Vehicle Account

Date	Debit	€	Date	Credit	€
1 Jan.	Balance b/d	22,000	1 Oct.	Disposal	10,000
		_____	31 Dec.	Balance c/d	<u>12,000</u>
		<u>22,000</u>			<u>22,000</u>

Provision for Depreciation on Motor Vehicle Account

1 Oct.	Disposal	2,750	1 Jan.	Balance b/d	3,800
31 Dec.	Balance c/d	<u>3,600</u>	31 Dec.	Income Statement	<u>2,550</u>
		<u>6,350</u>			<u>6,350</u>

Motor Vehicle Disposal Account

1 Oct.	Motor vehicle	10,000	1 Oct.	Depreciation	2,750
			1 Oct.	Cash	6,000
			1 Oct.	Loss from disposal	<u>1,250</u>
		<u>10,000</u>			<u>10,000</u>

Step 3 – Calculate the depreciation charge for 2018:

Motor vehicle no. 1: €10,000 x 10% x 9/12	€750
Motor vehicle no. 2: €12,000 x 15%	<u>€1,800</u>
Depreciation charge for the year	<u>€2,550</u>

Note: the depreciation charge for motor vehicle number 1 was calculated on the number of months it was used in the organisation. In this example it was sold on 1st October and thus it was used from January to September (9 months).

Step 4 – Since the company holds more than one non-current asset it is required to calculate the total depreciation on the non-current asset sold.

Motor vehicle no. 1 was purchased on 1st January 2016. Therefore, there is depreciation for 2016, 2017 and 2018. The respective calculations are shown below:

2016: €10,000 x 10%	€1,000
2017: €10,000 x 10%	€1,000
2018: €10,000 x 10% x 9/12	<u>€750</u>
Total depreciation on non-current asset	<u>€2,750</u>

Step 5 - Open the disposal account to determine the profit or loss derived from the sale of the non-current asset.

Journal as at 31 st December 2018	Debit	Credit
Depreciation on motor vehicle account	€2,750	
Cash account	€6,000	
Motor vehicle account		€10,000
Income Statement (loss on disposal)	<u>€1,250</u>	
	<u>€10,000</u>	<u>€10,000</u>
Being disposal of motor vehicle number 1 recorded in the accounts.		

Example: Part Exchange of a Non-Current Asset

Susan had a car hire garage. On 1st January 2016 she bought a new business car costing €6,500, which was paid by cheque. This car was depreciated by the straight-line method at the rate of 20% per annum. She disposed of it on 31st December 2018 and bought a different car for €8,000 from the same company. The old car was valued at €2,000. The remaining amount due was paid by cheque.

Required:

- The motor van account and provision for depreciation account for 2018.
- The asset disposal account.

Step 1 – Calculate the depreciation on the non-current asset:

For 2 years: €6,500 x 20% x 2 = €2,600

Step 2 - Open the motor vehicle and depreciation accounts, and enter the balance brought down.

Motor Vehicle Account

Date	Debit	€	Date	Credit	€
1 Jan.	Balance b/d	6,500	1 Oct.	Disposal	6,500
31 Dec.	Disposal	2,000	31 Dec.	Balance c/d	8,000
31 Dec.	Bank	<u>6,000</u>			_____
		<u>14,500</u>			<u>14,500</u>
Provision for Depreciation on Motor Vehicle Account					
1 Oct.	Disposal	3,900	1 Jan.	Balance b/d	2,600
		_____	31 Dec.	Income Statement	<u>1,300</u>
		<u>3,900</u>			<u>3,900</u>
Motor Vehicle Disposal Account					
31 Dec.	Motor vehicle	6,500	31 Dec.	Depreciation	3,900
			31 Dec.	Motor Vehicle	2,000
			31 Dec.	Loss from disposal	<u>600</u>
		<u>6,500</u>			<u>6,500</u>

Step 3 – Calculate the depreciation charge for 2018:

Depreciation: €6,500 x 20% = €1,300

Step 4 - Open the disposal account to determine the profit or loss derived from the sale of the non-current asset.

In a part exchange there will be the following three different transactions, which affect the non-current asset sold:

1. Credit motor vehicle account €6,500
Debit disposal account €6,500
This is the normal disposal transaction where the cost of the non-current asset sold is transferred to the disposal account.
2. Debit motor vehicle account €2,000
Credit disposal account €2,000
This transaction covers the value given to the asset sold. In this situation the firm is going to purchase another motor vehicle from

the same supplier. Therefore, the value given to the old motor vehicle will be deducted from the cost of the new motor vehicle.

3. Debit motor vehicle account €6,000

Credit bank account €6,000

This transaction covers the money the firm had to pay to purchase the new motor vehicle. Normal give and take principle applied here. The firm receives a motor vehicle (debit motor vehicle account) and money needs to be paid for it by cheque (credit bank account).

Note: if you add up transaction number 2 (€2,000) with transaction number 3 (€6,000), they make up the cost of the motor vehicle purchased of €8,000.

In a part-exchange one also needs to take into account the accumulated depreciation of the non-current asset sold, which in this case amounts to €3,900. This is the total of the figures computed in step 1 (€2,600) and step 3 (€1,300).

Review Questions

Question 1

a) Identify and explain three factors that lead to the depreciation of non-current assets. Give examples to support your explanation.

b) Alex Mifsud bought office equipment on 1st January 2016 for the value of €15,000. The useful life of this non-current asset is of five years with zero scrap value. Alex decided to use the straight-line method of depreciation. Calculate the depreciation charge for the year and prepare the provision for depreciation account for 2016.

Question 2

Noel Smith acquired a motor vehicle costing €20,000 on 1st January 2017. Noel decided to use the reducing balance method and charge a depreciation rate of 20%.

a) Determine the depreciation charge for 2017 and 2018.

b) Prepare the provision for depreciation account for 2017 and 2018.

Question 3

Smith Enterprises is an organisation engaged in renting motor vehicles. The following transactions took place during 2016, 2017 and 2018:

2016:

1st January bought a motor vehicle costing €25,000 by cheque. It has no scrap value.

2017:

1st January bought another motor vehicle costing €20,000 by cheque. It has no scrap value.

30th June bought a motor vehicle costing €12,000 by cash. It has a scrap value of €2,000.

2018:

30th June Sold the first motor vehicle bought on 1st January 2016 for €8,000 cash.

Smith Enterprises uses the straight-line method of depreciation. The useful life of all the motor vehicles acquired is of 10 years. Depreciation is charged for each month of ownership.

- a) Prepare the Motor Vehicle Account for 2016, 2017 and 2018.
- b) Prepare the Provision for Depreciation Account for 2016, 2017 and 2018.
- c) Prepare the Disposal Account for 2018.

Question 4

Use the same information present in question 3 and prepare the same accounts requested in question 3. However, assume that the depreciation method used is the reducing balance method at the rate of 10%.

Question 5

Alex Jones incurred the following transactions pertinent to computer equipment:

2016:

1st March bought computer equipment costing €7,000 by cheque.

1st October bought another computer equipment costing €10,000 by cheque.

2017:

1st June bought more computer equipment at a cost of €20,000 by cheque.

2018:

30th June sold the first computer equipment bought on 1st March 2016. It was valued at €2,000 and part-exchanged with new computer equipment costing €10,000. The remaining was paid by cheque.

Alex Jones decided to use the straight-line method of depreciation and the useful life of all the computer equipment bought is of five years. It is the firm's accounting policy to depreciate these non-current assets for each month of ownership.

- a) Prepare the Computer Equipment Account for 2016, 2017 and 2018.
- b) Prepare the Provision for Depreciation Account for 2016, 2017 and 2018.
- c) Prepare the Disposal Account for 2018.

CHAPTER 15

ACCOUNTING FOR BAD DEBTS AND PROVISION FOR DOUBTFUL DEBTS

Objectives

After you have read this chapter you should be able to:

- Account for bad debts written off;
- Distinguish between bad debts and provision for doubtful debts;
- Calculate and account for provision for doubtful debts;
- Account for bad debts recovered; and
- Post the respective entries in the income statement and statement of financial position.

15.1 Bad debts and Provision for Doubtful Debts

Firms selling on credit run the risk of incurring bad debts. Bad debts occur when customers are unable to pay their debts due to financial difficulties. Whenever this happens the organisation incurs a bad debt expense, which needs to be recorded in the accounts.

15.2 Double Entry for Bad Debts

When a debtor is bankrupt and is unable to pay his/her debt, the organisation is required to record this transaction through the double entry system. An explanation is provided of how a bad debt is recorded in the subsidiary ledgers and the journal through illustrative examples.

Example: An Accounts Receivable is Unable to Pay the Debt Due

Credit Enterprises accounts receivable balance as at 1st December 2019 was €26,000. James Zammit one of the firm's debtors was declared bankrupt on 14th December 2019 and was unable to pay his debt of €1,500.

Required:

- Prepare the accounts receivable account and bad debts account.
- Record the journal entry of the bad debt.

Accounts Receivable Account

Date	Debit	€	Date	Credit	€
1 Dec.	Balance b/d	26,000	14 Dec.	Bad debts	1,500
		=====	31 Dec.	Balance c/d	24,500
		<u>26,000</u>			<u>26,000</u>
Bad Debts Account					
14 Dec.	Accounts receivable	<u>1,500</u>	31 Dec.	Income Statement	<u>1,500</u>

Journal as at 31st December 2019		Debit	Credit
Bad debts account		€1,500	
Accounts receivable account			€1,500
Being bad debt recorded in the accounts.			

Example: An Accounts Receivable who was Able to Pay Part of his/her Debt

Zammit Enterprises accounts receivable balance as at 1st December 2019 was €32,000. James Abdilla one of the firm's debtors was declared bankrupt on 24th December 2019. He was able to pay by cheque €300 of the total amount due of €1,800.

Required:

- Prepare the accounts receivable account and bad debts account.
- Record the journal entry relevant to the bad debt.

In this case there are the following transactions:

- Receipt from accounts receivable of €300.
- Recording the unpaid debt, which amounts to €1,500 (€1,800 – €300).

Accounts Receivable Account

Date	Debit	€	Date	Credit	€
1 Dec.	Balance b/d	32,000	24 Dec.	Bank (a)	300
			24 Dec.	Bad debt (b)	1,500
		_____	31 Dec.	Balance c/d	<u>30,200</u>
		<u>32,000</u>			<u>32,000</u>
Bad Debts Account					
24 Dec.	Accounts Receivable	<u>1,500</u>	31 Dec.	Income Statement	<u>1,500</u>

Notes:

Transaction (a) – normal give and take applied here.

Take (debit side) – Received €300 by cheque (bank account)

Give (credit side) – Accounts receivable no longer has to pay us the €300 due (accounts receivable account).

Transaction (b) – same principle applied in the previous example is used. Deduct bad debt from accounts receivable by crediting the accounts receivable account, and transferring it to the bad debts account, as an expense.

Journal as at 31st December 2019		Debit	Credit
(a) Bank account		€300	
Accounts receivable account			€300
Being receipt from accounts receivable recorded in the accounts.			
(b) Bad debts account		€1,500	
Accounts receivable account			€1,500
Being bad debts written off in the accounts.			

15.3 Provision for Doubtful Debts

The prudence concept plays an important role in accounting for accounts receivable. This concept states that doubtful losses should be recorded in the accounts with the aid of a provision. In case of accounts receivable there is the risk that in the future some of the company's accounts receivables will be unable to pay their debts. Therefore, in order to follow the prudence concept, the firm is required to account for the provision for doubtful debts.

The difference between the bad debts and the provision for doubtful debts is that bad debts reflect accounts receivables that are bankrupt and unable to pay the amount due. The provision for doubtful debts is an estimate made by the management of the enterprise, of the anticipated amount of accounts receivable who will be unable to pay the amount due in the future. Illustrative examples are used to explain the computation and accounting for the provision for doubtful debts.

15.4 Accounting for the Provision for Doubtful Debts

Example: Creation of the Provision for Doubtful Debts

The accounts receivable of Alfred Mifsud at 31st December 2019 amounted to €20,000. The management of the enterprise decided to create a provision for doubtful debts, which amounts to 5% of the accounts receivable.

Required:

- Prepare the provision for doubtful debts account.
- Record the provision for doubtful debts transaction in the journal.
- Prepare the income Statement extract.
- Prepare the statement of financial position extract.

Step 1: Calculation of the provision for doubtful debts:

$$\text{Provision for doubtful debts} = \text{€}20,000 \times 5\% = \text{€}1,000$$

Step 2: Prepare the provision for doubtful debts account:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	<u>1,000</u>	31 Dec.	Income Statement	<u>1,000</u>

Note: a provision for doubtful debts is regarded as an expense because it is reducing the value of the accounts receivable in the statement of financial position. Therefore, an expense is recorded by debiting the income statement and crediting the provision for doubtful debts account.

Journal as at 31 st December 2019		Debit	Credit
Income Statement		€1,000	
Provision for doubtful debts account			€1,000
Being provision for doubtful debts created in the books.			

Income Statement Extract for the year ended 31st December 2019	€
<u>Expenses:</u>	
Provision for Doubtful Debts	1,000

Statement of Financial Position Extract as at 31st December 2019	€
<u>Current Assets:</u>	
Accounts Receivable	20,000
Less: Provision for doubtful debts	<u>1,000</u>
Total Current Assets	<u>19,000</u>

15.5 Increase in the Provision for Doubtful Debts

Amid Enterprises accounts receivable balance as at 31st December 2019 amounted to €30,000. The provision for doubtful debts balance at 1st January 2019 amounted to €1,300. It is the firm's policy to provide a 5% provision on the accounts receivables.

Required:

- Prepare the provision for doubtful debts account.
- Record the provision for doubtful debts transaction in the journal.
- Prepare the income statement extract.
- Prepare the statement of financial position extract.

Step 1: Calculation of the provision for doubtful debts:

Provision for doubtful debts = €30,000 x 5% = €1,500.

Step 2: Prepare the provision for doubtful debts account:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	1,500	1 Jan.	Balance b/d	1,300
		—	31 Dec.	Income Statement	<u>200</u>
		<u>1,500</u>			<u>1,500</u>

Note: the provision for doubtful debts calculated in step 1 should be entered as balance c/d. Only the increase from previous year should be charged as an expense.

Journal as at 31st December 2019	Debit	Credit
Income Statement	€200	
Provision for doubtful debts account		€200
Being increase in provision for doubtful debts recorded in the books.		

Income Statement Extract for the year ended 31st December 2019	€
<u>Expenses:</u>	
Increase in Provision for Doubtful Debts	200

Statement of Financial Position Extract as at 31st December 2019	€
<u>Current Assets:</u>	
Accounts Receivable	30,000
Less: Provision for doubtful debts	<u>1,500</u>
Total Current Assets	<u>28,500</u>

15.6 Decrease in the Provision for Doubtful Debts

Multiple Goods Limited accounts receivable balance as at 31st December 2019 amounted to €20,000. The provision for doubtful debts balance at 1st January 2019 amounted to €1,200. It is the firm's policy to provide a 5% provision on the accounts receivables.

Required:

- Prepare the provision for doubtful debts account.
- Record the provision for doubtful debts transaction in the journal.
- Prepare the income Statement extract.
- Prepare the statement of financial position extract.

Step 1: Calculation of the provision for doubtful debts:

$$\text{Provision for doubtful debts} = €20,000 \times 5\% = €1,000$$

Step 2: Prepare the provision for doubtful debts account:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
31 Dec.	Income Statement	200	1 Jan.	Balance b/d	1,200
31 Dec.	Balance c/d	<u>1,000</u>			—
		<u>1,200</u>			<u>1,200</u>

Note: when there is a decrease in the provision for doubtful debts, the decrease should be recognised as a gain and therefore it should be credited to the income statement.

Journal as at 31 st December 2019	Debit	Credit
Provision for doubtful debts account	€200	
Income Statement		€200
Being decrease in provision for doubtful debts recorded in the books.		

Income Statement Extract for the year ended 31 st December 2019	€
<u>Revenue:</u>	
Decrease in Provision for Doubtful Debts	200

Statement of Financial Position Extract as at 31 st December 2019	€
<u>Current Assets:</u>	
Accounts Receivable	20,000
Less: Provision for doubtful debts	<u>1,000</u>
Total Current Assets	<u>19,000</u>

15.7 The Provision for Doubtful Debts Remains the Same

The accounts receivable of Antoine Apap as at 31st December 2019 amounted to €25,000. The provision for doubtful debts balance at 1st January 2019 amounted to €1,250. It is the firm's policy to provide a 5% provision on the accounts receivables.

Required:

- Prepare the provision for doubtful debts account.
- Prepare the statement of financial position extract as at 31st December 2019.

Step 1: Calculation of the provision for doubtful debts:

$$\text{Provision for doubtful debts} = \text{€}25,000 \times 5\% = \text{€}1,250$$

Step 2: Prepare the provision for doubtful debts account:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	<u>1,250</u>	1 Jan.	Balance b/d	<u>1,250</u>

Note: there is no entry (expense/gain) in the income statement when the provision for doubtful debts remains the same.

Statement of Financial Position Extract as at 31 st December 2019	€
<u>Current Assets:</u>	
Accounts Receivable	25,000
Less: Provision for doubtful debts	<u>1,250</u>
Total Current Assets	<u>23,750</u>

15.8 The Bad Debts Recovered

It is not uncommon for a bad debt written off in the previous year/month to be recovered later on. In these instances, an adjustment needs to be made in the accounts, namely the accounts receivable account and the bad debts account in order to remove the impact of the bad debt.

Example: The Bad Debts, Provision for Doubtful Debts and Bad Debts Recovered

Joseph commenced business on 1st January 2017. For the year ended 31st December 2017, bad debts written off amounted to €800. It was also found necessary to create a provision for doubtful debts of 5% of the accounts receivable. The accounts receivable as at 31st December 2017 (before deducting the bad debts written off) amounted to €20,000.

In 2018, accounts receivable amounting to €1,200 proved to be bad and were written off. Mr. Said whose debt of €250 was written off as bad in 2017 was recovered and he settled the amount due by cheque. As at 31st December 2018 the accounts receivable (before deducting the bad debts written off) amounted to €30,000. It was decided to bring the provision for doubtful debts up to 7% of the accounts receivable.

Required:

- Prepare the bad debts account for 2017 and 2018.
- Record the transactions in the provision for doubtful debts account for 2017 and 2018.
- Prepare the bad debts recovered account.
- Prepare the income Statement extract for 2017 and 2018.
- Prepare the statement of financial position extract for 2017 and 2018.

2017

Step 1: Account for the bad debts written off:

Accounts Receivable Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance b/d	20,000	31 Dec.	Bad debts	800
		_____	31 Dec.	Balance c/d	19,200
		<u>20,000</u>			<u>20,000</u>
Bad Debts Account					
31 Dec.	Accounts Receivable	<u>800</u>	31 Dec.	Income Statement	<u>800</u>

Step 2: Calculation of the provision for doubtful debts:

$$\text{Provision for doubtful debts} = €19,200 \times 5\% = €960$$

Step 3: Prepare the provision for doubtful debts account:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	<u>960</u>	31 Dec.	Income Statement	<u>960</u>

2018

Step 1: Account for the bad debts written off and bad debts recovered:

Accounts Receivable Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance b/d	30,000	31 Dec.	Bad debts	1,200
31 Dec.	Bad debts recovered	250	31 Dec.	Bank	250
		—	31 Dec.	Balance c/d	<u>28,800</u>
		<u>30,250</u>			<u>30,250</u>
Bad Debts Account					
31 Dec.	Accounts Receivable	<u>1,200</u>	31 Dec.	Income Statement	<u>1,200</u>
Bad Debts Recovered Account					
31 Dec.	Income Statement	<u>250</u>	31 Dec.	Accounts Receivable	<u>250</u>

Notes:

There are two transactions covering the bad debts recovered:

1. Debit Accounts receivable account by €250
Credit Bad debts recovered account by €250
In this transaction the bad debt recovered is added up to the accounts receivable account and recorded as a gain.
2. Debit Bank account by €250
Credit Accounts receivable account by €250
Here the receipt of money from the accounts receivable recovered is posted in the books.

Step 2: Calculation of the provision for doubtful debts:

Provision for doubtful debts = €28,800 x 7% = €2,016

Step 3: Prepare the provision for doubtful debts account:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	2,016	1 Jan.	Balance b/d	960
		—	31 Dec.	Income Statement	<u>1,056</u>
		<u>2,016</u>			<u>2,016</u>

Income Statement Extract for the year ended 31 st December 2017	€
<u>Expenses:</u>	
Bad Debts	800
Increase in Provision for Doubtful Debts	<u>960</u>
	<u>1,760</u>

Income Statement Extract for the year ended 31 st December 2018	€
<u>Revenue:</u>	
Bad Debts Recovered	250
<u>Expenses:</u>	
Bad Debts	1,200
Increase in Provision for Doubtful Debts	<u>1,056</u>
	<u>2,256</u>

Statement of Financial Position Extract as at 31 st December 2017	€
<u>Current Assets:</u>	
Accounts Receivable	19,200
Less: Provision for doubtful debts	<u>960</u>
Total Current Assets	<u>18,240</u>

Statement of Financial Position Extract as at 31st December 2018	€
<u>Current Assets:</u>	
Accounts Receivable	28,800
Less: Provision for doubtful debts	<u>2,016</u>
Total Current Assets	<u>26,784</u>

Review Questions

Question 1

a. Describe the difference between bad debts and provision for doubtful debts.

b. The following bad debts took place during 2018:

13 March James Wood	€230
30 June Alex Smith	€50
8 November Eve Said	€300

Required:

Record these bad debts in the respective accounts.

Question 2

Alfred Agius is engaged in the retail of bathrooms and sanitary ware. The accounts receivable balance as at 31st December 2018 amounted to €30,000. During the year bad debts of €800 were incurred and deducted from the accounts receivable. One of your friends, who works in a credit rating agency suggested that a provision for doubtful debts should be adopted. You decided to set a rate of 2%.

Required:

- Calculate the provision for doubtful debts for 2018.
- Prepare the provision for doubtful debts account.
- Prepare the bad debts account.
- Prepare the Income Statement Extract for 2018
- Prepare the Statement of Financial Position Extract for 2018.

Question 3

Info-Computers is an organisation involved in the retail of computer and electronic equipment. Its accounts receivables, bad debts and provision for doubtful debts for the past three years are shown below:

Year	Bad Debts	Accounts Receivable	Provision for Doubtful Debts
2016	€1,000	€40,000	3%
2017	€1,500	€50,000	3%
2018	€600	€55,000	1%

The bad debts have not yet been deducted from the accounts receivable.

Required:

- Prepare the bad debts account for 2016, 2017 and 2018.
- Calculate the provision for doubtful debts for 2016, 2017 and 2018.
- Prepare the provision for doubtful debts for 2016, 2017 and 2018.
- Prepare the Income Statement Extract for 2016, 2017 and 2018.
- Prepare the Statement of Financial Position Extract for 2016, 2017 and 2018.

Question 4

A business, which started operating on 1st January 2017 had an accounts receivable balance at the end of the year of €65,000 and €1,900 bad debts were deducted from that amount. A credit rating agency was engaged in 2018, which helped to decrease the accounts receivable balance to €50,000 (net of bad debts) at the end of 2018 and also the bad debts of 2018 decreased to €1,100. There was a bad debt recovered of €200 during 2018. The provision for doubtful debts is 4% of accounts receivable for both years.

Required:

- Prepare the bad debts account for 2017 and 2018.
- Calculate the provision for doubtful debts for 2017 and 2018.
- Prepare the provision for doubtful debts for 2017 and 2018.
- Record the transaction in the bad debts recovered account
- Prepare the Income Statement Extract for 2017 and 2018.
- Prepare the Statement of Financial Position Extract for 2017 and 2018.

CHAPTER 16

ACCOUNTING FOR ACCRUALS AND PREPAYMENTS

Objectives

After you have read this chapter you should be able to:

- Understand the meaning of accruals and prepayments;
- Account for accrued expenses and prepaid expenses;
- Post accrued revenue and prepaid revenue in the respective accounts;
- Post accrued and prepaid expenses in the income statement and the statement of financial position; and
- Reflect accrued and prepaid revenue in the income statement and the statement of financial position.

16.1 Accruals and Prepayments

Accrued expenses comprise expenditure that has been incurred but it has not yet been paid by the organisation. Accrued revenue consists of revenue that has been incurred money has not yet been received for it. The Accruals concept states that expenses and revenue should be reflected in the accounts when they are incurred and not when payment or receipt of cash takes place. Thus, accrued expenses at the end of the year are added to their respective expense. They are also shown in the statement of financial position with the current liabilities, because they are unpaid expenses. Accrue revenue is added to the respective revenue and it is shown with the current assets in the statement of financial position.

Example: Treatment of Accrued Expense and Accrued Revenue

During the year €1,200 electricity was paid by the organisation and €500 commission was received in cash. At the financial year end, which is 31st December 2019 there was electricity due of €100, which was incurred in 2019. Furthermore, there was accrued commission received of €30.

The treatment of these accruals to the revenue and expense accounts consist of the following:

Revenue: Commission Received = €500 + €30 = €530

Expense: Electricity = €1,200 + €100 = €1,300

In the statement of financial position, the accrued commission received of €30 will be included with the current assets because this is additional revenue that will be received next year. On the contrary, the accrued electricity expense of €100 will be shown with the current liabilities since this is an expenditure that needs to be paid next year.

The treatment of prepaid expenses or revenue is the opposite to that of accruals. These are deducted from the revenue or expense. Prepaid revenue reflects money received for revenue that has not yet occurred. Prepaid expenditure comprises an expense paid that has not yet occurred.

Example: Treatment of Prepaid Expense and Prepaid Revenue

In 2019 the organisation paid rent of €1,300 and received commission of €750. €100 of the rent is prepared while €150 of the commission has also been received in advance.

The treatment of these prepaid revenue and expense, which are reflected in the income statement consist of the following:

Revenue: Commission Received = €750 - €150 = €600

Expense: Rent = €1,300 - €100 = €1,200

In the statement of financial position, the prepaid rent of €100 will be included with the current assets since such expenditure has already been settled and does not need to be paid next year. The prepaid commission received of €150 will be shown with the current liabilities because such income will not be received next year in cash despite its service will be incurred.

16.2 Accounting Treatment for Accrued Expenses

Example: Accrual at the End of the Year

During 2019 €500 electricity was paid by cheque. It is estimated that the accrued electricity at the end of the year amounts to €50.

Required:

- Record the following transactions in the respective accounts.
- Record the closing accrual transaction in journal format.

Electricity Account

Date	Debit	€	Date	Credit	€
31 Dec.	Bank (a)	500	31 Dec.	Income Statement	550
31 Dec.	Accrued c/d (b)	<u>50</u>			
		<u>550</u>			<u>550</u>

Notes:

Transaction (a) – this represents the electricity paid during the year. Normal give and take principle applied. Give (credit) payment by cheque and take (debit) electricity bill settled.

Transaction (b) – as already stated an accrued expense represents an unpaid amount. The accruals concept states that revenue incurred in a particular year should be matched with expenses incurred in that year. Therefore, one needs to include the accrued (unpaid) expense because this was actually incurred during the year. Thus, the electricity account is debited in order to include it with the electricity expense. In this case the balance c/d is shown as accrued c/d.

Since it is unpaid, it is a liability and therefore it must be included with the current liabilities by crediting the accruals account.

Journal as at 31 st December 2019	Debit	Credit
Electricity account	€50	
Accrual electricity account		€50
Being accrued electricity recorded in the books.		

Example: Accruals at the Beginning and End of the Year

Joseph Smith accruals for 2018 and 2019 amounted to the following:

	31/12/2018	31/12/2019
Water and electricity accrued	€100	€160

Expenses paid during the year amounted to:

Water and electricity €550

Required:

- Open the water and electricity account for 2019.
- Record the closing accrual transaction in journal format.

Water and Electricity Account

Date	Debit	€	Date	Credit	€
31 Dec.	Bank (b)	550	1 Jan.	Accrual b/d (a)	100
31 Dec.	Accrual c/d (c)	<u>160</u>	31 Dec.	Income Statement	<u>610</u>
		<u>710</u>			<u>710</u>

Notes:

Transaction (a) – this represents the accrued expense of last year. Such amount was settled when the water and electricity was paid in 2019.

Transaction (b) - this represents the expense paid during the year. Normal give and take principle applied. Give (credit) payment by cheque and take (debit) water and electricity bill settled.

Transaction (c) – as in the previous example one needs to add the accrued expense with the expense paid by debiting the water and electricity account. Since an accrued expense is an unpaid expenses one is required to consider it as a current liability in the statement of financial position.

Journal as at 31st December 2019	Debit	Credit
Water and electricity account	€160	
Accrued water and electricity account		€160
Being accrued water and electricity recorded in the books.		

16.3 Prepayments

Prepayments mean payments made in advance for expenditure or cash received for income before it is incurred. For example, rent is received before the individual resides in the building for the whole month. Prepaid expenses at the end of the year are deducted from their respective expense. They are also shown in the statement of financial position with the current assets, because they are expenses paid in advance and thus, they provide a cash flow benefit in the future.

16.4 Accounting Treatment for Prepaid Expenses

Example 1: Prepayment at the End of the Year

During 2019 €350 has been paid for motor vehicle insurance. €70 of this insurance is prepaid for next year.

Required:

- Record the following transactions in the respective accounts.
- Record the closing prepaid insurance transaction in journal format.

Insurance Account

Date	Debit	€	Date	Credit	€
31 Dec.	Bank (a)	350	31 Dec.	Prepayment c/d (b)	70
		—	31 Dec.	Income Statement	<u>280</u>
		<u>350</u>			<u>350</u>

Notes:

Transaction (a) – this represents the insurance paid during the year. Normal give and take principle applied. Give (credit) payment by cheque and take (debit) insurance bill settled.

Transaction (b) – as stated previously a prepaid expense represents a payment made before the expense occurs. The accruals concept states that revenue incurred in a particular year should be matched with expenses incurred in that year. Therefore, one needs to deduct the prepaid expense from the expenses paid by crediting the insurance account. Payments made in advance are considered as current assets in the statement of financial position.

Journal as at 31st December 2019	Debit	Credit
Prepaid insurance account	70	
Insurance account		70
Being prepaid insurance recorded in the books.		

Example: Prepayments at the Beginning and End of the Year

The prepayments of James Saliba for 2018 and 2019 amounted to the following:

	31/12/2018	31/12/2019
Insurance prepaid	€100	€120

Expenses paid during the year amounted to:

Insurance €500

Required:

- Open the insurance account for 2019.
- Record the closing prepayment transaction in journal format.

Insurance Account

Date	Debit	€	Date	Credit	€
1 Jan.	Prepayment b/d (a)	100	31 Dec.	Prepayment c/d (c)	120
31 Dec.	Bank (b)	<u>500</u>	31 Dec.	Income Statement	<u>480</u>
		<u>600</u>			<u>600</u>

Notes:

Transaction (a) – this represent the prepayment made last year. This should be included with the insurance of 2019 because such expenditure will be incurred during 2019.

Transaction (b) - this represents the expense paid during the year. Normal give and take principle applied. Give (credit) payment by cheque and take (debit) insurance bill settled.

Transaction (c) – as in the previous example one needs to deduct the prepaid expense from the expense paid by crediting the insurance account. Since prepaid expenses are payments made in advance one is required to consider them as current assets in the statement of financial position.

Journal as at 31st December 2018	Debit	Credit
Prepaid insurance account	€120	
Insurance account		€120
Being prepaid insurance recorded in the books.		

16.5 Accruals and Prepayments at the Same Time

Example: Rent Accrued and Insurance Prepaid

M. Telford is a manufacturer of furniture. He prepares his final accounts on 31st December. There were the following accruals and prepayments:

- The rent account showed that rent of €300 was owing for the year ended 31st December 2018.
- The insurance account indicated that €160 had been paid in advance for the year ended 31st December 2018.

The following expenditure was paid during the year ended 31st December 2019:

Rent paid	1 st January 2019	€600
	1 st April 2019	€900
	1 st July 2019	€900
	1 st October 2019	€900
Insurance paid	1 st February 2019	€960

Accruals and prepayments at 31st December 2019 comprised the following:

Rent in arrears	€600
Insurance paid in advance	€160

Required:

Prepare the rent account and insurance account for the year ended 31st December 2019.

Rent Account

Date	Debit	€	Date	Credit	€
1 Jan.	Bank (b)	600	1 Jan.	Accrual b/d (a)	300
1 April	Bank (b)	900	31 Dec.	Income Statement	3,600
1 July	Bank (b)	900			
1 Oct.	Bank (b)	900			
31 Dec.	Accrual c/d (d)	<u>600</u>			—
		<u>3,900</u>			<u>3,900</u>

Insurance Account

1 Jan.	Prepayment b/d (c)	160	31 Dec.	Prepayment c/d (e)	160
1 Feb.	Bank (b)	<u>960</u>	31 Dec.	Income Statement	<u>960</u>
		<u>1,120</u>			<u>1,120</u>

As you can notice the same principle applied in the previous examples was applied for this question. For simplicity the transactions were noted as (a), (b), (c), (d) and (e) so you can easily follow the respective entries.

Notes:

Transaction (a) – this represents accrued rent of last year. Such amount was settled when the rent was paid in 1st January 2019.

Transactions (b) – these represent the rent and insurance paid during the year. Normal give and take principle is applied here, where give (credit) is the payments by cheque and take (debit) comprises the rent and insurance bills settled.

Transaction (c) – this reflects the prepaid insurance of last year. This should be included with the insurance of 2019 because such expenditure will be incurred during 2019.

Transaction (d) – at this stage one is required to reflect the closing accrual at the end of the year. Accrued expenses are a liability and thus it needs to be included with the current liabilities.

Transaction (e) – this transaction concerns the closing prepayment at the end of the year. A prepaid expense is an asset and therefore this needs to be included with the current assets.

16.6 Accounting Treatment for Accrued Revenue

Example 1: Accrued Revenue at the End of the Year

In 2019 Good Rent Ltd. received rent of €11,000 by cheque. There was still rent due of €1,000 at the financial year end.

Required:

- Record the following transactions in the respective accounts.
- Record the accrued rent in journal format.

Rent Received Account

Date	Debit	€	Date	Credit	€
31 Dec.	Income Statement	12,000	31 Dec.	Bank (a)	11,000
		—	31 Dec.	Accrual c/d (b)	<u>1,000</u>
		<u>12,000</u>			<u>12,000</u>

Notes:

Transaction (a) – this represents the rent received during the year. Normal give and take principle applied. Take (debit) is the money received and give (credit) comprises the rent receivable settled by the tenant and no longer due.

Transaction (b) – accrued revenue represents money that will be received in the future. The accruals concept states that revenue incurred in a particular year should be matched with expenses incurred in that year. Therefore, one needs to include accrued revenue with the rent receivable by crediting the rent receivable account. The accrual needs to be considered as an asset since it reflects money that will be received in the future. Thus, one needs to reflect it as part of the firm's current assets in the statement of financial position.

Journal as at 31 st December 2019	Debit	Credit
Accrued rent received account	€1,000	
Rent received account		€1,000
Being accrued rent receivable recorded in the books.		

Example 2: Accrued Revenue at the Beginning and End of the Year

The accrued revenue of Adma Ltd. for 2018 and 2019 amounted to the following:

	31/12/2018	31/12/2019
Accrued commission received	€300	€430

Commission received during the year amounted to €1,500.

Required:

- Open the commission received account for 2019.
- Record the closing prepayment transaction in journal format.

Commission Received Account

Date	Debit	€	Date	Credit	€
1 Jan.	Accrual b/d (a)	300	31 Dec.	Bank (b)	1,500
31 Dec.	Income Statement	<u>1,630</u>	31 Dec.	Accrual c/d (c)	<u>430</u>
		<u>1,930</u>			<u>1,930</u>

Notes:

Transaction (a) – this represents accrued commission received of last year. Such amount was settled with the commission received by cheque in 2019.

Transaction (b) - this represents the commission received during the year. Normal give and take principle applied in this case. Take (debit) payment received by cheque and give (credit) commission receivable settled.

Transaction (c) – as in the previous example one needs to add the accrued commission received at the end of 2019 to the revenue settled during the year. Since accrued commission received reflects future money to be received by the organisation, one is required to consider them as a current asset in the statement of financial position.

Journal as at 31 st December 2019	Debit	Credit
Accrued commission received account	€430	
Commission received account		€430
Being accrued commission received recorded in the books.		

16.7 Accounting Treatment for Prepaid Revenue

Example: Prepaid Revenue at the End of the Year

In 2019 Adam Seale received commission of €1,000 by cheque. €200 of this commission reflected services not yet rendered by Adam Seale.

Required:

- Record the following transactions in the respective accounts.
- Record the closing prepaid commission received in journal format.

Commission Received Account

Date	Debit	€	Date	Credit	€
31 Dec.	Prepayments c/d (b)	200	31 Dec.	Bank (a)	1,000
31 Dec.	Income Statement	<u>800</u>			
		<u>1,000</u>			<u>1,000</u>

Notes:

Transaction (a) – this represents the commission received during the year. Normal give and take principle applied. Take (debit) money received and give (credit) commission is received and is no longer due.

Transaction (b) – prepaid revenue reflects money that was received by the organisation/individual but the service has not yet been rendered. The accruals concept states that revenue incurred in a particular year should be matched with expenses incurred in that year. Therefore, one needs to remove prepaid revenue from the commission received by debiting the commission received account. The prepayment needs to be considered as a liability since it reflects money already received but service not yet given. Thus, one needs to include it as part of the current liabilities in the statement of financial position.

Journal as at 31 st December 2019	Debit	Credit
Commission received account	€200	
Prepaid commission received account		€200
Being prepaid commission received posted in the accounts.		

Example: Prepaid Revenue at the Beginning and End of the Year

The prepaid revenue of Angelo Punch for 2018 and 2019 comprised the following:

	31/12/2018	31/12/2019
Prepaid royalties received	€280	€510

Royalties received by cheque during the year amounted to €1,900.

Required:

- Open the royalties received account for 2019.
- Record the closing prepayment transaction in journal format.

Royalties Received Account

Date	Debit	€	Date	Credit	€
31 Dec.	Prepayment c/d (c)	510	1 Jan.	Prepayment b/d (a)	280
31 Dec.	Income Statement	<u>1,670</u>	31 Dec.	Bank (b)	<u>1,900</u>
		<u>2,180</u>			<u>2,180</u>

Notes:

Transaction (a) – this consists of prepaid royalties received last year. This should be included with the royalties received of 2019 because such revenue will be incurred during 2019.

Transaction (b) – this represents the royalties received during the year. Normal give and take principle applied in this case. Take (debit) payment received by cheque and give (credit) royalties receivable settled.

Transaction (c) – as in the previous example one needs to deduct the prepaid royalties received at the end of 2019. This should be included with the current liabilities in the statement of financial position because it represents money received for royalties that have not yet been incurred.

Journal as at 31st December 2019	Debit	Credit
Royalties received account	€510	
Prepaid royalties received account		€510
Being prepaid royalties received recorded in the books.		

16.8 Accrued and Prepaid Revenue at the Same Time

Example: Rent Received Accrued and Commission Received Prepaid

The final accounts on 31st December 2018 of A. Smith comprised the following accrual and prepayment:

- The rent received account showed that €400 rent has not yet been received for the year ended 31st December 2018.
- The commission received account indicated that €200 had been received in advance for the year ended 31st December 2018.

The following revenue was received during the year ended 31st December 2019:

Rent Received	1 st January 2019	€300
	1 st March 2019	€600
	1 st July 2019	€900
	1 st October 2019	€800
Commission Received	1 st April 2019	€1,000

The accrual and prepayment at 31st December 2019 comprised the following:

Rent in arrears	€500
Insurance paid in advance	€260

Required:

Prepare the rent received account and commission received account for the year ended 31st December 2019.

Rent Received Account

Date	Debit	€	Date	Credit	€
1 Jan.	Accrual b/d (a)	400	1 Jan.	Bank (b)	300
31 Dec.	Income Statement	2,700	1 Mar.	Bank (b)	600
			1 July	Bank (b)	900
			1 Oct.	Bank (b)	800
		—	31 Dec.	Accrual c/d (d)	<u>500</u>
		<u>3,100</u>			<u>3,100</u>

Commission Received Account					
31 Dec.	Prepayments c/d (e)	260	1 Jan.	Prepayments b/d (c)	200
31 Dec.	Income Statement	<u>940</u>	1 April	Bank (b)	<u>1,000</u>
		<u>1,200</u>			<u>1,200</u>

As you can notice the same principle applied in the previous examples was applied for this question. For simplicity the transactions were noted as (a), (b), (c), (d) and (e) so you can easily follow the double-entry transactions.

Notes:

Transaction (a) – this represents the accrued rent receivable of last year. This rent was received in 1st January 2019.

Transactions (b) – these represent the money received during the year for rent and commission. Normal give and take principle are applied, where give (credit) is the rent and commission received, which are no longer due, and take (debit) comprises the money (bank) received.

Transaction (c) – this reflects prepaid commission received last year. This should be included with the commission received of 2019 because such income will be incurred during 2019.

Transaction (d) – at this stage one is required to reflect the closing accrual at the end of the year. Accrued revenue is an asset and thus it needs to be included with the current assets in the statement of financial position.

Transaction (e) – this transaction represents the closing prepayment at the end of the year. Prepaid revenue is a liability and therefore this needs to be included with the current liabilities in the statement of financial position.

Review Questions

Question 1

- a) What is meant by accrual? Provide an example to illustrate your answer.
- b) What is meant by prepayment? Provide an example to explain your answer.
- c) Explain the impact of accrued expenditure on the profitability of the organisation.
- d) Reflect the following transactions in the wages account:
Wages paid during the month of December 2019 by cheque amounted to €11,500. At the end of the year there was still €300 wages due.

Question 2

The following information is pertinent to the business of R. Maringe for the year ended 31st December 2019:

Balances at 1st January 2019:

Prepaid Insurance	€1,000
Accrued Wages	€300

Payments made during the year by cheque:

Insurance	€12,000
Wages	€23,500

Balances at 31st December 2019:

Prepaid Insurance	€2,000
Accrued Wages	€250

Required:

- a) Reflect the transactions in the insurance account and highlight the amount transferred to the income statement.
- b) Post the transactions in the wages account and outline the amount transferred to the income statement.
- c) Prepare the statement of financial position extract.

Question 3

The following information is relevant to the business of K. Armeni for the year ended 31st December 2019:

Balances at 1st January 2019:

Prepaid Rent	€800
Accrued Royalties Received	€180

Receipts and payments made during the year by cheque:

Rent Paid	€9,800
Royalties Received	€890

Balances at 31st December 2019:

Prepaid Rent	€1,000
Accrued Royalties Received	€230

Required:

- Reflect the transactions in the rent account and highlight the amount transferred to the income statement.
- Post the transactions in the royalties received account and outline the amount transferred to the income statement.
- Prepare the statement of financial position extract.

CHAPTER 17

ERRORS NOT IDENTIFIED BY THE TRIAL BALANCE

Objectives

After you have read this chapter you should be able to:

- Identify errors that do not affect the trial balance;
- Correct errors that do not affect the trial balance; and
- Distinguish between the different types of errors that do not influence the trial balance.

17.1 Errors not Revealed by a Trial Balance

As explained in chapter 7 a trial balance is a statement which distinguishes between those accounts that hold a debit balance and those with a credit balance. If the total of the debit side equals the total of the credit side, then the ledger accounts are correct. However, there are certain errors unveiled in this chapter which are not revealed by a trial balance. These are discovered with the help of proper internal controls adopted by the accountant and/or internal auditor. These errors are described in this section with the help of examples.

17.1.1. Error of Omission

This error arises when transactions are not recorded in the accounts.

Example: Bought stationary costing €50 by cheque. This transaction was not recorded in the accounts.

This transaction is corrected as follows:

Journal	Debit	Credit
Stationery account	€50	
Bank account		€50
Being a correction of an error of omission.		

Normal give and take principle applied to post this transaction:

Take (debit side) – Stationery account

Give (credit side) – Payment through bank account

17.1.2. Error of Commission

This error occurs when a posting is made to a wrong personal account.

Example: J. Smith, a trade receivable, paid the amount due of €200 by cheque. This transaction was properly entered in the bank account but was incorrectly credited to S. Smith account.

Subsidiary ledgers are used in order to further illustrate the error and its respective correction.

S. Smith Account

Debit	€	Credit	€
J. Smith	200	Bank	200
J. Smith Account			
		S. Smith	200

The payment was entered in the wrong account, which is S. Smith account. To correct the error one needs to remove it from S. Smith account (debit) and post it to the correct account, which is J. Smith account (credit).

Journal	Debit	Credit
S. Smith account	€200	
J. Smith account		€200
Being a correction of an error of commission.		

17.1.3. Error of Principle

This error arises when a posting is made to an account which is not only the wrong account, but of the wrong type.

Example: Bought a motor van costing €9,000 paying by cheque. This was recorded properly in the bank account but debited incorrectly to the rent account.

Motor Van Account

Debit	€	Credit	€
Rent	9,000		
Rent Account			
Bank	9,000	Motor van	9,000

The payment was entered in the wrong account (Rent account). To correct this error one should transfer it from the rent account to the correct account (Motor Van account) by debiting motor van and crediting rent.

Journal	Debit	Credit
Motor van account	€9,000	
Rent account		€9,000
Being a correction of an error of principle.		

17.1.4. Complete Reversal of Entries

This error occurs when both entries are entered on the other side of the correct accounts.

Example: Paid insurance of €200 by cheque. Incorrectly, this entry was debited in the bank account and credited in the insurance account.

Bank Account

Debit	€	Credit	€
Insurance	200	Insurance	400
Insurance Account			
Bank	400	Bank	200

An amount posted to the wrong side of an account causes an error twice its own size. The correct entry should have been debit the insurance account

and credit the bank account. In order to cancel the wrong transaction and pass the correct transaction one needs to multiply the amount by 2 and post it to the other side.

Journal	Debit	Credit
Insurance account	€400	
Bank account		€400
Being a correction of complete reversal of entries.		

17.1.5. An Error of Original Entry

Arises where the amounts of the transactions recorded are wrong, but the double entry is still correct.

When the amount recorded is lower than the actual amount

Example: Paid wages by cash amounting to €350. This transaction was recorded as €300 in the general ledger.

Wages Account

Debit	€	Credit	€
Cash	300		
Cash	50		
Cash Account			
		Wages	300
		Wages	50

In this case one needs to record the difference between the correct amount (€350) and the amount recorded (€300) in the accounts. Normal give and take principle applied:

Take (Debit side) – wages settled

Give (Credit side) – payment by cash.

Journal	Debit	Credit
Wages account	€50	
Cash account		€50
Being a correction of an error of original entry.		

When the amount recorded is higher than the actual amount

Example: Paid electricity bill by cheque amounting to €100. This transaction was recorded as €120 in the general ledger.

Electricity Account

Debit	€	Credit	€
Bank	120	Bank	20
Bank Account			
Electricity	20	Electricity	120

In this case the difference one needs to remove is the excess amount recorded in the accounts, which comprises €20 (€120 - €100). In the electricity account the €120 were posted on the debit side. Therefore, in order to deduct the difference of €20 it should be entered on the credit side. The same principle applies to the bank account.

Journal	Debit	Credit
Electricity account	€20	
Bank account		€20
Being a correction of an error of original entry.		

17.1.6. Transposition Error

This error arises when the wrong sequence of the individual characters within a number are entered.

When the amount recorded is lower than the actual amount

Example: Paid telephone expenses by cash amounting to €132. These were recorded in the accounts as €123.

Telephone Expenses Account

Debit	€	Credit	€
Cash	123		
Cash	9		
Cash Account			
		Telephone expenses	123
		Telephone expenses	9

In this case one is required to record the difference between the correct amount (€132) and the amount recorded (€123) in the accounts. Normal give and take principle applied:

Take (Debit side) – telephone expenses paid
Give (Credit side) – payment by cash.

Journal	Debit	Credit
Telephone expenses account	€9	
Cash account		€9
Being a correction of an error of transposition.		

When the amount recorded is higher than the actual amount

Example: Paid rates by cheque amounting to €145. These were recorded in both accounts as €154.

Rates Account

Debit	€	Credit	€
Bank	154	Bank	9
Bank Account			
Rates	9	Rates	154

In this case the difference one needs to remove is the excess amount posted in the accounts, which consists of €9 (€154 - €145). In the rates account the €154 were posted on the debit side. Thus, in order to deduct the difference of €9 it should be posted on the credit side. The same principle applies to the bank account.

Journal	Debit	Credit
Bank account	€9	
Rates account		€9
Being a correction of an error of transposition.		

17.1.7. Compensating Errors

These are errors which cancel each other out. If sales of €4,000 are posted to the sales account as €4,010, the credit balance of the trial balance would be €10 higher. However, if purchases of €3,100 are posted to the purchases account as €3,110, then the debit balance of the trial balance would also be €10 higher. Thus, the trial balance would still agree.

Example: Paid rent by cheque amounting to €230. This was recorded in the rent account as €220. One of our receivables, B. Terry paid us €300 by cheque. The receipt in the personal account of the receivable was recorded as €290.

Rent Account

Debit	€	Credit	€
Bank	220		
S. Smith	10		
B. Terry Account			
		Bank	290
		Rent	10

The errors are in the rent account and in B. Terry account. The debit side of the rent account is understated by €10, while the credit side of B. Terry account is understated by €10. In order to correct the error, one needs to increase the understated columns of both accounts.

Journal	Debit	Credit
Rent account	€10	
B. Terry account		€10
Being a correction of a compensating error.		

Review Questions

Question 1

- What is the main reason why the trial balance should agree?
- What is an error of commission?
- Give an example of an error of commission.
- What is a transposition error?
- Give an example of an error of transposition.

Question 2

The accounts clerk has prepared the trial balance as at 31st March 2019, which agreed. However, upon further investigation the accountant discovered the following errors:

- i) Purchases on credit from Marija Spiteri of €650 were not recorded in the accounts.
- ii) Insurance paid by cheque of €320 was correctly recorded in the bank account but was erroneously reflected in the rent account.
- iii) A payment of stationery of €23 by cash was inputted in both accounts as €32.
- iv) Sales on credit of €200 to Olivia Ferry were posted in the wrong side of each account.
- v) Purchases of €150 from Alfred Micallef were recorded in Antoine Mifsud account.

Required:

- a) Identify the errors made by the accounts clerk.
- b) Correct these errors in the subsidiary ledgers (accounts).

Question 3

With reference to question 2 adjust the mistakes made by the accounts clerk through Journals.

CHAPTER 18

THE SUSPENSE ACCOUNT

Objectives

After you have read this chapter you should be able to:

- Open the suspense account;
- Identify errors that are reflected in the suspense account; and
- Close the suspense account by adjusting the errors identified.

18.1 Errors which Affect the Trial Balance

The suspense account is opened when there is a difference between the total debit side and the total credit side of the trial balance. The business transactions should then be investigated in order to identify the errors, close the suspense account and prepare the final accounts.

There are a variety of errors which affect the trial balance. As a basic principle one entry is made in the respective account in order to correct the error, while the other entry is passed in the suspense account in order to close this account.

There are certain errors which will affect the profit of the business, while there are other errors that will not affect the profit of the organisation. It is important to make a distinction between these two kinds of errors.

Errors which affect the profit of the business.	Errors which do not affect the profit of the organisation.
Errors on all expenses.	Errors on all non-current assets.
Errors on all gains.	Errors on all current assets.
Errors on the sales account.	Errors on all current liabilities.
Errors on the purchases account.	Errors on all non-current liabilities.
Errors on the returns in and returns out accounts.	Errors on the capital account.
	Errors on the drawings account.

Basically, errors that influence the items shown in the statement of financial position with the exception of the profit figure comprise errors which do not affect the profit of the business.

Example: Correction of Errors and Revision of Profit

Roger Smith extracted a trial balance as at 31st December 2019. The trial balance totals were: Debit side – €10,600 and Credit side – €10,923. Roger debited the difference of €323 to a suspense account in order to prepare a draft Income Statement. The net profit for the year resulted in €3,700 before the correction of any errors.

After further investigations, Roger discovered the following errors:

1. Discounts allowed of €70 were correctly posted in the receivables account but were omitted from the discounts allowed account.
2. Rent expense paid by cheque of €150 had been wrongly credited to the Rent account.
3. Wages of €700 paid by cheque were correctly entered in the bank account but were mistakenly entered in the motor vehicles account.
4. During the year bought office equipment amounting to €365 by cheque. This was wrongly entered as Lm356 in both accounts.
5. A cheque paid to S. Jones of €120 was correctly credited to the bank account as €120 but was wrongly entered in payables account as €167.

Required:

- a) The suspense account.
- b) The journal entries to correct the errors identified.
- c) A revised profit figure for the year ended 31st December 2019.

Part a)

First one needs to examine if the errors affect the suspense account or not. As a general guideline, the only errors that do not affect the suspense account are those types of errors discussed in chapter 17. These errors are analysed below:

Error 1 – Omitted from discount allowed account only implies that it will affect the suspense account.

Error 2 – Rent expense credited incorrectly instead of debited. It will affect the suspense account.

Error 3 – Error of Principle. It will not affect the suspense account.

Error 4 – Transposition error. It will not affect the suspense account.

Error 5 – Amount incorrectly entered in payables account only. It will affect the suspense account.

Suspense Account

Debit	€	Credit	€
Balance b/d (a)	323	Discount allowed (b)	70
S. Jones (d)	<u>47</u>	Rent (c)	<u>300</u>
	<u>370</u>		<u>370</u>
Discounts Allowed Account			
Suspense (b)	<u>70</u>	Income Statement	<u>70</u>
Rent Account			
Suspense (c)	<u>300</u>	Income Statement	<u>300</u>
S. Jones Account			
Balance c/d	<u>47</u>	Suspense (d)	<u>47</u>

Notes:

Transaction (a) – The first amount that is entered in the suspense account is the amount making up the difference in the trial balance between the total debit side and the total credit side. This is referred to as the Balance b/d and is either entered on the debit side or on the credit side of the suspense account depending on the difference.

Rule of thumb:

If the debit side is greater than the credit side, the balance b/d is entered on the credit side of the suspense account.

If the debit side is smaller than the credit side (like in this example), the balance b/d is entered on the debit side of the suspense account.

Transaction (b) – In this error the discount was omitted from the discount allowed account only. Therefore, one needs to add the discount allowed by debiting it and deduct the error from the suspense account by crediting it.

Transaction (c) – This error consisted of a rent expense entered on the wrong side of the rent account. Thus, one is required to multiple the amount by 2 because the error made needs to be adjusted and the transaction must be inputted as well.

Transaction (d) – In this case the difference between the actual amount (€167) and the recorded amount (€120) should be deducted from the amount reflected in S. Jones account. In the payables account the previous amount was on the debit side. Therefore, in order to deduct the difference of €47 it should be entered on the credit side.

Journal (€)	Debit	Credit
Error no. 1:		
Discounts allowed account	70	
Suspense account		70
Being discount omitted from the discount allowed account.		

Error no. 2:		
Rent account	300	
Suspense account		300
Being rent recorded on the wrong side of the rent account.		

Error no. 3:		
Wages account	700	
Motor vehicle account		700
Being a correction of an error of principle.		

Error no. 4:		
Office equipment account	9	
Bank account		9
Being a correction of a transposition error.		

Error no. 5:		
Suspense account	47	
S. Jones account		47
Being a payment to a S. Jones overstated in the personal account.		

First one needs to determine which errors affect the profit of the business. This can be done by looking at the accounts where changes were made in order to correct the errors. The following errors affect the profit figure:

Error no. 1 – It affects the discount allowed account which appears as an expense in the income statement.

Error no. 2 – It affects the rent account which is an expense in the income statement.

Error no. 3 - It affects the wages accounts which consists of an expense in the income statement.

Revised Profit Statement for the year ended 31st December 2019	€
Profit before correction of errors	3,700
Less: Discounts allowed	70
Less: Rent	300
Less: Wages	<u>700</u>
Revised net profit	<u>2,630</u>

The profit before the corrected errors of €3,700 was taken from the question.

The errors can either be added or deducted from the profit figure. The following rule of thumb shows the transactions that increase the profit figure and the transactions that diminish the profit figure:

Item	Increase	Decrease
Sales	Add to net profit	Deduct from net profit
Returns Outwards	Add to net profit	Deduct from net profit
Gains	Add to net profit	Deduct from net profit
Purchases	Deduct from net profit	Add to net profit
Returns Inwards	Deduct from net profit	Add to net profit
Expenses	Deduct from net profit	Add to net profit

Review Questions

Question 1

- a) Why is an organisation required to open a suspense account?
- b) The following errors were discovered:
- i) Discount allowed of €150 was reflected on the credit side of the discount received account.
 - ii) A payment of €480 to a supplier by cheque was erroneously reflected in the cash account.
 - iii) Purchases were understated by €123.
 - iv) The owner withdrew €800 cash for personal use. This was recorded in the cash account and general expenses account.
 - v) Sales were overstated by €160.

Indicate the errors that will affect the profit figure and state the monetary impact of these errors on the net profit of €12,000.

Question 2

Andre Seale prepare the trial balance as at 30th April 2019. The trial balance did not agree where the debit side amounted to €125,010 while the credit side amounted to €127,500. The transactions were investigated and the following errors were identified:

- i) Purchases were overstated by €1,500.
- ii) Insurance of €1,250 was posted as €1,520 in the insurance account.
- iii) Stationery of €110 was bought by cheque. This was not reflected in the stationery account.
- iv) Sales was overstated by €4,250.
- v) Discount received of €100 was not recorded in the discount received account.

Required:

- a) Open the suspense account and reflect the relevant mistakes to the suspense account and other respective accounts.
- b) The profit generated by the organisation amounted to €8,950. Calculate the profit figure after reflecting the relevant mistakes.

Question 3

John Xuereb is a sole trader who discovered that the debit side of the trial balance of May 2019 was €740 higher than the credit side. The following errors were identified after investigating the accounts:

- i) Equipment of €300 purchased by cheque was wrongly posted in the purchases account.
- ii) Received €230 from L. Mangion for goods sold on credit. This was incorrectly posted to L. Abela's account.
- iii) Returns in were overstated by €30.
- iv) Returns out were overstated by €50.
- v) Rent paid by cash of €200 was incorrectly posted in the cash account as €2,000.
- vi) Sales were understated by €2,500.
- vii) Discount received of €30 was erroneously posted on the debit side of the discount allowed account.

Required:

- a) Open the suspense account and correct the relevant mistakes to the suspense account and other respective accounts.
- b) Adjust all the errors through a journal.
- c) Calculate the profit after reflecting the pertinent mistakes. The profit generated by the firm was €7,500.

PART 6:

**FINAL ACCOUNTS OF DIFFERENT
TYPES OF ORGANISATIONS**

CHAPTER 19

FINAL ACCOUNTS OF A DEPARTMENTAL ORGANISATION

Objectives

After you have read this chapter you should be able to:

- Define department stores;
- Understand the uses of departmental accounts;
- Apportion the expenditure between the different departments; and
- Prepare the income statement and the statement of financial position of department stores.

6.1 Department Stores

Department stores consist of organisations that develop retail establishments, which sell numerous consumable products. These consumable products are classified in diverse categories, such as cosmetics, home products and office supplies.

6.2 Uses of Departmental Accounts

The preparation of departmental accounts helps to provide more detailed financial information to external users like investors and lenders. Departmental accounts show the profit generated by each department. Thus, external users can assess the profitability of each department. Departmental accounts are also useful to internal users like management in order to evaluate the financial performance of the department. The following example helps to illustrate this point in further depth:

Example: Information Provided by Departmental Accounts

An enterprise has two departments, which are Cosmetics and Electronic Consumables. The sales and expenses incurred by each department are as follows:

	€
Sales: Cosmetics	30,000
Electronic Consumables	20,000
Costs: Cosmetics	16,000
Electronic Consumables	24,000

The total profit figure would be as follows:

Sales (€30,000 + €20,000)	€50,000
Costs (€16,000 + €24,000)	<u>€40,000</u>
Net profit	<u>€10,000</u>

The total profit figure of €10,000 indicates that the departmental stores are operating profitably. However, something interesting emerges when one looks at each department store separately. This is done below:

Department Profit Statement	Cosmetics	Electronic Consumables
Sales	€30,000	€20,000
Less: costs	<u>€16,000</u>	<u>€24,000</u>
Net profit/(loss)	<u>€14,000</u>	<u>(€4,000)</u>

The departmental profit statement indicates that the Electronic Consumables Department is generating losses of €4,000. Thus, measures should be adopted by management in order to enhance the profitability of this section. Otherwise, it is financially feasible to close the section because the total profitability of the organisation would increase by €4,000.

6.3 Allocation and Apportionment of Revenue and Expenditure

In departmental accounts one is required to allocate and apportion expenditure between different departments. There are certain items like sales, purchases and inventory balances that can be easily traced to each department. In this case there is no need of apportionment. However,

expenses like rent, water and electricity, and administration costs need to be apportioned between each department through an adequate basis of apportionment. For example, electricity will be apportioned in the accordance to the floor area of each department.

Example: Allocation and Apportionment of Revenue and Expenditure

The following items reflect the balances of Departments A and B for the year ended 31st December 2019:

Items	€
Sales: Department A	90,000
Department B	75,000
Purchases: Department A	45,000
Department B	30,000
Inventories at 1 st January:	
Department A	9,000
Department B	4,500
Rates	3,400
Insurance	900
Administrative Salaries	12,000
Electricity	1,900
Delivery Costs	3,400
General Expenses	1,200
Inventories at 31 st December	
Department A	10,000
Department B	2,000

Expenses should be apportioned on the following bases:

Administrative salaries, insurance and general expenses in the ratio 3:2

Electricity – in proportion to the floor area, which is Department A 600m² and Department B 400m².

Delivery costs – in proportion to sales.

All other expenses should be apportioned equally between the departments.

Income Statement for the year ended 31 st December 2019	Department A		Department B	
	€	€	€	€
Sales		90,000		75,000
<u>Less: Cost of Sales:</u>				
Opening stock	9,000		4,500	
Purchases	<u>45,000</u>		<u>30,000</u>	
	54,000		34,500	
Less: closing stock	<u>10,000</u>	<u>44,000</u>	<u>2,000</u>	<u>32,500</u>
Gross profit		46,000		42,500
<u>Less: Expenses:</u>				
Rates	1,700		1,700	
Insurance	540		360	
Administrative salaries	7,200		4,800	
Electricity	1,140		760	
Delivery costs	1,855		1,545	
General expenses	<u>720</u>	<u>13,155</u>	<u>480</u>	<u>9,645</u>
Net profit		<u>32,845</u>		<u>32,855</u>

Workings:

Apportionment of Rates (Equally):

Department A = €3,400/2 = €1,700

Department B = €3,400/2 = €1,700

Apportionment of Insurance (3:2):

Department A: €900 x 3/5 = €540

Department B: €900 x 2/5 = €360

Apportionment of Administrative Salaries (3:2):

Department A: €12,000 x 3/5 = €7,200

Department B: €12,000 x 2/5 = €4,800

Apportionment of Electricity (Floor Area):

Department A: €1,900 x 600/(600 + 400) = €1,140

Department B: €1,900 x 400/(600 + 400) = €760

Apportionment of Delivery Costs (Sales):

Department A: €3,400 x €90,000/(€90,000 + €75,000) = €1,855

Department B: €3,400 x €75,000/(€90,000 + €75,000) = €1,545

Apportionment of General Expenses (3:2):

Department A: €1,200 x 3/5 = €720

Department B: €1,200 x 2/5 = €480

Example: Detailed Income Statement of Department Stores

Felix is the owner of a department store in London that mainly holds three departments, which are Cosmetics, Stationery and Houseware. The trial balance as at 31st December 2019 is shown below:

	€	€
Capital		150,000
Sales: Cosmetics		75,000
Stationery		47,000
Houseware		41,000
Purchases: Cosmetics	30,000	
Stationery	18,500	
Houseware	9,650	
General Expenses	14,000	
Trade Receivables	11,000	
Trade Payables		8,000
Bank	4,230	
Cash	2,030	
Heat and Light	5,000	
Repairs	3,000	
Inventories at 1 st January:		
Cosmetics	4,000	
Stationery	4,800	
Houseware	2,040	
Rates	5,000	
Discount Received: Cosmetics		450
Houseware		300
Insurance	5,500	
Fuel Costs	3,000	
Administrative Salaries	30,000	
Premises	145,000	
Employee Salaries	20,000	
Advertising	<u>5,000</u>	
	<u>321,750</u>	<u>321,750</u>

Additional Information:

1. Inventories at 31st December were as follows: Cosmetics €3,500, Stationery €5,000 and Houseware €2,400.
2. Administrative salaries are apportioned in proportion to the number of managers, which is as follows: Cosmetics 4, Stationery 4 and Houseware 2.

3. Employees' salaries are apportioned in line to the number of employees, which comprises: Cosmetics 80, Stationery 20 and Houseware 100.

4. Accrued employees' salaries was: Cosmetics €150, Stationery €80 and Houseware €100.

5. Prepaid insurance was: Cosmetics €70, Stationery €20 and Houseware €50.

6. Heat and Light is apportioned in line to floor area, which is Cosmetics 300m², Stationery 200m² and Houseware 500m².

7. Other expenses are apportioned as follows:

Expenses	Cosmetics	Stationery	Houseware
General Expenses	30%	40%	30%
Repairs	8%	2%	90%
Rates	30%	35%	35%
Insurance	18%	2%	80%
Fuel Costs	10%	5%	85%
Advertising	50%	25%	25%

Required:

- Prepare the departmental income statement for Felix.
- Prepare the statement of financial position.

Departmental Income Statement for the year ended 31 st December 2019	Cosmetics		Stationery		Houseware	
	€'000	€'000	€'000	€'000	€'000	€'000
Sales		75.00		47.00		41.00
Cost of Sales:						
Opening Stock	4.00		4.80		2.04	
Purchases	<u>30.00</u>		<u>18.50</u>		<u>9.65</u>	
	34.00		23.30		11.69	
Closing Stock	<u>3.50</u>	<u>30.50</u>	<u>5.00</u>	<u>18.30</u>	<u>2.40</u>	<u>9.29</u>
Gross Profit		44.50		28.70		31.71
Add: Revenue:						
Discount Received		<u>0.45</u>				<u>0.30</u>
		44.95				32.01
Less: Expenses:						
General Expenses	4.20		5.60		4.20	
Heat and Light	1.50		1.00		2.50	

Repairs	0.24		0.06		2.70	
Rates	1.50		1.75		1.75	
Insurance	0.92		0.09		4.35	
Fuel Costs	0.30		0.15		2.55	
Administrative Salaries	12.00		12.00		6.00	
Employees' Salaries	8.15		2.08		10.10	
Advertising	<u>2.50</u>	<u>31.31</u>	<u>1.25</u>	<u>23.98</u>	<u>1.25</u>	<u>35.40</u>
Net Profit/(Loss)		<u>13.64</u>		<u>4.72</u>		<u>(3.39)</u>

Workings:

Apportionment of General Expenses (Table Given):

Cosmetics: €14,000 x 30% = €4,200

Stationery: €14,000 x 40% = €5,600

Houseware: €14,000 x 30% = €4,200

Apportionment of Heat and Light (Floor Area):

Cosmetics: €5,000 x 300/(300 + 200 + 500) = €1,500

Stationery: €5,000 x 200/(300 + 200 + 500) = €1,000

Houseware: €5,000 x 500/(300 + 200 + 500) = €2,500

Apportionment of Repairs (Table Given):

Cosmetics: €3,000 x 8% = €240

Stationery: €3,000 x 2% = €60

Houseware: €3,000 x 90% = €2,700

Apportionment of Rates (Table Given):

Cosmetics: €5,000 x 30% = €1,500

Stationery: €5,000 x 35% = €1,750

Houseware: €5,000 x 35% = €1,750

Apportionment of Insurance (Table Given):

Cosmetics: €5,500 x 18% = €990

Stationery: €5,500 x 2% = €110

Houseware: €5,500 x 80% = €4,400

Consideration of Prepaid Insurance:

Cosmetics: €990 - €70 = €920

Stationery: €110 - €20 = €90

Houseware: €4,400 - €50 = €4,350

Apportionment of Fuel Costs (Table Given):

Cosmetics: €3,000 x 10% = €300

Stationery: €3,000 x 5% = €150

Houseware: €3,000 x 85% = €2,550

Apportionment of Administrative Salaries (Number of Managers):

Cosmetics: $\text{€}30,000 \times 4/(4 + 4 + 2) = \text{€}12,000$ Stationery: $\text{€}30,000 \times 4/(4 + 4 + 2) = \text{€}12,000$ Houseware: $\text{€}30,000 \times 2/(4 + 4 + 2) = \text{€}6,000$

Apportionment of Employees' Salaries (Number of Employees):

Cosmetics: $\text{€}20,000 \times 80/(80 + 20 + 100) = \text{€}8,000$ Stationery: $\text{€}20,000 \times 20/(80 + 20 + 100) = \text{€}2,000$ Houseware: $\text{€}20,000 \times 100/(80 + 20 + 100) = \text{€}10,000$

Consideration of Accrued Employees' Salaries:

Cosmetics: $\text{€}8,000 + \text{€}150 = \text{€}8,150$ Stationery: $\text{€}2,000 + \text{€}80 = \text{€}2,080$ Houseware: $\text{€}10,000 + \text{€}100 = \text{€}10,100$

Apportionment of Advertising (Table Given):

Cosmetics: $\text{€}5,000 \times 50\% = \text{€}2,500$ Stationery: $\text{€}5,000 \times 25\% = \text{€}1,250$ Houseware: $\text{€}5,000 \times 25\% = \text{€}1,250$

Statement of Financial Position as at 31st December 2019	€'000	€'000
<u>Non-Current Assets:</u>		
Premises		145.00
<u>Current Assets:</u>		
Stock ($\text{€}3.50 + \text{€}5.00 + \text{€}2.40$)	10.90	
Trade Receivables	11.00	
Prepaid Expenses ($\text{€}0.07 + \text{€}0.02 + \text{€}0.05$)	0.14	
Bank	4.23	
Cash	<u>2.03</u>	<u>28.30</u>
Total Assets		<u>173.30</u>
<u>Financed By:</u>		
Capital		150.00
Add: Net Profit ($\text{€}13.64 + \text{€}4.72 - \text{€}3.39$)		<u>14.97</u>
		164.97
<u>Current Liabilities:</u>		
Trade Payables	8.00	
Accrued Expenses ($\text{€}0.15 + \text{€}0.08 + \text{€}0.10$)	<u>0.33</u>	
Total Current Liabilities		<u>8.33</u>
Total Capital and Liabilities		<u>173.30</u>

Review Questions

Question 1

Karl owns a department store that holds two departments, which consist of Toys and Electricals. The firm's trial balance for the financial year ended 31st December 2019 is shown below:

	€	€
Sales: Toys		273,100
Electricals		390,000
Inventories: Toys	17,500	
Electricals	21,000	
Purchases: Toys	130,000	
Electricals	204,000	
General Expenses	3,000	
Office Equipment	2,500	
Trade Payables		10,000
Salaries and Wages	40,000	
Bank	10,000	
Machinery	10,000	
Motor Vehicles	3,000	
Trade Receivables	14,000	
Fuel Costs	2,000	
Repairs and Maintenance	1,000	
Administration Expenses	50,000	
Premises	200,000	
Capital		110,000
Advertising	50,000	
Discounts Allowed:		
Toys	50	
Electricals	500	
Insurance	3,550	
Drawings	9,000	
Rent	<u>12,000</u>	
	<u>783,100</u>	<u>783,100</u>

Additional Information:

1. Inventories at 31st December comprised the following: Toys €18,000 and Electricals €20,000.

2. Salaries and wages are apportioned in proportion to the number of staff, which consist of: Toys 3 and Electricals 7.
3. Rent is apportioned in line to the floor area, which comprise: Toys 800 and Electricals 400 square metres.
4. Accrued advertising was: Toys €200 and Electricals €310.
5. Prepaid Rent was: Toys €800 and Electricals €400.
6. Insurance and fuel costs are apportioned in line to the number of motor vehicles, which are Toys 1 and Electricals 4.
7. Other expenses were apportioned as follows:

Expenses	Toys	Electronics
General Expenses	50%	50%
Repairs and Maintenance	20%	80%
Administration Expenses	10%	90%
Advertising	40%	60%

Required:

- a) Prepare the department income statement for the year ended 31st December 2019.
- b) Prepare the statement of financial position.

Question 2

Alfred Sammut manages three department stores: X, Y and Z. The trial balance as at 31st December 2019 is shown below:

	€	€
Sales: X		100,000
Y		60,000
Z		55,000
Inventory: X	10,000	
Y	2,000	
Z	7,500	
Purchases: X	55,000	
Y	30,000	
Z	32,000	
Trade Receivables and Payables	8,000	7,500
Bank	10,000	
Premises	98,000	
Fixtures and Fittings	25,500	
Motor Vehicles	32,400	

Fuel Costs	4,600	
Repairs and Maintenance	500	
Selling and Distribution Expenses	5,000	
Discounts Allowed:		
Y	80	
Z	20	
Administration Expenses	5,800	
Salaries and Wages	2,000	
Capital		120,000
Rent and Rates	400	
Carriage Out	600	
Drawings	8,000	
Insurance	4,800	
Stationery and Printing	<u>300</u>	
	<u>342,500</u>	<u>342,500</u>

Additional Information:

1. Closing inventory at 31st December 2019: X €5,500; Y €5,400 and Z €5,800.
2. Insurance prepared amounted to €100.
3. Insurance is distributed between X, Y and Z in the following ratio: 4:4:2
4. Stationery and printing and carriage out are distributed equally between the departments.
5. Accrued salaries and wages amounted to €500.
6. Salaries and wages are distributed in line to the number of employees, which is: X 30 employees, Y 25 employees and Z 45 employees.
7. Administration expenses, and rent and rates are distributed between X, Y and Z as follows: 2:1:2.
8. Fuel costs, selling and distribution expenses, and repairs and maintenance are apportioned in line to the number of motor vehicles, which is as follows: X 5 motor vehicles, Y 8 motor vehicles and Z 7 motor vehicles.

Required:

- a) Prepare the department income statement for the year ended 31st December 2019.
- b) Prepare the statement of financial position.

Question 3

An organisation holds three department stores, which are A, B and C. The respective trial balance for the year ended 30th April 2019 is shown below:

	€	€
Sales: A		330,000
B		289,000
C		140,000
Inventories at 1 May 2018:		
A	25,500	
B	42,600	
C	11,800	
Purchases: A	145,000	
B	62,000	
C	90,000	
Trade Receivables and Payables	18,000	8,900
Cash in hand	1,500	
Cash at bank	20,000	
Premises	275,000	
Fixtures and Fittings	30,000	
Provision for Depreciation Fixtures and Fittings		6,000
Motor Vehicles	25,000	
Provision for Depreciation Motor Vehicles		900
Returns Inwards:		
A	230	
C	300	
General Expenses	3,200	
Repairs and Maintenance	9,000	
Discounts Received:		
A		250
B		120
C		60
Bad Debts	1,200	
Salaries and Wages	20,000	
Capital		50,000
Light and Heat	2,000	
Rent	1,700	
Drawings	35,800	

Stationery and Postage	900	
Rates	4,500	
	<u>825,230</u>	<u>825,230</u>

Additional Information:

1. Inventories at 30th April 2019 consist of: A €23,000, B €32,000 and C €13,000.
2. The provision for depreciation on fixtures and fittings is 10% on cost.
3. The provision for depreciation for motor vehicles is 5% on cost.
4. Stationery and Postage, depreciation on fixtures and fittings, repairs and maintenance, general expenses and rates are divided equally between the departments.
5. Depreciation on motor vehicles is spread in line to the number of vans, which is as follows: A 6 cars, B 2 cars and C 2 cars.
6. Bad debts are divided in accordance to sales revenue.
7. Accrued light and heat amounted to €100.
8. Light and heat, and rent are apportioned in compliance to floor area, which is: A 100, B 200 and C 300 square metres.
9. Salaries and wages not yet paid on 30th April 2019 are €1,000.
10. Salaries and wages are divided in line to the number of employees, which comprises the following: A 20 employees, B 10 employees and C 20 employees.

Required:

- a) Prepare the department income statement for the year ended 30th April 2019.
- b) Prepare the statement of financial position.

CHAPTER 20

FINAL ACCOUNTS OF A MANUFACTURING FIRM

Objectives

After you have read this chapter you should be able to:

- Understand the key information provided by the manufacturing account;
- Distinguish between direct production costs and indirect production overheads;
- Prepare the manufacturing account;
- Reflect the production cost of goods completed in the income statement; and
- Post the three different types of inventory in the statement of financial position.

20.1 Key Information Provided by the Manufacturing Account

There are certain business enterprises that are involved in the physical production of a good, like for example cars and electronic equipment. An additional account is developed for these manufacturing organisations, which is known as the manufacturing account. This is prepared with the final accounts of the firm and it helps in the determination of the total cost of producing the goods. Furthermore, the manufacturing account highlights new types of costs, which are production costs that have not yet been outlined in this textbook.

20.2 Different Types of Costs

20.2.1 Fixed and Variable Costs

Fixed costs are costs, which do not vary in compliance to the units produced by the manufacturing enterprise. Indeed, fixed costs also occur even if no production is made during that period. Rent is a typical example of such cost. If the factory was on a rental agreement, the firm would still have to pay the rent even if it did not produce anything during that particular month.

Variable costs are costs that vary in line to the units produced by the manufacturing enterprise. Examples of variable costs are water and electricity, fuel costs, and labour.

20.2.2 Prime Cost and Production Overheads

There are two types of costs which take place in a manufacturing organisation. These are known as direct costs and indirect costs.

Direct costs are costs, which vary, in direct proportion with the units produced and can be traced directly to a particular product. Direct costs are usually made up of the following:

- Direct materials – these are raw materials necessary to manufacture the product. For example, the direct materials of a manufacturer of furniture will be the cost of wood involved in the production of the furniture.
- Direct labour – these are the costs of the workers involved in the manufacturing process of the goods. For example, a manufacturer of furniture requires 10 employees to produce 1,000 tables per month, and each worker takes 5 hours to produce these tables at a wage rate of €6 per hour. The direct labour cost would amount to €300 ($€6 \times 5 \times 10$).
- Direct expenses – these consist of any other expenses directly incurred in the production process, which can be traceable to a particular product. For example, fuel costs incurred by a machine producing tables.

The total of all these direct costs makes up the prime cost, which is shown in the manufacturing account.

Indirect costs are costs that cannot be directly attributable to a particular product. For example, factory electricity and indirect factory wages. Factory overheads are costs generated during the production process. Examples of factory overheads encompass factory water and electricity, and factory rent.

The manufacturing account is made up of the prime cost added to the factory overheads and comprises any movements in raw materials and work in progress during the period. A more detailed illustration of the manufacturing account is shown below by using fictitious figures:

Manufacturing account for the year ended.....	Notes	€	€
Opening stock of raw materials			1,000
Add: purchases of raw materials			10,000
Less: returns of raw materials			500
Add: carriage of raw materials			<u>250</u>
			11,250
Less: closing stock of raw materials			<u>1,100</u>
Cost of raw materials consumed	A		10,150
Add: Direct wages			5,000
Add: Direct expenses			<u>3,000</u>
Prime cost	B		18,150
<u>Add: Factory Overheads:</u>	C		
Water and electricity		350	
Rent		1,200	
Depreciation of machinery		<u>1,500</u>	<u>3,050</u>
			21,200
Add: opening stock of work in progress	D		<u>500</u>
			21,700
Less: closing stock of work in progress	D		<u>800</u>
Production cost of goods completed	E		<u>20,900</u>

Notes:

A - The initial step of the manufacturing account is the computation of the cost of the raw materials used in production (direct materials). This is done by including the purchases of raw materials and its associated costs, and the movement in raw material stock during the year.

B - Once the costs of raw material consumed is calculated, all the other direct costs are added to this figure in order to derive the prime cost (total direct costs).

C - The next stage consists of including all the factory overheads (costs that are associated with the production of the goods). In this stage some expenses will need to be divided between the factory (in the manufacturing account) and the administration (in the income statement) in compliance to a suitable basis of apportionment.

D - Finally, the movement in work in progress needs to be included.

E - The ending figure of the manufacturing account is known as the production cost of goods completed, which is the total cost of the production process. It is made up of prime cost (total direct costs), factory overheads (indirect costs) and movement in work in progress. This figure is then transferred to the income statement instead of the purchases figure.

Example: Manufacturing and Income Statement

Toyota is a manufacturer of motor vehicles. The trial balance for the past financial year is shown below:

Trial balance as at 31st December 2019	€	€
Purchases of raw materials	250,000	
Direct labour	150,000	
Stocks at 1 st January 2019:		
Raw materials	65,000	
Work in progress	52,500	
Finished goods	48,000	
Indirect factory labour	16,000	
Factory maintenance costs	16,700	
Machine repairs	31,500	
Sales		788,100
Other factory overheads	24,500	
Heating and lighting	19,000	
Factory rates	11,500	
Administration expenses	42,000	
Selling costs	46,800	
Trade receivables and trade payables	49,900	22,000
Freight of raw materials	1,600	
Bank balance	45,000	
Factory	180,000	
Motor vehicles	20,000	
Accumulated depreciation of motor vehicles		9,900

Capital		<u>250,000</u>
	<u>1,070,000</u>	<u>1,070,000</u>

Additional information:

- (a) The stocks held at 31st December 2019 consist of:
- a) Raw materials €51,400
 - b) Work in progress €42,600
 - c) Finished goods €63,000
- (b) One quarter of the administration expenses are allocated to the factory.
- (c) Heating and lighting should be apportioned between factory and office on the basis of the floor area occupied, which is Factory 1,000 m² and Office 600 m².
- (d) Expenses in arrear at 31st December 2019 are:
- a) Direct labour €2,500
 - b) Other factory overheads €700
 - c) Selling costs €1,500
- e) Motor vehicles are depreciated at the rate of 20% on the net book value.

Required:

For the year ended 31st December 2019 prepare:

- a) The manufacturing account.
- b) The income statement.
- c) The statement of financial position.

Manufacturing account for the year ended 31st December 2019	€	€
Opening stock of raw materials		65,000
Purchases of raw materials		250,000
Freight of raw materials		<u>1,600</u>
		316,600
Less: Closing stock of raw materials		<u>(51,400)</u>
Cost of raw materials consumed		265,200
Direct labour (€150,000 + €2,500)		<u>152,500</u>
Prime Cost		417,700
<u>Add: Factory Overheads:</u>		
Indirect factory labour	16,000	
Factory maintenance costs	16,700	
Machine repairs	31,500	
Other factory overheads (€24,500 + €700)	25,200	
Heat and light	11,875	
Factory rates	11,500	
Administration expenses (€42,000 x 1/4)	<u>10,500</u>	<u>123,275</u>
		540,975
Opening stock of work in progress		<u>52,500</u>
		593,475
Less: Closing stock of work in progress		<u>(42,600)</u>
Production cost of goods completed		<u>550,875</u>

Workings:

Note 1: Calculation of Heat and Light:

Factory = €19,000 x (1,000/1,600) = €11,875

Administration = €19,000 x (600/1,600) = €7,125

Income Statement for the year ended 31st December 2019	€	€
Sales		788,100
<u>Less: Cost of Sales:</u>		
Opening stock of finished goods	48,000	
Production cost of goods completed	<u>550,875</u>	
	598,875	
<u>Less: Closing stock of finished goods</u>	<u>(63,000)</u>	<u>535,875</u>
Gross profit		252,225
<u>Less: Operating Expenses:</u>		
Administration expenses (€42,000 x $\frac{3}{4}$)	31,500	
Heat and light	7,125	
Selling costs (€46,800 + €1,500)	48,300	
Depreciation of Motor Vehicles	<u>2,020</u>	<u>88,945</u>
Net Profit		<u>163,280</u>

Workings:

Note 2: Calculation of Depreciation Charge for Motor Vehicles:

Cost of motor vehicle	€20,000
Less: Accumulated Depreciation	<u>€9,900</u>
Net book value	<u>€10,100</u>
Depreciation charge = €10,100 x 20% = €2,020	

Statement of financial position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Factory	0	180,000
Motor vehicles	20,000	
Less: Accumulated Depreciation	<u>11,920</u>	<u>8,080</u>
		188,080
<u>Current Assets:</u>		
Stocks:		
Raw materials	51,400	
Work in progress	42,600	
Finished goods	63,000	
Trade receivables	49,900	
Bank	<u>45,000</u>	<u>251,900</u>
Total Assets		<u>439,980</u>
<u>Financed By:</u>		
Capital		250,000
Net profit		<u>163,280</u>
		413,280
<u>Less: Current Liabilities:</u>		
Trade Payables	22,000	
Accrued Expenses (€2,500 + €700 + €1,500)	<u>4,700</u>	
Total Current Liabilities		<u>26,700</u>
Total Capital and Liabilities		<u>439,980</u>

Note:

The closing stock of raw materials, work in progress, and finished should be included with the current assets in the statement of financial position under the heading of stock.

Review Questions

Question 1

- a) State two purposes of preparing the manufacturing account.
- b) Distinguish between direct and indirect costs.
- c) Allocate the following costs to the Manufacturing Account and the Income Statement: direct wages, advertising, factory light and heat, direct materials and administrative staff salaries.
- d) What are the different types of stock a manufacturer keeps in an organisation?

Question 2

Alfred Lumby owns a printing press that manufactures books. The trial balance for 2019 is shown below:

Trial Balance as at 31st December 2019	Debit €	Credit €
Opening stock of raw materials	12,000	
Opening stock of work in progress	3,000	
Opening stock of finished goods	8,500	
Returns of raw materials		450
Purchases of raw materials	81,000	
Sales of finished goods		205,500
Returns of finished goods	1,000	
Direct wages	21,300	
Factory insurance	5,600	
Bad debts	650	
Advertising	16,000	
Wages and salaries	30,000	
Factory	95,000	
Capital		105,000
Discounts allowed	100	
Drawings	16,000	
Carriage out	800	
Plant and machinery	20,000	
Provision for depreciation of plant and machinery		4,000
Office equipment	5,000	

Provision for depreciation of office equipment	_____	<u>1,000</u>
	<u>315,950</u>	<u>315,950</u>

Additional Information:

1. The closing stock as at 31st December 2019 is: raw materials €12,500; work in progress €2,000, finished goods €10,000.
2. Prepaid factory insurance is €600.
3. Wages and salaries are all administration expenses.
4. Accrued wages and salaries are €650.
5. Depreciation of plant and machinery is 10% on cost.
6. Depreciation of office equipment is 5% on cost.

Required:

- a) Prepare the manufacturing and income statement accounts.
- b) The statement of financial position for 2019.

Question 3

Jackson Smith operate an organisation that manufactures tomato paste. The trial balance as at 30th June 2019 is shown below:

Trial Balance as at 30th June 2019	Debit €	Credit €
Sales		480,100
Royalties	2,300	
Purchases of raw materials	265,000	
Opening stock of raw materials	10,800	
Opening stock of work in progress	6,500	
Opening stock of finished goods	28,000	
Factory Wages	52,000	
Discount Allowed	100	
Office Salaries	11,000	
Heat and Light	12,000	
Machinery Repairs	6,500	
Insurance	11,000	
Administration Expenses	25,000	
Selling and Distribution Expenses	18,000	
Trade receivables and payables	15,000	9,800
Bank		1,400
Cash	300	
Administration Building	60,000	
Drawings	7,500	
Capital		80,000
Plant and machinery	30,000	
Provision for depreciation of plant and machinery		6,000
Motor vehicles	20,000	
Provision for depreciation of motor vehicles	—	<u>3,700</u>
	<u>581,000</u>	<u>581,000</u>

It was also remarked that:

1. Inventory at 30th June 2018 consists of: raw materials €11,000, work in progress €8,000 and finished goods €30,000.
2. Plant and machinery is depreciated at the rate of 10% on cost.

3. Motor vehicles are depreciated at the rate of 10% by using the reducing balance method.
4. Heat and light is apportioned 40% to factory and 60% to administration.
5. Insurance mainly covers the motor vehicles, which are used to deliver finished goods to customers.
6. Carriage on raw materials of €500 was mistakenly reflected in the selling and distribution expenses.

Required:

- a) Prepare the manufacturing account and the income statement of the organisation.
- b) Prepare the statement of financial position as at 30th June 2019.

CHAPTER 21

FINAL ACCOUNTS OF A PARTNERSHIP

Objectives

After you have read this chapter you should be able to:

- Distinguish between a sole trader and a partnership;
- Understand the main elements of the partnership deed;
- Understand and prepare the capital and current accounts;
- Prepare the profit and loss appropriation account; and
- Prepare the statement of financial position.

21.1 Sole Trader versus Partnership

The sole trader is mainly managed by one-person, while a partnership is a business formed by two or more people (usually not more than 20). Sole trader and partnership have their distinct advantages and disadvantages, which are shown below:

Sole Trader	Partnership
Advantages	
1. Independence, which decreases the risk of managerial conflict.	1. Larger sums of capital available since more than one partner is involved. Furthermore, capital can be increased with the introduction of new partners.
2. Personal control of staff.	2. Division of responsibility.
3. Ability to take decisions faster.	
4. Privacy of affairs.	
5. Owner is not required to share profits.	

Disadvantages	
1. Illness affects the conduct of business.	1. Unlimited liability.
2. Unlimited liability.	2. Profits shared between partners.
3. Hard to raise capital for expansion.	3. Disagreements likely to occur between partners that might stop the business progress.

Unlimited liability means that if the organisation stops operating or is declared bankrupt, the owners are personally liable for unpaid liabilities.

21.2 Partnership Agreement or Deed

Partners are advised to draw up a partnership deed or agreement, which should cover the following:

- (a) The basis of allocation of profits or losses between partners;
- (b) The capital that each partner needs to provide;
- (c) The rate of interest, if applicable, to be allowed to the partners' capital;
- (d) The rate of interest, if applicable, chargeable to the partners' drawings;
- (e) The salaries to be paid to the active partners working in the organisation.
- (f) Procedures that need to be followed when one of the partners retires or dies.
- (g) Procedures adopted when a new partner is introduced.

21.3 Partnership Capital and Current Accounts

In partnership separate capital accounts are prepared for each partner. The capital account only reflects the money or assets invested by the partner. Additions or deductions like net profit or net loss, drawings, interest on capital, interest on drawings and salaries are reflected in the current account. The capital account and the current account of each partner must be shown in the statement of financial position. The preparation of the capital and current accounts is outlined in the next section after discussion the profit and loss appropriation account.

21.4 Profit and Loss Appropriation Accounts

The profit and loss appropriation account is an extension of the income statement and it starts from the net profit or loss made during the period. As

already noted above it reflects the interest on drawings, interest on capital, partners' salaries and the profit or loss shared between the partners.

Example: The Final Accounts of a Partnership

James and Alex are in partnership sharing profits or losses in the ratio 3:2. The partnership deed states the following:

- Partners are allowed 10% interest on capital;
- 5% interest is charged on yearly drawings incurred by the partners; and
- Alex is entitled to a salary of €6,500.

The stock at 31st December 2019 was valued at €25,000.

The trial balance as at 31st December 2019 was as follows:

	Dr	Cr
Capital: James		50,000
Alex		40,000
Current Accounts: James	1,500	
Alex		4,300
Drawings: James	7,000	
Alex	4,000	
Freehold buildings	65,000	
Stock at 1 st January 2019	22,000	
Motor Vehicles	10,000	
Trade receivables	16,500	
Cash at bank	17,900	
Trade payables		12,000
Sales		100,000
Purchases	60,000	
Water and Electricity	2,100	
Rent Receivable		3,700
Fuel costs	3,000	
Insurance	1,000	
	<u>210,000</u>	<u>210,000</u>

Required:

- Prepare the income statement, and the profit and loss appropriation account.
- Prepare the partners' current accounts.
- Prepare the statement of financial position.

Income Statement and Profit and Loss Appropriation Account for the year ended 31st December 2019	€	€
Sales		100,000
Less: <u>Cost of Sales:</u>		
Opening Stock	22,000	
Purchases	<u>60,000</u>	
	82,000	
Less: Closing Stock	<u>25,000</u>	<u>57,000</u>
Gross Profit		43,000
<u>Add: Revenue:</u>		
Rent Receivable		<u>3,700</u>
		46,700
Less: <u>Expenses:</u>		
Water and Electricity	2,100	
Fuel Costs	3,000	
Insurance	<u>1,000</u>	<u>6,100</u>
Net Profit		40,600
<u>Add: Interest on Drawings:</u>		
James	350	
Alex	<u>200</u>	<u>550</u>
		41,150
<u>Less: Interest on Capital:</u>		
James	5,000	
Alex	<u>4,000</u>	9,000
<u>Less: Salary:</u>		
Alex		<u>6,500</u>
		<u>25,650</u>
<u>Profits Shared:</u>		
James	15,390	
Alex	<u>10,260</u>	<u>25,650</u>

Partners' Current Account					
Debit	James €	Alex €	Credit	James €	Alex €
Balance b/d	1,500	-	Balance b/d	-	4,300
Int. on drawings	350	200	Int. on capital	5,000	4,000
Drawings	7,000	4,000	Salaries	-	6,500
Balance c/d	11,540	20,860	Profits shared	15,390	10,260
	<u>20,390</u>	<u>25,060</u>		<u>20,390</u>	<u>25,060</u>

Statement of Financial Position as at 31 st December 2019	€	€
<u>Non-Current Assets:</u>		
Freehold Buildings	65,000	
Motor Vehicles	<u>10,000</u>	75,000
<u>Current Assets:</u>		
Stock	25,000	
Trade Receivables	16,500	
Bank	<u>17,900</u>	<u>59,400</u>
Total Assets		<u>134,400</u>
<u>Financed By:</u>		
Capital: James		50,000
Alex		<u>40,000</u>
		90,000
Current Account: James	11,540	
Alex	<u>20,860</u>	<u>32,400</u>
		122,400
<u>Current Liabilities:</u>		
Trade Payables		<u>12,000</u>
		<u>134,400</u>

Review Questions

Question 1

- a) Distinguish a partnership from a sole trader.
- b) What are the key advantages and disadvantages of a partnership?
- c) What is included in the current account of a partner?
- d) What is included in the capital account of a partner?

Question 2

Alfred, Felix and Tony are in partnership. They have invested the following capital: Alfred €30,000, Felix €30,000 and Tony €20,000. In 2019 the partnership generated a net profit of €80,000.

The partnership deed comprises the following:

- a) The partners are entitled to an interest on capital of 5%.
- b) Alfred and Tony are active partners who receive a salary of €15,000 each.
- c) The partners are charged 10% interest on drawings.
- d) Alfred and Felix are entitled to 40% of the profit made, while Tony is entitled to 20% of the profit generated.

The current account at 1st January 2019 was:

Alfred	€4,000 (Credit Balance)
Felix	€180 (Debit Balance)
Tony	€2,800 (Credit Balance)

Drawings made by the partners during the year were: Alfred €6,000, Felix €14,000 and Tony €7,000.

Required:

- a) Prepare the partners' appropriation account for the year ended 31st December 2019.
- b) Prepared the partners' current accounts.

Question 3

Peter, Martin and Frank are in partnership who share profits and losses as 30%, 50% and 20%. The trial balance of the partnership at 31st December 2019 is shown below:

	€	€
Capital: Peter		80,000
Martin		100,000
Frank		60,000
Current: Peter	2,000	
Martin	2,500	
Frank		500
Drawings: Peter	8,000	
Martin	4,500	
Frank	16,000	
Trade Receivables and Payables	10,000	6,900
Purchases and Sales	60,000	178,000
Fuel Costs	1,800	
Repairs and Maintenance	650	
Administration Expenses	20,000	
Premises	230,000	
Motor Vehicles	31,000	
Advertising	15,000	
Discount Received		450
Stock at 1 st January 2019	3,600	
Bank	5,600	
Provision for doubtful debts		300
Bad Debts	1,500	
General Expenses	8,000	
Rent	6,000	
	<u>426,150</u>	<u>426,150</u>

It was also noted that:

1. Stock at 31st December 2019 amounted to €4,500.
2. The provision for doubtful debts is 3.5% of trade receivables.
3. Prepaid rent amounted to €500.
4. Accrued administration expenses was €1,000.
5. Partners are allowed 10% interest on capital and are charged 15% interest on drawings.

6. Peter and Martin are receiving a salary of €8,000 each.

Required:

- a) Prepare the partners' income statement and appropriation account for 2019.
- b) Prepare the partners' current accounts.
- c) Prepare the partners' statement of financial position.

CHAPTER 22

FINANCIAL STATEMENTS OF COMPANIES

Objectives

After you have read this chapter you should be able to:

- Describe the main features of a limited company;
- Distinguish a limited company from a partnership;
- Differentiate between a private and public company;
- Determine the dividends paid to preference and ordinary shareholders;
- Prepare the income statement of a company; and
- Prepare the statement of financial position of a company.

22.1 Main Features of Limited Companies

Limited companies are formed for the following reasons:

- To generate significant amounts of capital necessary to finance the operations of the company and/or capital projects.
- To protect the owners of the company through limited liability. This arises because the company has a separate legal entity, which implies that for legal purposes the company has a separate existence from its owners. The shareholders of a limited liability company are not liable for the debts of the company beyond the amounts they have agreed to pay on their shares. Thus, in case of bankruptcy the shareholders' personal assets are safe.

On the creation of a limited company a memorandum and articles of association need to be prepared. The memorandum defines the relationship of the company to the outside world and the articles of association highlights the internal rules governing the rights of shareholders and the running of the company.

22.2 Distinction between Limited Companies and Partnerships

Limited Companies	Partnerships
Owners are at least two members.	Owners consist of at least two partners.
Maximum number of investors determined by the number of shares.	Not more than 20 partners (except for professional firms)
Limited liability	Unlimited liability
Amount of capital limited only by the authorised share capital stated in the memorandum of association. However, this may increase through a change in the memorandum.	Capital as determined in the partnership agreement and limited by the personal resources of the partners.
Profits are distributed to investors through dividends. Some profits are retained in company as internally generated funds.	All profits are distributed to the partners in line to the partnership agreement and credited to the partners' current accounts.
Companies are liable to pay Corporation Tax on their profits.	Progressive tax is charged on partnership depending on the profit allocated to each partner.

22.3 Distinction between Public and Private Companies

A public company is a company whose shares are offered to the public by being traded in the stock exchange.

A private company is an organisation where a limited number of individuals agree to form the organisation and invest a specific amount of money. A private company is not listed in the stock exchange and thus the amount of finance available is limited to a small number of investors.

22.4 The Income Statement of Limited Companies

The income statement of a company would appear as follows:

Company Name

Income Statement

For the year ended

	Notes	€'000	€'000	€'000
Sales				100
Cost of Sales				(54)
Gross profit				46
<u>Selling and Distribution Expenses:</u>				
Salespersons' salaries			(2.1)	
Warehouse expenses			(1.9)	
Depreciation: delivery van			(1.3)	(5.3)
<u>Administration Costs:</u>				
Administrative salaries			(14.6)	
Telephone expenses			(16.0)	
Depreciation: office machinery			(0.7)	
Fixtures & fittings			(0.2)	(31.5)
<u>Financial Charges:</u>				
Interest on debentures	A			(0.4)
Profit before taxation	B			8.8
Taxation	C			(2.5)
Profit after taxation				6.3
Transfer to the general reserve	D		(2.0)	
<u>Dividends Paid and Proposed:</u>	E			
Preference dividend - paid	F	(0.4)		
proposed		(0.4)		
Ordinary dividend - paid	G	(0.6)		
proposed		(1.2)	(2.6)	(4.6)
Retained profits for the year	H			1.7

Retained profits brought forward				<u>1.5</u>
Retained profits carried forward				<u>3.2</u>

The income statement looks very similar to that of a sole trader or a partnership. The main difference is that instead of grouping expenditure under one heading, these are subdivided under three main headings being Selling and Distribution expenses, Administration costs, and Financial Charges.

Notes:

A – A debenture is a loan made to the company. Similar to any other loan, debentures lead to a fixed interest charge, which is reflected as an expense under the financial charges in the income statement.

B – The profit before tax is actually the net profit figure, which is reflected in the accounts of a sole trader. This consists of the income that the company made before charging corporate taxation.

C – This is the corporate tax, which is deducted from the profit made. Sometimes, corporate taxation is paid one year in arrear. In such case the taxation not yet paid needs to be reflected in the current liabilities.

D – The transfer to the general reserve increases one of the revenue reserves of the organisation. The general reserve consists of the profits generated by the organisation, which are kept in the firm. These can be used as internal funds to finance future projects or working capital. The general reserve can also be used for paying dividends in periods when the profitability of the company is weak and insufficient profits were made to sustain the firm's dividend policy.

E – Dividends are the direct return given to shareholders for investing in the company.

F – The preference dividend is the dividend paid to preference shareholders. Preference dividends are fixed and are normally expressed as a percentage of the preference share capital.

G – Ordinary dividends are dividends paid to ordinary shareholders. The ordinary dividends paid are flexible and the amount given is at the discretion of the board of directors.

How to Calculate Ordinary Dividends

In a question, dividends can be either as a percentage or cents per share. In case of percentages it is calculated on the monetary value of the ordinary shares. If it is in cents per share it is determined on the number of ordinary shares. For example, a company holds 200,000 ordinary shares of 50 cents each. If the directors decide to propose a dividend of 10%, it is calculated as follows:

$$\begin{aligned} &\text{Value of shares} \times 10\% \\ &(200,000 \times \text{€}0.50) \times 10\% = \text{€}10,000 \end{aligned}$$

On the other hand, if the directors decide to propose a dividend of 10 cents per share, it is computed as follows:

$$\begin{aligned} &\text{Number of ordinary shares} \times 10 \text{ cents} \\ &200,000 \times \text{€}0.10 = \text{€}20,000 \end{aligned}$$

H – The retained profits are the remaining balance in the income statement after transfers to reserves, and dividends paid and proposed are deducted from the profit after taxation. It is added to retained profits brought forward from the previous year to provide the total retained profits carried forward to the next year.

22.5 The Statement of Financial Position of Limited Companies

The Statement of Financial Position of a company would appear as follows:

Company name

Statement of Financial Position as at

	Notes	€'000	€'000	€'000
<u>Non-Current Assets:</u>				
Intangible Non-Current Assets	I			10
Tangible Non-Current assets	J			87
Investments	K			<u>5</u>
				102
<u>Current Assets:</u>				
Stock			4	
Trade Receivables			16.8	
Bank			<u>17.4</u>	<u>38.2</u>
Total Assets				<u>140.2</u>
<u>Share Capital and Reserves:</u>				
<u>Authorised Share Capital:</u>				
60,000 Ordinary Shares of €1 each	L			60
20,000 8% Preference Shares				<u>20</u>
				<u>80</u>
<u>Issued and Fully Paid:</u>				
Ordinary share capital	M			45
8% Preference shares	N			10
<u>Reserves:</u>				
Share premium account	P		22.5	
Revaluation reserve	Q		20	
General reserve	R		5	
Retained earnings	S		<u>3.2</u>	<u>50.7</u>
				105.7
<u>Current Liabilities:</u>				
Trade Payables		26.4		

Corporate Taxation	T	2.5		
Dividends - Proposed	U	<u>1.6</u>		
Total Current Liabilities			30.5	
<u>Non-Current Liabilities:</u>				
10% Debentures	V		<u>4</u>	
Total Liabilities				<u>34.5</u>
Total Equity and Liabilities				<u>140.2</u>

Notes:

I – The intangible non-current assets are assets that lack physical presence but are still important resources for the company. For example, goodwill is an intangible non-current asset.

J – The tangible non-current assets are those that have a physical existence and can be touched, such as plant and machinery.

K – Investments are mainly made in the securities of other companies or property. These investments are held for the long term. A company might invest in another company to have some influence (vertical or horizontal integration) in that company and/or to gain a return from that investment (dividends).

L – The authorised share capital is the maximum amount of share capital that a company may issue as stated in the memorandum of association. This amount cannot be exceeded unless the company issues a new memorandum of association, which encompasses a higher authorised share capital.

M – The issued ordinary share capital is the amount of share capital that has actually been issued by the company. This share capital is made up of shares that hold a particular monetary value, which is known as the nominal value (usually on a per share basis). The nominal value is the original value at which the shares were issued. The ordinary shareholders are the last individuals who have the right to receive a dividend. Before paying the dividend to the ordinary shareholders, a company has the legal obligation to pay the debenture holders the interest due and the preference shareholders the dividend due. The dividend paid to the ordinary shareholders is subject to the directors' discretion and may vary.

In case of liquidation, the ordinary shareholders have to wait that everybody is paid, including the preference shareholders before receiving their own

capital. However, if the company was successful the ordinary shareholders may receive more than the capital they invested. The ordinary shareholders have the voting power and may choose the directors who will manage the company.

N – Preference Share Capital:

The preference shareholders are entitled to receive a fixed rate of dividend, which is paid before the dividend given to the ordinary shareholders. This dividend is normally shown as a percentage of the share's nominal value. There are two types of preference shares:

- The non-cumulative preference shares are a type of share where the preference shareholders can lose the dividend in a situation where the company has generated insufficient profits to pay the dividends and it does not hold enough revenue reserves.
- The cumulative preference shares are shares that are entitled for dividends even when the company is unable to pay dividends. In such case the dividends are considered as an arrear and paid in subsequent years.

The participating preference shares provide the right to the preference shareholders to participate in the distribution of profits. In such case the preference shareholders are given an additional return based on the profits generated.

O - Reserves

There are two types of reserves, which comprise revenue reserves and capital reserves:

Revenue Reserves

The revenue reserves (R & S) are profits that have been put back into the company by the directors for finance purposes or as a buffer for future periods where the firm's profitability is weak. The revenue reserves may be either specific or general.

The specific reserves are revenue reserves which have been set aside for some specific purpose, such as the replacement of non-current assets or for specific projects.

The general reserves are reserves considered desirable or necessary to reinforce the financial position of the company.

Setting profits aside as revenue reserves reduces the amount available for dividends at least for the time being. If at some future date the revenue reserves are found to be excessive, they may be made available for the payment of dividends.

Capital Reserves

The capital reserves are prepared in order to comply with specific regulations present in the International Financial Reporting Standards or other relevant laws. These reserves cannot be distributed as dividends to shareholders. The following are examples of capital reserves:

- The share premium account (P) is created whenever ordinary shares are issued at a price above their nominal value. For example, the nominal value of the company's ordinary shares is €1 per share. If the shares are issued at a price of €1.25 per share, then the additional 25 cents per share are considered as share premium.
- The revaluation reserve (Q) is created when the value of a non-current asset increases in order to comply with its market value. The bookkeeping entry is debit the non-current asset account and credit the revaluation reserve. Such an increase will lead to a higher depreciation charge if the non-current asset is depreciated.
- The capital redemption reserve arises when a company redeems or buys back any of its own shares. This serves to protect stakeholders because it does not allow shareholders to redeem the original money invested. Whenever there is a redemption of shares, the board of directors is either required to issue corresponding new shares or transfer part of the profits to the capital redemption reserve.

T – The corporate taxation reflects the taxation due to the government, which has not yet been paid at the financial year end.

U – The dividends proposed are stated by the directors at the year-end and will be paid to the ordinary shareholders next year.

V – The debentures are non-current liabilities unless they are due to be redeemed (paid back) within twelve months of the date of the statement of

financial position. The debentures are examined in more depth in subsection 22.5.3.

22.5.1 Distinction between Provisions, Reserves and Liabilities

Provisions are profits set aside in order to cater for an anticipated loss in the value of the non-current and current assets. An increase or decrease in a provision is reflected in the income statement.

The reserves are created either to put profits aside so that the company grows larger, as a buffer or to comply with relevant laws and regulations.

The liabilities are the present financial obligations that the organisation needs to settle in the future.

22.5.2 The Dividend Policy

The directors of a company need to consider the following before paying or proposing dividends:

- The availability of profits and/or revenue reserves.
- The availability of cash to pay the dividends.
- The amount of profits retained in the company.
- The effect of the dividend policy on the market price of the ordinary shares.
- The main return required by the majority of the company's ordinary shareholders.

The directors may pay interim (mid-year) dividends if they are satisfied that sufficient mid-term profits have been made or the company has excess revenue reserves. The board of directors also considers the liquidity of the company before paying dividends.

22.5.3 Debentures

A debenture is a document containing details of a loan made to a company. The loan may be secured on the assets of the company through a general hypothec or specific hypothec. Such security gives the right to the debenture holders to acquire these assets if the company goes into liquidation. If the loan is secured on specific assets (specific hypothec) the debenture holders have the right to the proceeds of those assets on liquidation of the company.

The debenture holders are not owners of the company in the same way as ordinary shareholders are. They have no voting power.

Review Questions

Question 1

- Define a company.
- What is the difference between a limited company and a partnership?
- Distinguish between a private and a public company.
- Who owns the company and who manages the company?

Question 2

- What is non-cumulative preference share?
- What is the difference between revenue reserves and capital reserves?
- Distinguish between interim and proposed dividends.
- A company has issued ordinary share capital of €100,000, which hold a nominal value of 25 cents per share. The board of directors decided to propose a dividend of 10 cents per share. What is the total dividend proposed to the ordinary shareholders?

Question 3

Alliance Ltd. have an authorised share capital of €500,000 shares divided into €300,000 ordinary shares of €1 each and €200,000 10% preference shares of €1 each. The balances as at 31st December 2019 are shown below:

Assets, Liabilities, Reserves and Share Capital	€
Premises	250,000
General Reserve	18,000
Ordinary Shares	170,000
10% Preference Shares	30,000
8% Debentures	15,000
Bank	15,200
Profit and Loss Balance at 1 st January 2019	40,000
Trade Receivables	5,000
Trade Payables	8,000
Net Profit generated during the year	25,000
Motor Vehicles	40,000
Provision for depreciation on motor vehicles	14,000
Closing inventory	11,000
Debenture interest not paid	1,200

The directors suggested:

- i) To transfer €3,600 to the general reserve.
- ii) Propose an ordinary dividend of 10%.

Required:

- a) Determine the retained profits carried forward to 2020.
- b) Prepare the statement of financial position as at 31st December 2019.

Question 4

The trial balance of Image Ltd. is shown below:

Trial Balance as at 30th June 2019	€	€
Inventory at 1 st July 2018	17,000	
Issued Ordinary Share Capital (0.50 cents each)		100,000
Equipment	55,000	
Provision for Depreciation on Equipment		5,000
Motor Vehicles	40,500	
Provision for Depreciation on Motor Vehicles		3,500
Premises	330,000	
Trade Receivables	26,500	
Trade Payables		19,900
Wages and Salaries	35,000	
Repairs and Maintenance	2,200	
Administration Expenses	7,125	
Commission	690	710
Returns In	770	
Returns Out		415
Purchases and Sales	480,000	790,000
8% Debentures		20,000
Discount Received		350
Carriage In	2,100	
General Expenses	7,600	
Bank	30,900	
Provision for Doubtful Debts		2,000
Bad Debts	1,490	
5% Preference Shares (€1 each)		30,000

Profit and loss account at 1 st July 2018	_____	<u>65,000</u>
	<u>1,036,875</u>	<u>1,036,875</u>

Additional Information:

- i) Stock at 30th June 2019 was valued at €21,500.
- ii) Accrued wages and salaries amounted to €560.
- iii) Equipment is depreciated at the rate of 10% by using the straight line method.
- iv) Motor vehicles are depreciation via the reducing balance method at the rate of 5%.
- v) The directors proposed a dividend of 8 cents per share.
- vi) The provision for doubtful debts is 7% of trade receivables.
- vii) €4,280 need to be transferred to the general reserve.

Required:

- a) Prepare the income statement of Image Ltd.
- b) Prepare the statement of financial position.

CHAPTER 23

ACCOUNTING FOR NON-PROFIT MAKING ORGANISATION

Objectives

After you have read this chapter you should be able to:

- Understand what is a non-profit making organisation;
- Comprehend the main financial reports present in a non-profit making organisation;
- Identify the different elements included in the subscriptions account;
- Understand the accounting treatment of donations;
- Prepare the bar trading account;
- Prepare the club's income and expenditure account;
- Calculate the accumulated fund; and
- Prepare the club's statement of financial position.

23.1 The Non-Profit Making Organisation

Non-profit making organisations are set up for a variety of purposes. For example, a charitable organisation is generated in order to provide financial support and/or services to individuals with low financial wealth or to other people who require special needs. Profit is still important for a non-profit making organisation because it is necessary for the firm to survive. However, the main objective of such organisations is not to make profit.

23.2 Main Financial Reports of the Non-Profit Making Organisations

The financial reports listed below are related to clubs:

1. An Income and Expenditure account replaces the Income Statement.
2. A trading account is only prepared for a subsidiary activity of the club like a bar.
3. In the Income and Expenditure account the surplus of income over expenditure replaces the net profit of an income statement. Excess of expenditure over income is used instead of the net loss.
4. In the statement of financial position, the term accumulated fund is used to replace the capital account.
5. In the statement of financial position, subscriptions in arrear are included with the Current Assets because they are subscriptions not yet received from members of the club. Subscriptions in advance are included with the Current Liabilities because they represent subscriptions prepaid by the members of the club.

23.3 Members' Subscriptions Account

The subscriptions account is made up of the following elements:

- Subscriptions in arrear from previous month.
- Subscriptions prepaid from previous month.
- Subscriptions paid during the month.
- Subscriptions still owing at the end of the month.
- Subscriptions paid in advance at the end of the month.
- Amount credited or debited to the income and expenditure account. This is usually found as a missing figure.

Note: Subscriptions in arrears are similar to trade receivables of a sole trader. Sometimes trade receivables fail to pay the organisation. This can also happen for a club where members fail to pay the subscription. These can be written off as a bad debt.

Example: Subscriptions Account

The treasurer of Illustrations club provided the following information:

Receipts	€	Payments	€
Balance 1 August 2018	3,170	Sports meeting expenses	3,420
Subscriptions received	6,900	Administration	6,380
Sports meetings fees	5,140	Insurance	750
Bar sales receipts	18,950	Repairs to buildings	1,640
		Bar wages	3,500
		Creditors for bar supplies	4,850
	_____	Balance 31 August 2018	<u>13,620</u>
	<u>34,160</u>		<u>34,160</u>

Other assets and liabilities of Illustrations club comprise the following:

	1 August 2018	31 August 2018
Subscriptions in arrears	€250	€400
Subscriptions in advance	€100	€150

Only €200 have been received for the subscriptions in arrear of 1st August 2018. The remaining amount was written off as a bad debt.

Required:

Prepare the club's subscriptions account.

Subscriptions Account

Debit	€	Credit	€
Balance b/d (Note 1)	250	Balance b/d (Note 2)	100
Income and expenditure (Note 7)	7,050	Receipts and Payments (Note 3)	6,900
Balance c/d (Note 6)	150	Bad debt (Note 4)	50
		Balance c/d (Note 5)	<u>400</u>
	<u>7,450</u>		<u>7,450</u>

Notes:

1. Subscriptions in arrears at 1st August 2018 are shown on the debit side of the subscriptions account because they consist of subscriptions not yet paid to the club. Therefore, they are assets of the club and should be included on the debit side.

2. Subscriptions in advance at 1st August 218 comprise subscriptions paid by the member of the club before receiving the services from the club. Therefore, the club has the duty to provide the services to these members because they have already paid for these services. In this case they are a liability for the club.
3. For subscriptions received normal double entry principle is applied where the money received (receipts and payments account) is debited and credit reflected in the subscriptions account.
4. The bad debt reflects the subscriptions due at 1st August 2018, which remained unpaid. The bad debt is an expense, which should be entered on the debit side of the bad debt account.
5. The same principle adopted in 1 is applied here. Since they are considered as assets, the balance b/d should be on the debit side. Therefore, the balance c/d should be on the credit side.
6. The same principle applied in 2 is adopted here. Since they are considered as liabilities, the balance b/d should be on the credit side. Therefore, the balance c/d should be on the debit side.
7. This figure is found as a balancing figure to close off the account. This figure will be shown as income in the Income and Expenditure Account.

23.4 Donations

The treatment of donations made to a club depend upon the purpose for which they are made. If the donation is simply intended to add to the club funds, it may be shown as income during that period in the income and expenditure account. If the donation is given for a special purpose, such as for a new clubhouse, the wishes of the donor should be respected. They should be recognised by crediting the donation to a special fund (not the accumulated fund) and shown in the statement of financial position.

Example: Financial Reports of a Club

The Bingo Social Club was formed as a meeting place where senior citizens of the locality could spend some time together. The club's financial year ends on 31st December.

The following information has been prepared by the club's secretary:

Balances as at:	31st Dec 2018	1st Jan 2018
Bar payables	€1,443	€1,000
Bank balance	?	€2,500
Accrued wages	€20	€10
Accrued subscriptions	€96	€120
Prepaid rent	€35	€50
Bar stocks	€1,720	€2,200
Payments:		€
Bar payables		3,660
Water and Electricity		1,010
Rent		500
Telephone		80
Wages		3,610
Sundry expenses		120
Receipts:		
Subscriptions		5,225
Bar takings		5,444
Christmas dinner		450

Note 1: Two-fifths of the wages are paid to the barman and three-fifths are paid to the club's caretaker.

Note 2: The receipt of €450 represents the net profit made from the Christmas dinner.

Required:

1. A subscriptions account.
2. A bar trading and profit and loss account for the year ended 31st December 2018.
3. An income and expenditure account for this period.
4. A statement of financial position.

The Accumulated Fund (capital) can be calculated with the aid of a Statement of Affairs as follows:

Statement of affairs as at 1st January 2018	€	€	€
<u>Current Assets:</u>			
Bar stocks		2,200	
Expenses prepaid		50	
Subscriptions accrued		120	
Bank		<u>2,500</u>	
<u>Current Liabilities:</u>		4,870	
Accounts Payable	1,000		
Expenses accrued	<u>10</u>	<u>1,010</u>	
			<u>3,860</u>
<u>Financed By:</u>			
Accumulated Fund (missing figure)			<u>3,860</u>

Subscriptions Account

Debit	€	Credit	€
Owing b/d	120	Receipts & payments	5,225
Income & expenditure	<u>5,201</u>	Owing c/d	<u>96</u>
	<u>5,321</u>		<u>5,321</u>

Bar trading and profit and loss account for the year ended 31st December 2018	€	€
Sales		5,444
<u>Less: Cost of Sales:</u>		
Opening stock	2,200	
Purchases (Note 1)	<u>4,103</u>	
	6,303	
Less: Closing stock	<u>(1,720)</u>	<u>4,583</u>
Gross profit		861
Less: Bar wages (€3,620 x 2/5)		<u>1,448</u>
Loss from bar activities		<u>(587)</u>

Payables Control Account

Debit	€	Credit	€
Receipts & payments	3,660	Balance b/d	1,000
Balance c/d	<u>1,443</u>	Purchases (missing figure)	<u>4,103</u>
	<u>5,103</u>		<u>5,103</u>

Normally, the purchases of bars are computed with the help of the payables control account, as shown above.

Income and Expenditure account for the year ended 31st December 2018	€	€
<u>Income:</u>		
Subscriptions (refer to subscriptions account)		5,201
Christmas dinner		<u>450</u>
		5,651
<u>Expenditure:</u>		
Loss from bar activities	587	
Wages (€3,620 x 3/5) (Note 1)	2,172	
Water and electricity	1,010	
Rent (Note 2)	515	
Telephone	80	
Sundry expenses	<u>120</u>	<u>4,484</u>
Surplus of Income over Expenditure		<u>1,167</u>

Workings:

Note 1 - Accrued Wages:

Wages paid during the year	€3,610
Less: wages accrued last year	€ (10)
Add: wages accrued this year	<u>€ 20</u>
	<u>€3,620</u>

Note 2 - Prepaid Rent:

Rent paid during the year	€500
Add: rent prepaid last year	€ 50
Less: rent prepaid this year	<u>€ 35</u>
	<u>€515</u>

Statement of Affairs as at 31st December 2018	€	€
<u>Current Assets:</u>		
Bar stocks		1,720
Expenses prepaid		35
Subscriptions accrued		96
Bank (Note 3)		<u>4,639</u>
		<u>6,490</u>
<u>Financed By:</u>		
Accumulated Fund		3,860
Surplus of income over expenditure		<u>1,167</u>
		5,027
<u>Current Liabilities:</u>		
Accounts Payable	1,443	
Expenses accrued	<u>20</u>	<u>1,463</u>
		<u>6,490</u>

Note 3: Bank Balance

Opening balance	€ 2,500
Add: Receipts	€11,119
Less: Payments	<u>€(8,980)</u>
Closing balance	<u>€ 4,639</u>

Review Questions

Question 1

The balances at 1st January 2019 of UniRace are shown below:

Accounts Payable	€250
Bar Premises	€36,000
Bar Stocks	€480
Subscriptions prepaid	€95
Subscriptions accrued	€120
Bank	€1,550
Prepaid Rent	€90
Accrued Wages	€110
Accumulated Fund	?

Required:

Determine the accumulated fund as at 1st January 2019.

Question 2

- a. What is the main difference between clubs and a sole trader?
- b. What is the term used for capital in clubs?
- c. State two key financial reports prepared for clubs.
- d. What is the main income for clubs?
- e. What is the term used for net profit in clubs?

Question 3

The assets and liabilities of Shire Football Club at 1st January 2019 are shown below:

Club bar premises €150,000; Equipment €10,000; Payables for bar supplies €700; Bank €5,000; Bar Stocks €750; Subscriptions paid in advance €310; and Accrued Subscriptions €210.

Receipts and Payments for year ended 31st December 2019 were:

Receipts:	Bar Takings	€13,800
	Subscriptions	€3,000
	Donation	€500
Payments:	Equipment	€1,300
	Repairs	€900
	Payables for bar supplies	€1,510
	Light and Heat	€350

Additional information at 31st December 2019:

- i) Subscriptions in advance were €350.
- ii) Subscriptions in arrear were €180.
- iii) €170 was received for accrued subscriptions at 1st January 2019. The other subscriptions were written off as bad debts.
- iv) Bar stocks amounted to €500.
- v) Depreciation on equipment is 10% on cost. Depreciation is charged on the end of year balance.
- vi) Payables for bar supplies amounted to €650.

Required:

- a) Calculate the accumulated fund at 1st January 2019.
- b) Prepare the income and expenditure account for the year ended 31st December 2019.
- c) Prepare the statement of financial position as at 31st December 2019.

Question 4

The receipts and payments account of the Gold Tulip Club is outlined below for the financial year ended 30th April 2019:

Receipts	€	Payments	€
Balance b/d	1,300	Bar Payables	980
Bar Receipts	3,600	Raffle Expenses	260
Subscriptions	1,250	Barman Wages	135
Annual Raffle	760	Treasurer Wages	320
		Equipment	1,680
		Printing and Postage	440
		Light and Heat	490
		Balance c/d	<u>2,605</u>
	<u>6,910</u>		<u>6,910</u>

The assets and liabilities at 1st May 2018 were as follows:

equipment €1,320; bar stock €900; accrued treasurer wages €30; bar payables €550; subscriptions accrued €110; and subscriptions prepaid €160.

Additional information at 30th April 2019:

- i) Bar stocks amounted to €1,000, subscriptions accrued were €130, subscriptions prepaid were €150 and bar payables amounted to €220.
- ii) The treasurer of Gold Tulip Club was unable to collect €50 of the opening subscriptions due.
- iii) Equipment is depreciated at the rate of 15% on the balance at 30th April 2019.

Required:

- a) Prepare the income and expenditure account for the year ended 30th April 2019.
- b) Prepare the statement of financial position as at 30th April 2019.

CHAPTER 24

FIRMS WITH INCOMPLETE ACCOUNTING RECORDS

Objectives

After you have read this chapter you should be able to:

- Understand the type of information provided by firms with incomplete accounting records; and
- Identify the main steps for preparing the final accounts.

24.1 Type of Information Given by Firms with Incomplete Accounting Records

Numerous enterprises in Malta, especially sole traders do not keep proper accounting records. They do not reflect double entry in the appropriate ledgers. These types of business enterprises only keep information that the owner of the business sees necessary. Examples of such information are:

- Records of cash sales made during the year or receipts from trade receivables.
- Records of payments to trade payables.
- Records of expenses paid during the year.
- Bank balance at the end of the year.
- Balances at the beginning of the year of assets and liabilities.
- Accounting policies like depreciation adopted in previous years.
- Balances at the end of the year of assets and liabilities.

A good accountant needs to use this information in order to prepare a full set of final accounts. Let us see in sequential order how this information is used.

24.2 Main Steps for Preparing the Final Accounts

Step 1 – Calculation of capital

Initially the opening balances of assets and liabilities are used in order to determine the capital invested by the owner. A statement of affairs is prepared in order to compute the capital. A statement of affairs is like a statement of financial position.

Step 2 – Preparation of the trading account

The trading account is then prepared, which is the first part of the income statement till the gross profit figure. Sales is the first item of the trading account, which can be determined by preparing the receivables control account. This normally includes the following items:

- Debit side – The opening balance at beginning of the year (Balance b/d).
- Credit side – The receipts from debtors (Bank/Cash received).
- Credit side – The discounts allowed to debtors, if any.
- Credit side – The closing balance at end of the year (Balance c/d).
- Debit side – The credit sales (calculated as a missing figure in order for the debit side total to agree with the credit side total).

An enterprise might incur cash sales during the year. Cash sales should not be included in the receivables control account but should be added with the credit sales (derived from the receivables control account) in order to determine the final sales figure.

Cost of sales is the second item in the trading account, which comprise the following:

- Opening stock
- Purchases
- Closing stock

Opening and closing stock are normally determined by the sole trader.

Purchases should be calculated with the help of the payables control account. In this account one needs to input the following information:

- Credit side – The opening balance at beginning of the year (Balance b/d).

- Debit side – The payments made to payables (Bank/Cash paid).
- Debit side – The discounts received from payables, if any.
- Debit side – The closing balance at end of the year (Balance c/d).
- Credit side – The credit purchases (calculated as a missing figure in order for the debit side total needed to agree with the credit side total).

The firm may buy stock by cash during the year. These cash purchases should not be included in the payables control account but should be added with the credit purchases (derived from the payables control account) in order to determine the final purchases figure.

A trading account may also include returns inwards, which are deducted from the sales and returns outwards that are deducted from purchases. Normally in examination questions covering incomplete records, these items are not included. If they are included, they will be provided in the question and should be reflected in the control accounts. Returns inwards from receivables should be included on the credit side of the receivables control account. Returns outwards to payables should be included on the debit side of the payables control account.

Step 3 – Preparation of the Income Statement

Once the gross profit is calculated in the trading account one can proceed to determine the net profit figure. The following variables should be considered when preparing the income statement:

Gains – the most common type of gain consists of the discount received from payables. This can normally be determined by looking at the invoices sent by suppliers.

Expenses – expenses can be derived by looking at the bank statement, which highlights the payments made during the year. The accountant should also investigate if expenses were paid by cash. Invoices can support the identification of these expenses. Furthermore, the accountant needs to identify accrued or prepaid expenses, which need to be reflected in the final accounts. These can be identified by looking at the invoices received close to the financial year end. Chapter 16 provides more detailed information about accounting for accruals and prepayments. Attention should also be devoted to non-cash transactions like depreciation and bad debts. Accounting policies need to be discussed and developed with the owner. The profit or loss made from disposals of non-current assets should also be

considered. Chapter 14 is useful in order to explain how disposals are reflected in the accounts.

Step 4 – Preparation of the Statement of Financial Position

The Non-Current Assets

Cost of the Non-Current Assets

One can determine the opening balances of the non-current assets by considering the past year final accounts, if any. However, if these are not available discussions are necessary with the owner in order to identify such assets, which are valued accordingly. When the closing balances are not available the accountant needs to consider movements along the year, such as the acquisition of new non-current assets or the disposal of non-current assets.

Depreciation of the Non-Current Assets

Usually only the opening balance of depreciation is provided in the question. The closing balance of depreciation is determined by adding the depreciation charge for the year recorded in the income statement.

The Current Assets

These are usually provided by the owner (closing balances at end of the year) and should be recorded in the following sequence in the statement of financial position:

- Stock (closing stock showed also in the trading account).
- Trade receivables (closing balance at the year-end).
- Deduct the balance of the provision for doubtful debts, if any.
- Prepaid expenses (closing balance at the year-end).
- Accrued gains (closing balance at the year-end).
- Bank (bank balance at the year-end).

The Current Liabilities

These are also provided in the question and should be recorded in the following sequence in the statement of financial position:

- Bank overdraft, if any (balance c/d on the debit side of the bank account).
- Trade payables (closing balance at the year-end).

- Accrued expenses (closing balance at the year-end).
- Prepaid gains (closing balance at the year-end).

The Capital

This figure was calculated in step 1. However, if during the year the owner invests additional assets in the company, one needs to add them to the capital figure calculated in step 1.

The Net Profit or Loss

This figure is taken from the income statement.

The Drawings

The owner can normally state how much money and/or other assets were taken by the organisation. Normally these comprise money taken by the owner, stock or personal expenses paid by the firm's money.

The Non-Current Liabilities

Details on loans are usually provided by the owner. Special care needs to be taken on loans which hold an interest. Interest payable is an expense that needs to be included in the income statement. There are two situations that may arise when accounting for interest on loans, which consist of the following:

1. Interest on loan paid during the year – in this case the interest payable should be included as an expense in the income statement.
2. Interest on loan not yet paid – in this circumstance one needs to include the interest payable as an expense in the income statement and the interest due with the current liabilities in the statement of financial position.

Example: Final Accounts when there are Incomplete Records

Gerald Terry is a sole trader. He does not keep a full set of accounting records. However, it has been possible to extract the following financial information from the few records available:

Balances as at:	1st January 2019 (€)	31st December 2019 (€)
Office equipment:		
Cost	50,000	47,000
Depreciation	10,000	?
Stock, at cost	22,000	20,000
Trade debtors	19,000	21,500
Insurance prepaid	130	200
Cash in hand	300	300
Trade creditors	16,800	17,000
Rent due	500	550
Telephone accrued	120	90
5% Loan	20,000	10,000

The bank transactions for the year ended 31st December 2019 were as follows:

Debit	€	Credit	€
Balance at start	1,000	Payments to trade payables	139,200
Receipts from trade receivables	199,600	Electricity	2,200
Proceeds from disposal	800	Rent	1,100
Deposit by owner	5,000	Insurance	800
		Drawings	8,800
		Motor vehicle	9,000
		5% Loan	10,000
		Loan interest	1,000
		Wages	14,000
		Telephone expenses	300
		Balance at close	<u>20,000</u>
	<u>207,400</u>		<u>207,400</u>

The following additional information is available:

- (a) During the year Gerald disposed of some old equipment purchased on 1st January 2019.
- (b) Gerald's sales were mainly on credit but there were a few cash customers. During the year cash sales amounted to €1,000, which were used for a cash purchase of €800 and the remaining €200 were taken by Gerald for his personal use.
- (c) Goods costing €800 were taken by Gerald during the year.
- (d) Discounts allowed to trade receivables amounted to €970, while discounts received from trade payables were €1,020.
- (e) Depreciation is provided annually at the following rates:
Office equipment 10% on cost.
Motor vehicle 15% on net book value.

Required:

Prepare a set of final accounts for the year ended 31st December 2019.

Step 1 – Calculation of Capital:

Statement of affairs as at 1 st January 2019	€	€
<u>Non-Current Assets:</u>		
Office Equipment		50,000
Less: Depreciation		<u>10,000</u>
		40,000
<u>Current Assets:</u>		
Stock	22,000	
Trade Receivables	19,000	
Expenses Prepaid	130	
Bank	1,000	
Cash	<u>300</u>	<u>42,430</u>
Total Assets		<u>82,430</u>
<u>Financed By:</u>		
Capital (missing figure)		45,010
<u>Current Liabilities:</u>		
Trade Payables	16,800	
Expenses Accrued	<u>620</u>	
Total Current Liabilities	17,420	
<u>Non-Current Liabilities:</u>		
5% Loan	<u>20,000</u>	<u>37,420</u>
Total Capital and Liabilities		<u>82,430</u>

Step 2 – Preparation of the Trading Account

Calculation of Sales:

Receivables Control Account

Debit	€	Credit	€
Balance b/d	19,000	Bank	199,600
Sales (missing figure)	203,070	Discount allowed	970
		Balance c/d	21,500
	<u>222,070</u>		<u>222,070</u>

Credit sales during the year	€203,070
Cash sales during the year	<u>€ 1,000</u>
Total sales (Note 1)	<u>€204,070</u>

Calculation of Purchases:

Payables Control Account

Debit	€	Credit	€
Bank	139,200	Balance b/d	16,800
Discount received	1,020	Purchases (missing figure)	140,420
Balance c/d	<u>17,000</u>		
	<u>157,220</u>		<u>157,220</u>

Credit purchases during the year	€140,420
Cash purchases during the year	€ 800
Less: Drawings of stock	<u>€ (800)</u>
Total purchases (Note 2)	<u>€140,420</u>

Trading account for the year ended 31 st December 2019	€	€
Sales (Note 1)		204,070
<u>Less: Cost of Sales:</u>		
Opening stock (Opening Balance)	22,000	
Purchases (Note 2)	<u>140,420</u>	
	162,420	
Less: Closing stock (Closing Balance)	<u>(20,000)</u>	<u>142,420</u>
Gross profit		<u>61,650</u>

Step 3 – Preparation of the Income Statement

Disposal of the Non-Current Asset:

Disposal Account (Note 3)

Debit	€	Credit	€
Office equipment	3,000	Depreciation	600
		Bank	800
		Loss on disposal	<u>1,600</u>
	<u>3,000</u>		<u>3,000</u>

Depreciation on the asset disposed: €3,000 x 10% x 2 years = €600

Depreciation Charge for the Year (Note 4):

Depreciation on the office equipment: €47,000 x 10% = €4,700.

Depreciation on the motor vehicle: €9,000 x 15% = €1,350

Insurance Prepaid (Note 5):

Insurance paid during the year	€ 800
Add: insurance prepaid last year	€ 130
Less: insurance prepaid this year	<u>€(200)</u>
	<u>€ 730</u>

Rent Accrued (Note 6):

Rent paid during the year	€1,100
Less: rent accrued last year	€ (500)
Add: rent accrued this year	<u>€ 550</u>
	<u>€1,150</u>

Telephone Accrued (Note 7):

Telephone paid during the year	€ 300
Less: telephone accrued last year	€ (120)
Add: telephone accrued this year	<u>€ 90</u>
	<u>€ 270</u>

Income Statement for the year ended 31st December 2019	€	€
Gross profit		61,650
<u>Add: Revenue:</u>		
Discount received (add. information d)		<u>1,020</u>
		62,670
<u>Less: Expenses:</u>		
Discount allowed (add. information d)	970	
Loan interest paid (bank account)	1,000	
Depreciation (Note 4): Office equipment	4,700	
Motor vehicles	1,350	
Insurance (Note 5)	730	
Rent (Note 6)	1,150	
Telephone expenses (Note 7)	270	
Loss on disposal (Note 3)	1,600	
Electricity (Bank Account)	2,200	
Wages (Bank Account)	<u>14,000</u>	<u>27,970</u>
Net Profit		<u>34,700</u>

Step 4 - Preparation of the Statement of Financial Position

Net Book Value of the Non-Current Assets (Note 8):

	Office Equipment €	Motor Vehicles €
Balance at beginning of year	50,000	0
Add: Acquisitions (Purchase of Assets)	0	9,000
Less: Disposals	<u>(3,000)</u>	<u>0</u>
Balance of cost at end of year	<u>47,000</u>	<u>9,000</u>
Depreciation:		
Balance at beginning of year	10,000	0
Add: Depreciation charge for year	4,700	1,350
Less: Release on disposal	<u>(600)</u>	<u>0</u>
	<u>14,100</u>	<u>1,350</u>
Net book value	<u>32,900</u>	<u>7,650</u>

Calculation of Capital (Note 9):

Capital at beginning of year (step 1 - statement of affairs)	€45,010
Add: Capital deposit in bank account during the year	<u>€ 5,000</u>
Capital at end of year	<u>€50,010</u>

Computation of Drawings (Note 10):

Money taken by the owner (€8,800 bank + €200 cash sales)	€9,000
Stock taken by the owner (add. information c)	<u>€ 800</u>
Total drawings	<u>€9,800</u>

Statement of Financial Position as at 31 st December 2019	€	€
<u>Non-Current Assets (Note 8):</u>		
Office Equipment	47,000	
Less: Depreciation	<u>14,100</u>	32,900
Motor vehicle	9,000	
Less: Depreciation	<u>1,350</u>	<u>7,650</u>
		40,550
<u>Current Assets:</u>		
Stock	20,000	
Trade receivables	21,500	
Expenses prepaid	200	
Bank	20,000	
Cash	<u>300</u>	62,000
Total Assets		<u>102,550</u>
<u>Financed By:</u>		
Capital (Note 9)		50,010
Add: Net profit		<u>34,700</u>
		84,710
Less: Drawings (Note 10)		<u>9,800</u>
		74,910
<u>Current Liabilities:</u>		
Trade payables	17,000	
Expenses accrued (€550 + €190)	<u>640</u>	17,640
<u>Non-Current Liabilities:</u>		
Loan		<u>10,000</u>
Total Capital and Liabilities		<u>102,550</u>

Example: Determination of Profit from Opening and Closing Balances

The financial position on 1st February 2018 of Joseph Stellini showed the following information:

	€
Trade payables	8,000
Trade receivables	7,500
Bank and cash	2,800
Stock in trade	4,500
Office equipment	6,500
Premises	25,000
Accrued expenses	2,700
Prepaid expenses	2,500

The balances after one year, during which Joseph Stellini introduced additional capital of €5,000 and withdrew €7,500 for his own use amounted to:

	€
Trade payables	9,500
Trade receivables	7,000
Bank and cash	4,500
Stock in trade	6,500
Office equipment	6,000
Premises	25,000
Accrued expenses	2,300
Prepaid expenses	2,000

Required:

- The statement of affairs to show Joseph Stellini's capital position as at 1st February 2018.
- Calculation of the profit or loss made by Joseph Stellini during the year.

First one needs to determine the Capital position as at 1st February 2018 with the aid of the Statement of Affairs:

Statement of affairs as at 1st February 2018	€	€
<u>Non-Current Assets:</u>		
Premises		25,000
Office Equipment		<u>6,500</u>
		31,500
<u>Current Assets:</u>		
Stock	4,500	
Trade Receivables	7,500	
Expenses Prepaid	2,500	
Bank and Cash	<u>2,800</u>	<u>17,300</u>
Total Assets		<u>48,800</u>
<u>Financed By:</u>		
Capital (missing figure)		38,100
<u>Current Liabilities:</u>		
Trade Payables	8,000	
Expenses Accrued	<u>2,700</u>	10,700
Total Capital and Liabilities		<u>48,800</u>

The introduction of additional capital during the year should be added to the capital figure computed above. This is done below:

Capital as at 1 st February 2018	€38,100
Add: Additional capital	<u>€ 5,000</u>
	<u>€43,100</u>

The profit for the year can be calculated with the help of the statement of financial position, as shown below:

Statement of Financial Position as at 31st January 2019	€	€
<u>Non-Current Assets:</u>		
Premises		25,000
Office Equipment		<u>6,000</u>
		31,000
<u>Current Assets:</u>		
Stock	6,500	
Trade Receivables	7,000	
Expenses Prepaid	2,000	
Bank and Cash	<u>4,500</u>	<u>20,000</u>
Total Assets		<u>51,000</u>
<u>Financed By:</u>		
Capital (Note 1)		43,100
Add: Net profit (missing figure)		<u>3,600</u>
		46,700
Less: Drawings		<u>7,500</u>
		39,200
<u>Current Liabilities:</u>		
Trade Payables	9,500	
Expenses Accrued	<u>2,300</u>	<u>11,800</u>
Total Capital and Liabilities		<u>51,000</u>

Review Questions

Question 1

- Define incomplete records.
- What statement or account is normally used to determine the opening capital?
- What statement or account is normally used to compute the sales?
- What statement or account is normally used to calculate the purchases?

Question 2

Adam George Borg is a clothes retailer who does not keep proper accounting records. At 1st January 2019 his state of affairs reflected the following:

Assets and Liabilities	€
Motor Vehicle (value)	9,800
Trade receivables	5,600
Trade payables	5,000
Equipment	6,800
Stock	15,000
Bank	3,900

Adam's drawings amounted to €850, which comprised money taken from the bank account. Additional equipment of €300 was paid immediately by cheque.

At 31st December 2019 Adam's assets and liabilities were as follows:

Assets and Liabilities	€
Motor Vehicle (value)	9,000
Trade receivables	3,000
Trade payables	3,800
Equipment	7,100
Stock	18,000
Bank	2,750

Additional Information:

- i) The total amount of money received from trade receivables amounted to €12,300. There were also cash sales of €3,150 that were deposited in the business bank account.
- ii) There were no disposals of non-current assets.
- iii) Trade payables paid were €8,500 by cheque.
- iv) The remaining balancing figure in the bank account represents the expenses paid.
- v) Accrued expenses amounted to €120.

Required:

Prepare a statement outlining the net profit or loss generated during the year.

Question 3

Terry Micallef is the owner of a small grocery shop who do not keep proper accounting records. He managed to retrieve the following information as at 31st March 2018:

Assets and Liabilities	€
Bank	10,000
Trade receivables	8,000
Trade payables	6,950
Equipment	5,000
Stock	18,100
Wages due	150
Premises	45,000

From the bank statement you were able to prepare the following receipts and payments account:

Receipts	€	Payments	€
Balance b/d	10,000	Equipment	2,100
Equipment	500	Wages	1,500
Trade receivables	17,000	Trade payables	8,000
		Electricity	350
		Drawings	1,200
		General expenses	360
		Bank charges	50
		Balance c/d	<u>13,940</u>
	<u>27,500</u>		<u>27,500</u>

The assets and liabilities at 31st March 2019 comprised the following:

Assets and Liabilities	€
Bank	13,940
Trade receivables	11,500
Trade payables	9,000
Equipment	6,200
Stock	20,500
Wages due	210
Premises	45,000

Additional Information:

i) During the year Terry sold equipment costing €900.

Required:

- a) An income statement for the year ended 31st March 2019.
- b) A statement of financial positions at 31st March 2019.

PART 7:
INTERPRETATION OF ACCOUNTS

CHAPTER 25

THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

Objectives

After you have read this chapter you should be able to:

- Understand the content of the annual report and the financial statements;
- Distinguish between operating activities, investing activities and financing activities;
- Understand the main advantages of the financial statements; and
- Understand the key limitations of the financial statements.

25.1 The Annual Report

The annual report consists of the annual document that the board of directors prepare, which is distributed to ordinary shareholders and stakeholders in order to assess the financial performance and financial position of the organisation. This helps the ordinary shareholders and stakeholders to take an appropriate decisions.

The items included in the annual report depend on the directors' discretion. The information that is normally disclosed in the annual report consists of the: highlights; chairman's statement; directors' report; promotional material; corporate governance report; financial summary; independent auditor's report; financial statements; accounting policies and explanatory notes. These areas are explained in the proceeding subsections.

25.1.1 Highlights

The highlights section provides an overview of the organisation and its financial performance for the past financial year. The items outlined in the highlights section are normally described in further depth in other sections

of the annual report. For example, the highlights section normally includes the interim dividends paid and the dividends proposed to the ordinary shareholders for the financial and comparative years. This provides information to the ordinary shareholders about the direct return they received during the year. Comparative figures are provided, which consist of the interim dividends paid and the dividends proposed in the previous year. Such information is given to the ordinary shareholders in order to show them if there was an increase or decrease in the dividends provided.

The highlights section normally outlines positive factors about the organisation. This may distort the image of the organisation in the eyes of the ordinary shareholders and stakeholders because negative aspects are not mentioned. However, a detailed examination of the annual report and the financial statements can help the ordinary shareholders and stakeholders to identify the weaknesses of the firm. A financial analyst is normally employed by investors in order to perform a detailed examination of the organisation. In the next chapter the accounting ratio technique that helps to analyse the company in order to identify its key financial strengths and weaknesses is explained.

25.1.2 The Chairman's Statement

Organisations frequently include the chairman's statement in the annual report where the chairman highlights the key accomplishments of the firm and the challenges that the company is facing in the business environment. The chairman's statement is usually normative in style and financial figures are used in order to support the key claims stated by the chairman.

The chairperson normally comments positively about the organisation by highlighting accomplishments that the firm made. When the organisation is facing severe financial problems, the chairman tends to state that a reorganisation is taking place, which will help the firm to overcome these challenges. Again, this may distort the image of the organisation in the eyes of the ordinary shareholders and stakeholders because it gives the impression that the issues that the company is presently facing are for the short term. However, unfortunately sometimes this is not the case. Such problems may lead the organisation into bankruptcy.

An example of a chairman's statement is shown below:

Group revenue increased by 5% to £567m (2018: £540m) and profit before tax and exceptional items decreased by 10% to £72.1m (2018: £80.1m) for

the 52 weeks ended 2 February 2019. Profit before tax decreased by 12.3% to £47.5m (2018: £54.2m). Performance has been adversely affected by the very difficult trading conditions throughout the year, which comprise competitive discounting in the retail industry, increasing consumer uncertainty, and the unseasonable weather across our global markets at different points throughout the period.

The main contents that are normally stated in the chairman's statement consist of the following:

- **Financial Results:** a summary of the key financial results of the organisation, such as turnover, operating profit, net income and earnings per share.
- **Business Environment:** an evaluation of the business environment by looking at political and competitive aspects. Key challenges are sometimes stated followed by the firm's strengths that will help to overcome these challenges.
- **Dividends:** the dividends provided by the organisation during the year are stated and entwined with the dividend policy set by the board of directors.
- **Employees:** a comment about the employees of the organisation who are often regarded as a key resource of the firm who play a key role to achieve competitive advantages.

25.1.3 The Directors' Report

The Companies Act (2013) states that the board of directors are required to prepare a report for each financial year. In this report the names of the individuals who served as directors are outlined and an overview of the principal activities of the organisation are described. The recommended dividend to ordinary shareholders is also stated in this report.

A business review is then provided, which encompasses the following key factors:

- An explanation of the firm's strategy and key business risks. Some organisations often provide a detailed description by highlighting key opportunities and threats present in the industry and measures that the organisation is adopting towards these opportunities and threats;

- An examination of the key achievements of the organisation and its impact on the firm's financial performance and financial position;
- Information about the firm's policies pertinent to environmental sustainability, employees and community issues;
- Reference to specific financial figures present in the annual report, such as operating profit and sales revenue; and
- Measures adopted by the board of directors to ensure that the independent external auditor was given all the necessary information to prepare the audit report.

25.1.4 Promotional Material

The annual report is used by the board of directors in order to promote the firm's products. One needs to remember that the shareholders and stakeholders can also be customers of the organisation. For example, promotional material is often used to separate the sections of the annual report.

25.1.5 The Corporate Governance Report

The corporate governance report is sometimes included with the directors' report. Different perspectives are adopted in the literature in order to define corporate governance, such as the operational perspective, the relationship perspective, the stakeholder perspective, the societal perspective and more (Tricker 2015). The operational perspective is used in this book because it specifically focuses on shareholders who are the central users of the annual report. The Cadbury Committee took an operational perspective when defining corporate governance. This is the first corporate governance report drafted in 1992 (Tricker 2015). Corporate governance is defined as a system that directs and controls organisations. In this definition it is remarked that the individuals managing the company (the board of directors) are not necessarily the owners of the organisation (shareholders). Thus, the role of shareholders in governance is to appoint directors and auditors in order to satisfy themselves that there is an adequate governance structure in place (Tricker 2015).

The need of appropriate corporate governance has increased considerably in the past years due to accounting scandals, such as Enron and WorldCom. The board of directors of Enron utilised fair value accounting in order to inflate profits. Similarly, WorldCom inflated the profitability of the

organisation by recording expenditure as investments. The window dressing adopted by these firms remained undetected for a number of years by the independent auditors. Thus, shareholders and stakeholders started demanding better internal measures to ensure that reliable annual reports are prepared, which are useful to assess the stewardship of the board of directors.

The London Stock Exchange requires listed companies to comply with the Combined Code. The Combined Code highlights different factors that organisations need to state in the annual report. The main disclosure requirements comprise the following (Dyson 2010):

- The board of directors need to state if they are complying with the principles present in the Combined Code. Justification for not complying with the Combined Code needs to be outlined by the board of directors, if this is the case;
- An explanation of the board. Details should be provided of the chairman, deputy chairman, chief executive officer, senior independent director/s, independent non-executive director/s, and members of the nomination, audit and remuneration committees;
- An assessment of the performance of the board of directors and committees during the year;
- A description of the measures adopted by the nomination committee, audit committee and remuneration committee during the year;
- Responsibilities of the board of directors with respect to the preparation of the financial statements;
- The going concern assumption taken by the board of directors;
- An evaluation of the internal control policies and procedures present in the organisation; and
- An explanation of the non-audit services provided by the external auditor.

25.1.6 The Independent Auditor's Report

The Companies Act (2013) requires that companies in the United Kingdom engage an independent external auditor in order to review the financial statements and provide an audit opinion about their truth and fairness. Small companies and dormant companies are exempted from appointing an independent external auditor.

The role of the independent external auditor is to provide reasonable assurance to shareholders and stakeholders that the financial statements comply with accounting standards and relevant legislations. This helps to improve the reliability of the financial statements. However, there were instances of window dressing that were not identified by external auditors. For example, Arthur Anderson, the external auditors of Enron were unable to notice that top management were inflating the profits of the organisation. Clean (unqualified) audit reports were provided by the external auditors, which implied that the financial statements of Enron complied with accounting standards and pertinent laws.

25.1.7 The Financial Statements

International accounting standard number 1 highlights the layout of the statement of financial position, profit or loss statement and statement of changes in equity. These are key elements of the financial statements. However, the financial statements also comprise the comprehensive income statement and the statement of cash flows. The layout of the statement of cash flows is highlighted in internal accounting standard number seven.

The statement of financial position and the profit or loss statement have already been described in previous chapters. The comprehensive income statement outlines aspects pertinent to the firm's profitability. International accounting standard number 1 does not highlight the specific format of the comprehensive income statement. This standard states that the main items that should be considered in the comprehensive income statement are:

- Revenue;
- Taxation;
- Finance expenditure;
- Total discontinued operations;
- Profits or losses accounted by using the equity method; and
- Each class of other comprehensive income.

The first item included in the statement of comprehensive income consists of the net profit or loss, which is derived from the profit or loss statement.

The statement of cash flows shows the cash generated or used in operations, investing activities and financing activities. Operating activities reflect the cash generated or used in the daily operations. In this section one includes the cash derived from revenue, the cash used for expenditure and the taxation paid. The investing activities reflect the investments made by the

organisation. Variables present in the investing activities section consist of cash paid to acquire property, plant and equipment, cash generated from the disposal of property, plant and equipment and cash used to buy other firms. The financing activities reflect cash pertinent to the long term finance of the organisation. Thus, one includes cash derived from the issue of shares or debentures, cash used for the repayment of loans and dividends paid to ordinary shareholders.

One needs to remember that an increase in the cash and bank balances rarely agrees with the net profit generated by the organisation. The following instances may arise:

- There is an increase or decrease in cash flow and the profit or loss is not influenced;
- There is an increase or decrease in profit whereby the company's cash flow is not affected; or
- Both the profit or loss and the firm's cash flow are influenced but by different amounts.

Example: Only Cash Flow is Affected

An organisation acquires furniture of €10,000, which is paid immediately by cash. The present cash balance of the organisation is €85,000. In this case the cash balance will diminish to €75,000. However, this will not affect the profit or loss because it is treated as a capital expenditure and it is shown in the statement of financial position.

Example: Only Profit is Affected

The management of the firm decided to increase the provision for doubtful debts by €180 due to a significant increase in trade receivables. In this case the profit will decline by €180. This is a provision that does not reflect receipts or payments of money. Thus, this transaction does not influence the cash flow of the organisation.

Example: Cash Flow and Profit or Loss are Affected by Different Amounts

In November the financial controller paid insurance of €12,000 by cheque. This represents the insurance of motor vehicles, which cover a whole year. The bank account will decrease by €12,000. Nevertheless, this transaction encompasses insurance prepaid of €10,000. In such case the impact on

profit will be of €2,000 because the other €10,000 will be reflected as a prepayment in the statement of financial position.

The statement of changes in equity shows how each component of equity has changed during the financial year. Examples of components of equity consist of the ordinary share capital, the retained earnings, the general reserve and the capital redemption reserve. An extract of the statement of changes in equity is shown below:

Statement of changes in equity for the 52 weeks ended 26 January 2019	Share Capital €'000	Translation Reserve €'000	Retained Earnings €'000
Balance at 27 January 2018	3,000	50	290,000
Profit for the period			56,000
Exchange differences on translation of foreign operations		4,210	
Current tax on foreign currency translation		(1,857)	
Total comprehensive income for the period	0	2,353	56,000
<u>Transactions with Owners Recorded Directly in Equity:</u>			
Increase in issued share capital	10		
Share-based payment charges			201
Movement on current and deferred tax on share-based payments			(465)
Dividends paid			(31,230)
Total transactions with owners	10	0	(31,494)
Balance at 26 January 2019	3,000	2,403	314,506

25.1.8 Accounting Policies and Explanatory Notes

Accounting policies are outlined after the financial statements in the annual report. Accounting policies consist of specific principles that the board of directors used in order to prepare the financial statements. For example, an accounting policy is set for property, plant and equipment, which highlights

the depreciation method used for each non-current asset, and the estimated life of the non-current assets.

Explanatory notes are then provided, which give additional explanation of specific variables present in the financial statements. For example, a note is provided for property, plant and equipment which highlights the variables that influenced the cost and depreciation of the non-current assets. An extract of this note is shown below:

	Freehold Land and Buildings €'000	Fixtures, fittings and office equipment €'000	Total €'000
Cost			
At 27 January 2018	67,000	87,000	154,000
Additions/transfers		16,300	16,300
Disposals		(1,536)	(1,536)
Exchange rate movement	_____	<u>680</u>	<u>680</u>
At 26 January 2019	<u>67,000</u>	<u>102,444</u>	<u>169,444</u>
Depreciation			
At 27 January 2018	1,000	67,020	68,020
Charge for the period	500	9,900	10,400
Disposal		(553)	(553)
Impairment		2,000	2,000
Exchange rate movement	_____	<u>599</u>	<u>599</u>
At 26 January 2019	<u>1,500</u>	<u>78,966</u>	<u>80,466</u>
Net Book Value			
At 27 January 2018	<u>63,200</u>	<u>20,005</u>	<u>83,205</u>
At 26 January 2019	<u>65,500</u>	<u>23,478</u>	<u>88,978</u>

25.2 Advantages of the Financial Statements

The agency theory states that the assets of the organisation, which are financed by shareholders and stakeholders are managed by other individuals who are commonly known as the board of directors. There is the risk that the board of directors seek their personal interests, which diminish the financial wealth that the firm can provide to investors. For example, a

director may be interested to purchase an expensive company car. The director could have bought a less expensive car and thus more cash would be kept in the firm.

The financial statements provide useful financial figures that can be used in order to assess the stewardship of the board of directors. The financial statements show the financial performance and financial position of the organisation. Indeed, the financial statements provide key figures that are used for ratio analysis. Ratio analysis is described in depth in the next chapter. The financial statements are reviewed by an external auditor who gives reasonable assurance that they are in line to accounting standards and relevant law/s.

25.3 Main Limitations of the Financial Statements

The financial figures present in the financial statements reflect past events. Shareholders and stakeholders are interested in the future financial performance and financial position of the company. Moreover, the financial statements highlight the financial figures of the firm. Qualitative factors, such as the reputation of the organisation in the market and the morale of employees are also very important, and have a substantial impact on the financial performance and financial position of the organisation.

The statement of financial position shows the balances of assets, liabilities and equity at the end of the financial year. These figures may be significantly different during the year. Thus, the financial position of the company may be substantially different and there is the risk that it may be weaker than what is shown in the statement of financial position at the end of the year. Therefore, lenders risk that they will not be paid interest on time. Ordinary shareholders also risk that the company will be unable to provide an interim dividend due to the limited cash and cash equivalents during the year.

The financial statements are criticised that they reflect an approximation of the true financial performance and financial position of the organisation. The property, plant and equipment of the firm are valued at historical cost. So, the net book value of the property, plant and equipment may be significantly different than the market value. The prudence concept prohibits that the organisation reflects unrealised gains, such as the gain derived from internally generated goodwill. Thus, the income statement will fail to show the true economic profit made by the organisation.

Inflation also distorts the true profit generated by the company. The closing stock figure would be overstated when the company uses the first in first out inventory method. In this method the inventory is valued in accordance to the most current prices, which are higher than past ones due to inflation. Therefore, the profit figure would be overstated.

Review Questions

Question 1

- a) What are the main financial statements present in the annual report?
- b) What is the purpose of the independent auditor's report?
- c) Describe the main content present in the corporate governance report?

Question 2

- a) What is the statement of changes in equity?
- b) What are the main advantages of the financial statements?
- c) What are the key limitations of the financial statements?

Question 3

- a) What is the statement of cash flows?
- b) What are the main factors present in the directors' report?
- c) What are the main contents present in the chairman's statement?

CHAPTER 26

ACCOUNTING RATIOS

Objectives

After you have read this chapter you should be able to:

- Understand the main techniques used to examine the financial performance and financial position of an organisation;
- Calculate the profitability, liquidity, efficiency, gearing and long term solvency, and investors' ratios;
- Interpret and analyse the profitability, liquidity, efficiency, gearing and long term solvency, and investors' ratios; and
- Understand the limitations of accounting ratios.

26.1 Main Techniques to Analyse an Organisation

There are four main techniques that can be used to examine the financial statements of an organisation, which are explained below:

- **Horizontal Analysis:** this technique basically consists of making a line by line comparison of variables present in the financial statements over the years. For example, one determines the percentage increase in sales from 2018 to 2019. Horizontal analysis is normally adopted on key variables present in the income statement and the statement of financial position. These key variables consist of sales, gross profit, operating profit, net profit, interest expenditure, current assets, current liabilities, equity, long term borrowings and other significant variables present in the financial statements.
- **Trend Analysis:** this method also involves a line by line comparison of variables present in the financial statements. The main difference is that a base line of 100 is given for a particular year and the subsequent years are converted in compliance to this base line. For example, operating profits for 2015 were €10,000,

€11,500 for 2016, €18,900 for 2017, €21,600 for 2018 and €22,500 for 2019. The base line is 2015 and the figures for subsequent years would be computed as follows: 2016: 115 ($€11,500 \times 100/€10,000$); 2017: 189 ($€18,900 \times 100/€10,000$); 2018: 216 ($€21,600 \times 100/€10,000$); and 2019: 225 ($€22,500 \times 100/€10,000$). This technique helps to identify the growth, decline or stability of variables present in the financial statements over a number of years.

- **Vertical Analysis:** in this technique the figures present in the financial statements are converted as a percentage to the total amount. For example, all the variables present in the income statement are converted as a percentage of sales. This helps to evaluate cost efficiency in the organisation. In 2018 the operating expenses as a percentage of sales amounted to 49%. In 2019 this increased to 55%. This shows that cost efficiency in operating expenses has deteriorated and this adversely affected the profitability of the company. The figures present in the statement of financial position are expressed as a percentage of the total assets.
- **Ratio Analysis:** there are numerous accounting ratios that help to analyse the profitability, liquidity, efficiency, long term solvency and investment potential in the chosen organisation. These will be explained in depth in this chapter. Ratios need to be compared over time or with similar companies in order to identify key financial strengths and financial weaknesses of an organisation. The other techniques can also be used in order to strengthen the analysis of a firm. Furthermore, the results stemming from ratios should be compared with qualitative factors like the strategy of the organisation and measures adopted by management in the past years in order to have a clearer picture of the financial health of the organisation.

26.2 Explanation and Illustration of Accounting Ratios

The main profitability, liquidity, efficiency, long term solvency and investment potential ratios are described and illustrated in the proceeding subsections.

26.2.1 Profitability Ratios

Mark-Up

The mark-up shows the gross profit that the company is generating as a percentage of the cost of sales.

$$\text{Mark - Up} = \frac{\text{Gross Profit}}{\text{Cost of Sales}} \times 100$$

Margin

The margin shows the gross profit generated by the firm as a percentage of the sales revenue.

$$\text{Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

Example: Calculation of Mark-Up and Margin

The inventories and purchases of Mr. Smith in 2019 were as follows:

Stock at 1 st January 2019	€10,000
Purchases for the year	€30,000
Stock at 31 st December 2019	€9,000

Mr. Smith adds 25% to his cost of sales in order to determine the product's selling price.

Required:

Determine the sales revenue generated in 2019.

The 25% represents the mark-up of the organisation. This can be used to calculate the gross profit. First, one needs to determine the cost of sales in order to calculate the mark-up. The cost of sales is calculated below:

Opening Stock	€10,000
Purchases	€30,000
Less: Closing Stock	<u>€9,000</u>
Cost of Sales	<u>€31,000</u>

$$\text{Mark - Up}(25\%) = \frac{\text{Gross Profit}}{\text{Cost of Sales (€31,000)}} \times 100$$

$$\text{Gross Profit} = \text{€}31,000 \times 25\% = \text{€}7,750$$

Now, one can easily determine the sales revenue figure, as follows:

Cost of Sales	€31,000
Gross Profit	<u>€7,750</u>
Sales	<u>€38,750</u>

Sometimes, one is required to convert from mark-up to margin or vice versa in order to determine specific figures present in the income statement. Gross profit is the difference between sales and cost of sales. Thus, if the cost of sales and profit figures are known, one can determine the sales by adding the cost of sales with the profit. This leads to the following equation:

$$\text{Gross Profit} = \text{Sales} - \text{Cost of Sales}$$

$$\text{Sales} = \text{Gross Profit} + \text{Cost of Sales}$$

On the contrary, if the sales revenue and gross profit are known, one can determine the cost of sales by deducting the sales from the gross profit. This leads to the following equation:

$$\text{Cost of Sales} = \text{Sales} - \text{Gross Profit}$$

Example: Converting from Margin to Mark-Up

Mr. Abela's accounting records show the following information for 2019:

Stock at 1 st January 2019	€8,000
Purchases for the year	€26,000

Mr. Abela usually makes a margin of 20% and the gross profit for the year amounted to €5,000.

Required:

Convert from margin to mark-up and determine the closing stock.

First, one needs to convert the margin into a fraction because it is easier to work through a fraction than a percentage. In fraction terms 20% is 1/5.

$$\text{Gross Profit} = \text{Sales} - \text{Cost of Sales}$$

$$\text{Cost of Sales} = \text{Sales} - \text{Gross Profit}$$

$$\text{Cost of Sales} = 5 - 1$$

$$\text{Cost of Sales (mark-up)} = 1/4$$

$$\text{Mark - Up}(25\%) = \frac{\text{Gross Profit (€5,000)}}{\text{Cost of Sales}} \times 100$$

$$\text{Cost of Sales} = \frac{€5,000}{25} \times 100 = €20,000$$

One can now determine the closing inventory as a missing figure:

Opening stock	€8,000
Add: purchases	<u>€26,000</u>
	€34,000
Less: closing stock	<u>€14,000</u>
Cost of sales	<u>€20,000</u>

Example: Converting from Mark-Up to Margin

Mr. Smith's accounting records show the following information for 2019:

Stock at 1 st January 2019	€11,000
Purchases for the year	€30,000

Mr. Smith usually makes a mark-up of 25% and the gross profit for the year amounted to €8,000.

Required:

Convert from margin to mark-up and determine the closing stock.

Initially one needs to convert the mark-up into a fraction because it is easier to work through a fraction than a percentage. In fraction terms 25% is 1/4.

$$\text{Gross Profit} = \text{Sales} - \text{Cost of Sales}$$

$$\text{Sales} = \text{Cost of Sales} + \text{Gross Profit}$$

$$\text{Sales} = 4 + 1$$

$$\text{Sales (margin)} = 1/5$$

$$\text{Margin}(25\%) = \frac{\text{Gross Profit } (\text{€}8,000)}{\text{Sales}} \times 100$$

$$\text{Sales} = \frac{\text{€}8,000}{25} \times 100 = \text{€}40,000$$

First, one needs to determine the total cost of sales, which is done below:

Sales	€40,000
Gross Profit	<u>€8,000</u>
Cost of Sales	<u>€32,000</u>

Then, one can use the total cost of sales figure and the other figures to determine the closing stock. This is shown below:

Opening stock	€11,000
Add: purchases	<u>€30,000</u>
	€41,000
Less: closing stock	<u>€9,000</u>
Cost of sales	<u>€32,000</u>

Return on Capital Employed

This is the primary profitability ratio, which measures the ability of management to make operating profit from the capital employed. The larger the return on capital employed the more effective was management in generating operating profit from the capital employed. There are different ways how to calculate the capital employed. Capital employed can be total equity plus long term debt or total assets less the current liabilities.

$$\text{Return on Capital Employed} = \frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

Operating Profit Margin

The operating profit margin is useful to assess the level of efficiency in the organisation's operating expenses. The operating profit margin calculates the operating profit that the company is making from sales. For example, an operating profit margin of 20% means that the company is making €20 operating profit from every €100 of sales. An increase in the operating profit margin implies that efficiency in operational expenses improved in the firm.

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

Net Profit Margin

The net profit margin helps to evaluate the overall profitability of the firm. This ratio calculates the net profit that the company is making from sales. An increase in the net profit margin shows that the profitability of the company has improved.

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

26.2.2 Liquidity Ratios

Current Ratio

The current ratio shows how many times the current liabilities are covered by the current assets. The higher the current ratio the better is the liquidity position of the business enterprise because the current assets are stronger to cover the current liabilities. The best current ratio depends on the type of industry that the organisation is engaged in. Thus, when evaluating the current ratio one should compare this figure with the industry average.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Acid Test Ratio

The acid test ratio compares the liquid assets with the current liabilities. Liquid assets consist of the current assets that can be easily converted into cash. Inventories are not included with the liquid assets because these are the least liquid of the firm's current assets. Inventories need to be sold and then the customer needs to pay for the inventories purchased. Thus, there is a long process for inventories to be translated into cash. The higher the acid test ratio the stronger is the liquidity of the business enterprise.

$$\text{Acid Test Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

Cash Ratio

The cash ratio also evaluates liquidity by considering the ability of the company's cash and cash equivalents to cover the current liabilities. This ratio shows the coverage of the firm's short term liabilities by the present cash flow of the organisation. An increase in this ratio implies stronger liquidity.

$$\text{Cash Ratio} = \frac{\text{Cash and Cash Equivalents}}{\text{Current Liabilities}}$$

26.2.3 Efficiency Ratios

Asset Turnover

The asset turnover helps to evaluate the efficiency of management to generate sales. This ratio calculates the revenue made from the company's total assets. An increase in the asset turnover shows that the company was more effective to make sales from the total assets.

$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Total Assets}}$$

Days Sales in Inventory

The days sales in inventory ratio is used to evaluate the inventory management of the company. This ratio determines the number of days the organisation needs in order to sell its inventories. A decrease in the days sales in inventory means that inventories are sold more quickly, which helps to improve the profitability and liquidity of the company. Profitability is improved because the company will be able to decrease the inventory holding expenditure. Inventory holding costs can be insurance costs and also the risk of inventory obsolescence. Liquidity is improved because the cash is tied up with inventory for a shorter period of time. One needs to remember that inventories are not considered when one is examining the acid test ratio and the cash ratio. Thus, it is better to have a high amount of cash and cash equivalents than a significant amount of inventories.

$$\text{Days Sales in Inventory} = \frac{\text{Inventories}}{\text{Cost of Sales}} \times 365$$

Receivables Collection Period and Payables Payment Period

These ratios cover two essential variables present in the current assets and current liabilities of the organisation. The receivables collection period calculates the average time that trade receivables take to pay the business enterprise. A decline in the receivables collection period indicates that the credit control department was more effective. This helps the cash flow of the organisation. However, tighter credit can adversely impact the sales revenue generated by the company because customers may buy the goods from competitors that give better credit terms.

$$\text{Receivables Collection Period} = \frac{\text{Trade Receivables}}{\text{Credit Sales}} \times 365$$

Sometimes the credit sales figure is not provided in the financial statements. In this case one can take the total sales revenue figure.

The payables payment period determines on average the time that the organisation takes to pay suppliers. An increase in this ratio means that the company is taking more time to pay suppliers, which improves its cash flow. However, management should be careful not to deliberately delay payments to suppliers because this harms the reputation of the organisation.

$$\text{Payables Payment Period} = \frac{\text{Trade Payables}}{\text{Cost of Sales}} \times 365$$

When evaluating the firm's efficiency one is also required to compare the receivables collection period with the payables payment period. The receivables collection period needs to be lower than the payables payment period. This indicates that money is first received from trade receivables before making payments to trade payables. This decreases the risk that the company faces a cash shortage, which can lead to severe financial issues.

26.2.4 Long Term Solvency Ratios

Gearing Ratio

The gearing ratio helps to evaluate the financial risk of the organisation. This ratio examines the firm's capital structure by showing the percentage of long term borrowings used to finance the organisation in comparison to equity. The higher the gearing ratio the greater the financial risk of the company. Financial risk is the risk that the company's operating profit is unable to cover the borrowings' interest and thus a dividend cannot be paid

to ordinary shareholders. Financial risk also reflects the risk that the company is unable to pay the loan when it reaches maturity.

$$\text{Gearing} = \frac{\text{Long Term Debt}}{\text{Equity}} \times 100$$

Interest Cover Ratio

The gearing ratio is a measure of financial risk. A company may have a high financial risk and it still holds a good long term solvency. The interest cover ratio helps to examine the long term solvency of the organisation. This ratio shows how many times the operating profit is covering the borrowings' interest. The larger the interest cover ratio the stronger the long term solvency of the business enterprise.

$$\text{Interest Cover} = \frac{\text{Operating Profits}}{\text{Interest}}$$

26.2.5 Investors' Ratios

Earnings per share

The earnings per share is a key ratio used by financial analysts in order to evaluate the potential return that ordinary shareholders can get from the company. This ratio is on a per share basis meaning that the potential return is for each share invested in the company.

$$\begin{aligned} \text{Earnings per share} \\ &= \frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares issued}} \end{aligned}$$

Price-Earnings Ratio

The price-earnings ratio is also an important ratio for investors. This ratio indicates how much an ordinary shareholder is ready to pay to acquire the firm's ordinary shares in view of its present earnings per share. So, a high price-earnings ratio indicates that the investors have a high level of confidence that the company will have a strong future financial performance. However, one needs to be careful when examining the price-earnings ratio. There are instances where the price-earnings ratio is very high because the earnings per share is low. In such case the future prospects of the organisation are not necessarily very good and the confidence of investors may be low.

$$\text{Price – Earnings Ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

Dividend Cover

Investors are also interested in the direct dividend return that they can get from the organisation. The dividend cover ratio calculates the number of times the profit attributable to ordinary shareholders covers the dividend paid. The higher the ratio the greater the ability of the organisation to sustain the dividend policy set. Thus, a high dividend cover ratio is necessary when the board of directors adopted a dividend growth policy.

$$\text{Dividend Cover} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Dividends paid}}$$

Dividend per share

The dividend provided to ordinary shareholders is also often presented on a per share basis in the company's annual report. This helps ordinary shareholders to identify the direct return that they are gaining from each share invested in the company.

$$\text{Dividend per share} = \frac{\text{Dividend paid}}{\text{Number of ordinary shares issued}}$$

Dividend Yield

The dividend yield determines the anticipated return from an investor by acquiring shares in the company. This ratio also reflects the expectations of investors about the organisation, which ultimately influence the firm's share price. The better the expectations the more investors are willing to buy the company's shares. This leads to an increase in the firm's share price.

$$\text{Dividend Yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

Example: Financial Analysis of an Organisation

The income statement and the statement of financial position of Robin Enterprises are outlined below:

Robin Enterprises Income Statement for the year ended 31st December (€'000)	2019	2018
Sales	16,000	14,000
Cost of Sales	<u>8,640</u>	<u>7,700</u>
Gross Profit	7,360	6,300
Distribution Costs	3,600	3,150
Administrative Expenses	<u>2,880</u>	<u>2,100</u>
Operating Profit	880	1,050
Finance Costs	<u>308</u>	<u>140</u>
Profit on ordinary activities before tax	572	910
Tax Expense	<u>117</u>	<u>165</u>
Profit for the year	<u>455</u>	<u>745</u>

Robin Enterprises Statement of Financial Position as at 31st December (€'000)	2019	2018
<u>Non-Current Assets:</u>		
Property, plant and equipment	<u>9,800</u>	<u>7,400</u>
<u>Current Assets:</u>		
Inventories	1,728	1,386
Receivables	1,500	1,100
Prepaid Expenses	100	160
Cash and Cash Equivalents	0	268
Total Current Assets	<u>3,328</u>	<u>2,914</u>
Total Assets	<u>13,128</u>	<u>10,314</u>
<u>Equity:</u>		
Ordinary Share Capital	3,000	3,000
Reserves	1,100	1,000
Retained Earnings	<u>3,272</u>	<u>2,917</u>
Total Equity	<u>7,372</u>	<u>6,917</u>
<u>Non-Current Liabilities:</u>		
Bank Loans	<u>4,400</u>	<u>2,000</u>
<u>Current Liabilities:</u>		
Bank Overdraft	29	0
Payables	1,210	1,232
Corporation Tax Payable	117	165
Total Current Liabilities	<u>1,356</u>	<u>1,397</u>
Total Liabilities	<u>5,756</u>	<u>3,397</u>
Total Equity and Liabilities	<u>13,128</u>	<u>10,314</u>

Additional Information:

1. 90% of all the company's sales are made on credit.
2. The inventory at the end of 2017 amounted to €1,200.
3. The nominal value of the company's ordinary share capital amounted to €0.50 per share.
4. The dividends paid by the organisation amounted to: 2019 €100,000 and 2018 €80,000.
5. The market value of the company's ordinary shares were: 2019 €2.50 and 2018 €2.00.
6. The average current ratio of similar organisations amounted to 1.95:1 in 2019.

Required:

Evaluate the profitability, liquidity, efficiency, long term solvency and investment potential of Robin Enterprises.

First, one needs to compute the accounting ratios, which is done below:

Profitability Ratios:

$$\text{Return on Capital Employed} = \frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

Capital Employed = Equity + Long Term Debt

$$\text{Capital Employed (2019)} = €7,372 + €4,400 = €11,772$$

$$\text{Capital Employed (2018)} = €6,917 + €2,000 = €8,917$$

$$\text{Return on Capital Employed (2019)} = \frac{€880}{€11,772} \times 100 = 7.48\%$$

$$\text{Return on Capital Employed (2018)} = \frac{€1,050}{€8,917} \times 100 = 11.78\%$$

$$\text{Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$\text{Margin (2019)} = \frac{€7,360}{€16,000} \times 100 = 46.00\%$$

$$\text{Margin (2018)} = \frac{\text{€6,300}}{\text{€14,000}} \times 100 = 45.00\%$$

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

$$\text{Operating Profit Margin (2019)} = \frac{\text{€880}}{\text{€16,000}} \times 100 = 5.50\%$$

$$\text{Operating Profit Margin (2018)} = \frac{\text{€1,050}}{\text{€14,000}} \times 100 = 7.50\%$$

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

$$\text{Net Profit Margin (2019)} = \frac{\text{€455}}{\text{€16,000}} \times 100 = 2.84\%$$

$$\text{Net Profit Margin (2018)} = \frac{\text{€745}}{\text{€14,000}} \times 100 = 5.32\%$$

Liquidity Ratios:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Current Ratio (2019)} = \frac{\text{€3,328}}{\text{€1,356}} = 2.45:1$$

$$\text{Current Ratio (2018)} = \frac{\text{€2,914}}{\text{€1,397}} = 2.09:1$$

$$\text{Acid Test Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

$$\text{Acid Test Ratio (2019)} = \frac{\text{€3,328} - \text{€1,728}}{\text{€1,356}} = 1.18:1$$

$$\text{Acid Test Ratio (2018)} = \frac{\text{€2,914} - \text{€1,386}}{\text{€1,397}} = 1.09:1$$

$$\text{Cash Ratio} = \frac{\text{Cash and Cash Equivalents}}{\text{Current Liabilities}}$$

$$\text{Cash Ratio (2019)} = \frac{-\text{€}29}{\text{€}1,356} = -0.02: 1$$

$$\text{Cash Ratio (2018)} = \frac{\text{€}268}{\text{€}1,397} = 0.19: 1$$

Efficiency Ratios:

$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Total Assets}}$$

$$\text{Asset Turnover (2019)} = \frac{\text{€}16,000}{\text{€}13,128} = 1.22 \text{ times}$$

$$\text{Asset Turnover (2018)} = \frac{\text{€}14,000}{\text{€}10,314} = 1.36 \text{ times}$$

$$\text{Days Sales in Inventory} = \frac{\text{Inventories}}{\text{Cost of Sales}} \times 365$$

$$\text{Days Sales in Inventory (2019)} = \frac{\text{€}1,728}{\text{€}8,640} \times 365 = 73 \text{ days}$$

$$\text{Days Sales in Inventory (2018)} = \frac{\text{€}1,386}{\text{€}7,700} \times 365 = 66 \text{ days}$$

$$\text{Receivables Collection Period} = \frac{\text{Trade Receivables}}{\text{Credit Sales}} \times 365$$

$$\begin{aligned} \text{Receivables Collection Period (2019)} &= \frac{\text{€}1,500}{(\text{€}16,000 \times 90\%)} \times 365 \\ &= 38 \text{ days} \end{aligned}$$

$$\begin{aligned} \text{Receivables Collection Period (2018)} &= \frac{\text{€}1,100}{(\text{€}14,000 \times 90\%)} \times 365 \\ &= 32 \text{ days} \end{aligned}$$

$$\text{Payables Payment Period} = \frac{\text{Trade Payables}}{\text{Cost of Sales}} \times 365$$

$$\text{Payables Payment Period (2019)} = \frac{\text{€}1,210}{\text{€}8,640} \times 365 = 51 \text{ days}$$

$$\text{Payables Payment Period (2018)} = \frac{€1,232}{€7,700} \times 365 = 58 \text{ days}$$

Long Term Solvency:

$$\text{Gearing} = \frac{\text{Long Term Debt}}{\text{Equity}} \times 100$$

$$\text{Gearing (2019)} = \frac{€4,400}{€7,372} \times 100 = 59.69\%$$

$$\text{Gearing (2018)} = \frac{€2,000}{€6,917} \times 100 = 28.91\%$$

$$\text{Interest Cover} = \frac{\text{Operating Profits}}{\text{Interest}}$$

$$\text{Interest Cover (2019)} = \frac{€880}{€308} = 2.86 \text{ times}$$

$$\text{Interest Cover (2018)} = \frac{€1,050}{€140} = 7.50 \text{ times}$$

Investment Ratios:

Earnings per share

$$= \frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares issued}}$$

First one needs to determine the number of ordinary shares issued, which is done below:

$$\text{Number of Ordinary Shares Issued} = \frac{\text{Value of Ordinary Shares}}{\text{Nominal Value per share}}$$

$$\begin{aligned} \text{Number of Ordinary Shares Issued} &= \frac{€3,000}{€0.50} \\ &= 6,000 \text{ ordinary shares} \end{aligned}$$

$$\text{Earnings per share (2019)} = \frac{€455}{6,000} \times 100 = 7.58 \text{ cents per share}$$

$$\text{Earnings per share (2018)} = \frac{\text{€745}}{6,000} \times 100 = 12.42 \text{ cents per share}$$

The earnings per share were multiplied by 100 in order to change from € to cents.

$$\text{Price – Earnings Ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

$$\text{Price – Earnings Ratio (2019)} = \frac{250 \text{ cents}}{7.58 \text{ cents}} = 32.98$$

$$\text{Price – Earnings Ratio (2018)} = \frac{200 \text{ cents}}{12.42 \text{ cents}} = 16.10$$

The market value per share was translated into cents in order to comply with the earnings per share ratio, which is in cents.

$$\text{Dividend Cover} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Dividends paid}}$$

$$\text{Dividend Cover (2019)} = \frac{\text{€455}}{\text{€100}} = 4.55 \text{ times}$$

$$\text{Dividend Cover (2018)} = \frac{\text{€745}}{\text{€80}} = 9.31 \text{ times}$$

One needs to remember that the profit attributable to ordinary shareholders, which is shown in the income statement is in thousands. Therefore, the dividends paid need to be converted in thousands as well while computing the dividend cover ratio.

$$\text{Dividend per share} = \frac{\text{Dividend paid}}{\text{Number of ordinary shares issued}}$$

$$\text{Dividend per share (2019)} = \frac{\text{€100}}{6,000} \times 100 = 1.67 \text{ cents per share}$$

$$\text{Dividend per share (2018)} = \frac{\text{€80}}{6,000} \times 100 = 1.33 \text{ cents per share}$$

The dividend per share is converted into cents in a similar manner to the earnings per share.

$$\text{Dividend Yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

$$\text{Dividend Yield (2019)} = \frac{1.67 \text{ cents}}{250 \text{ cents}} \times 100 = 0.67\%$$

$$\text{Dividend Yield (2018)} = \frac{1.33 \text{ cents}}{200 \text{ cents}} \times 100 = 0.67\%$$

The profitability, liquidity, efficiency, long term solvency and investment ratios are now analysed. Bar charts are often used in financial analysis in order to illustrate the movement in the ratios calculated. This is also performed in the financial analysis performed in this example.

Profitability of Robin Enterprises

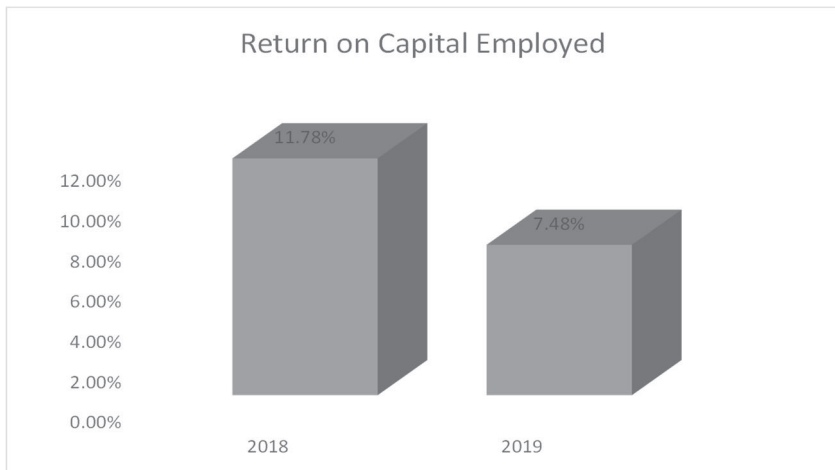


Figure 1 Robin Enterprises: Return on Capital Employed

The company's return on capital employed declined in 2019 meaning that the firm's management were less effective to make operating profit from the capital employed. Horizontal analysis shows that a key factor leading to a fall in the return on capital employed was the decrease in operating profit of 16.19% ((€880 - €1,050)/€1,050). Moreover, the capital employed increased by 32.02% ((€11,772 - €8,917)/€8,917). Therefore, the capital employed of the company increased and the profitability of the company did not increase at a similar or better rate. This shows mismanagement in the finance of the organisation.

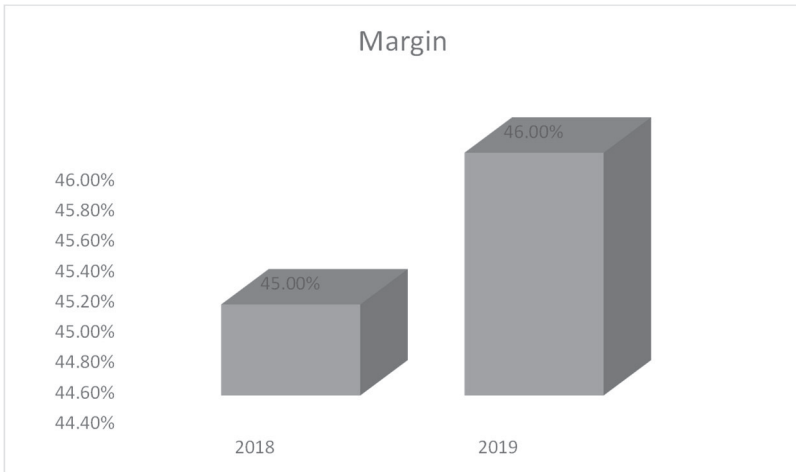


Figure 2 Robin Enterprises: Margin

The margin increased by 1% meaning that €1 more gross profit was made from every €100 revenue made. This helped to improve the firm's profitability, but the increase was marginal implying that the impact on the organisation's profitability was low. The gross profit margin may increase due to an increase in the company's product selling price, a more favourable sales mix if the firm is selling a mixture of products and/or better efficiency in the cost of goods sold, which may be due to trade discounts or cash discounts provided by suppliers.

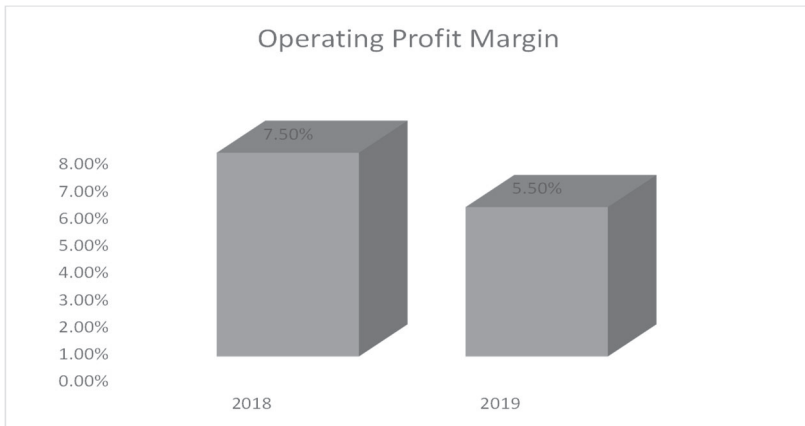


Figure 3 Robin Enterprises: Operating Profit Margin

The operating margin of Robin Enterprises decreased implying that the company made lesser operating profit from sales. The decrease in this ratio is evident in the fall in the company's operating profit of €170,000. A major factor that leads to a decline in the operating profit margin is lower efficiency in operating costs. The increase in distribution costs and administrative expenses amounted to 14.29% ($(€3,600 - €3,150)/€3,150$) and 37.14% ($(€2,880 - €2,100)/€2,100$). The increase in administrative expenses was bigger than the rise in sales of 14.29% ($(€16,000 - €14,000)/€14,000$). Thus, there is cost inefficiency in administration expenses.

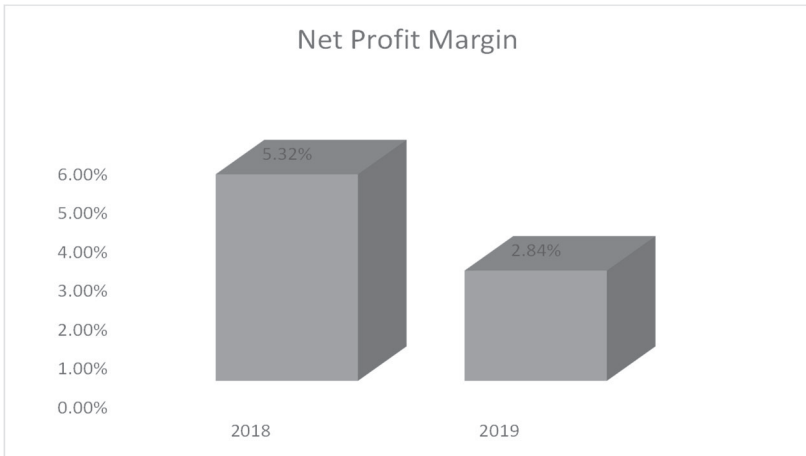


Figure 4 Robin Enterprises: Net Profit Margin

The net profit margin also declined meaning that the organisation generated lesser net profit from sales. The decrease in this ratio further supports the point that the profitability of Robin Enterprises worsened in 2019. The decline in the operating profit is an essential factor that led to a deterioration in the net profit margin. The 120% increase in finance costs ((€308 - €140)/€140) arising from an increase in bank loans is another factor that led to a decrease in net profit of €290,000.

Liquidity of Robin Enterprises

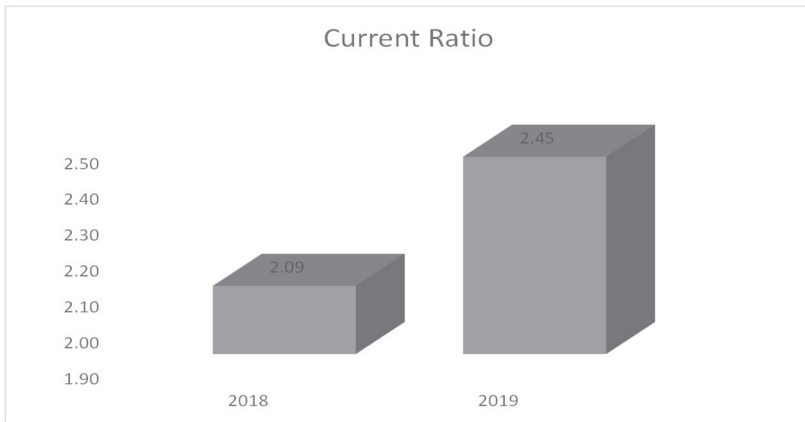


Figure 5 Robin Enterprises: Current Ratio

The increase in the current ratio of Robin Enterprises shows that the liquidity of the organisation improved. The rise in this ratio implies that the coverage of the current liabilities by the company's current assets was better. A better current ratio resulted from the 14.21% $((€3,328 - €2,914)/€2,914)$ increase in current assets and the 2.93% $((€1,356 - €1,397)/€1,397)$ decrease in current liabilities. The average current ratio of similar organisations of 1.95 is lower than the current ratio of Robin Enterprises. This shows that the liquidity of the company is better than similar organisations.

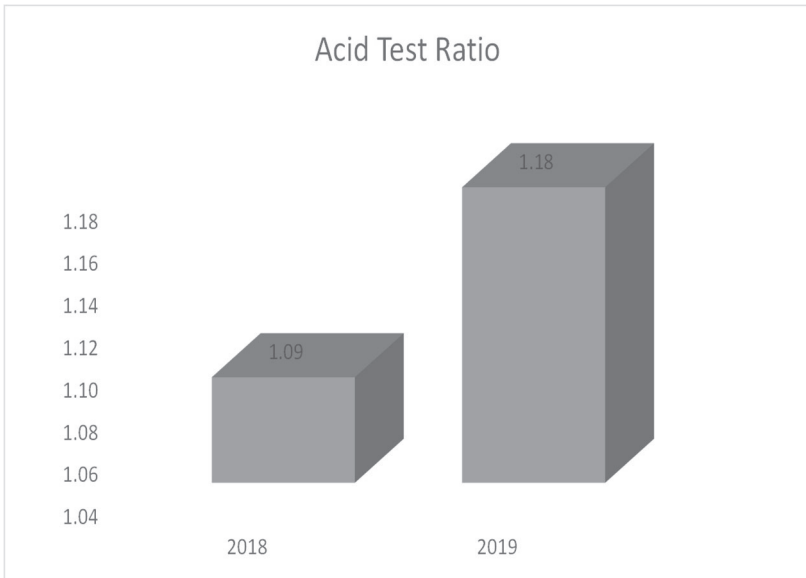


Figure 6 Robin Enterprises: Acid Test Ratio

The acid test ratio increased in 2019 indicating that the liquid assets got better in covering the current liabilities. This further supports the notion that the liquidity of Robin Enterprises improved.

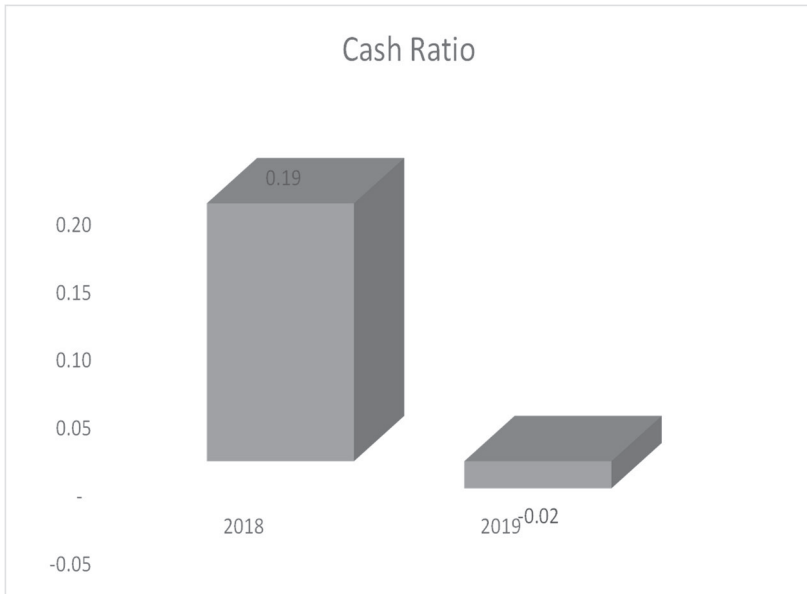


Figure 7 Robin Enterprises: Cash Ratio

The cash ratio deteriorated substantially in 2019, which means that the liquidity of Robin Enterprises got worst. Indeed, it is negative in 2019 because the organisation had a bank overdraft during that year. Thus, cash and cash equivalents were unable to cover the firm's current liabilities. This shows a high risk that the company will be unable to pay its short term financial obligations on time.

Efficiency of Robin Enterprises

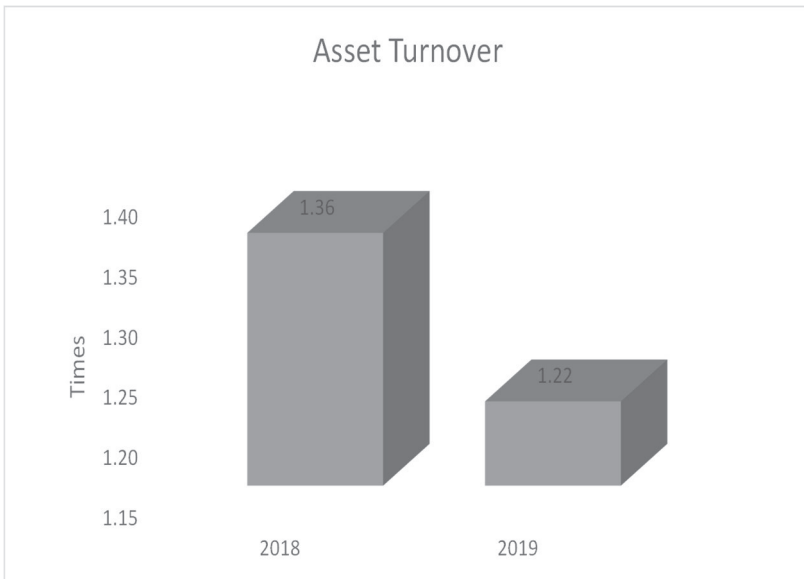


Figure 8 Robin Enterprises: Asset Turnover

The asset turnover of Robin Enterprises decreased in 2019 implying that the utilisation of the firm's assets was less effective to make sales. The increase in sales revenue of 14.29% was lower than the increase in total assets of 27.28% ($(€13,128 - €10,314)/€10,314$). This indicates that the new assets acquired by the firm has not yet been used well to makes sales. Such idle assets adversely affected the profitability of the firm.

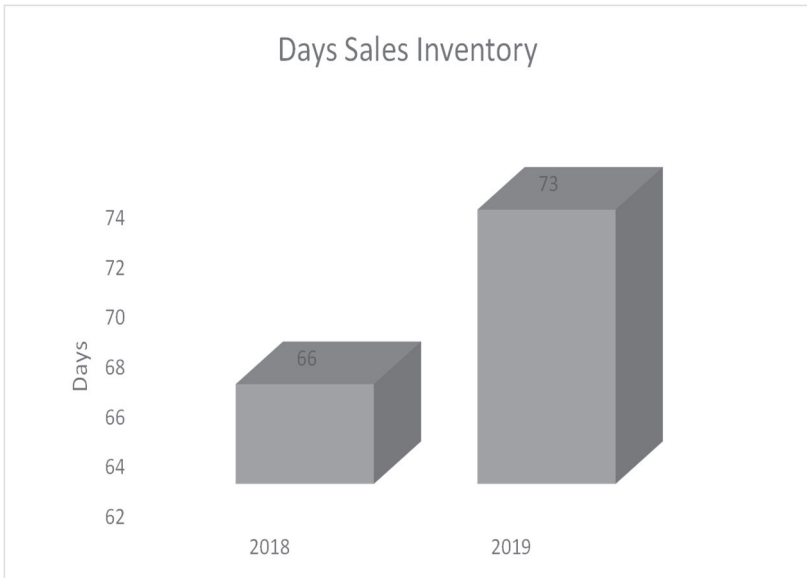


Figure 9 Robin Enterprises: Days Sales Inventory

In 2019 Robin Enterprises took seven days more to sell its inventories. This increased the risk of inventory obsolescence and higher inventory holding expenditure. Moreover, cash flow was tied with unsold inventory for a longer period of time. So, the increase in days sales inventory has also adversely affected the liquidity of Robin Enterprises.

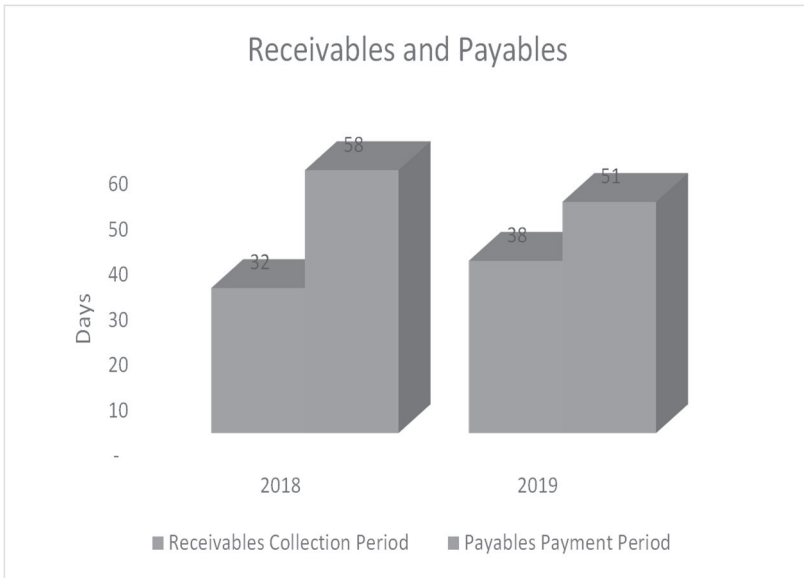


Figure 10 Robin Enterprises: Receivables and Payables

The receivables collection period increased by 6 days implying that trade receivables took a longer period of time to pay Robin Enterprises. This negatively impacted the cash flow of the organisation. However, customers viewed Robin Enterprises better because a longer period of credit was given. This helped the company to increase sales revenue. The payables payment period declined by 7 days implying that the company took a shorter period of time to pay trade payables. This negatively affected the cash flow of Robin Enterprises.

The receivables collection period was shorter than the payables payment period both in 2018 and 2019. This is positive for the cash flow of Robin Enterprises because cash was first received from consumers before payments to suppliers were performed. This decreased the risk of a cash shortage.

Long Term Solvency of Robin Enterprises

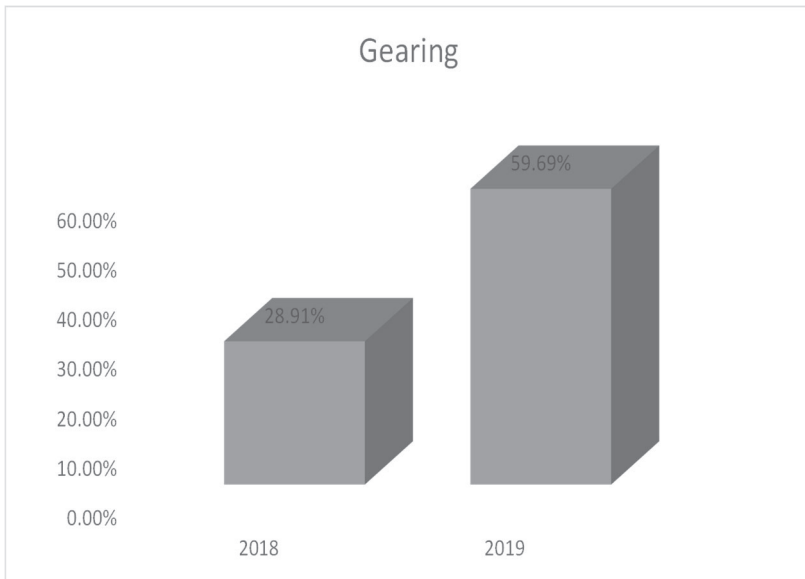


Figure 11 Robin Enterprises: Gearing

The gearing of Robin Enterprises increased drastically in 2019 and it exceeded 50%. This means that Robin Enterprises is a high-g geared company. A high-g geared company is an organisation that is financed by a high amount of long term debt. This implies that the financial risk of Robin Enterprises is significant. Therefore, Robin Enterprises needs a strong profitability and liquidity in order to support such a substantial financial risk.

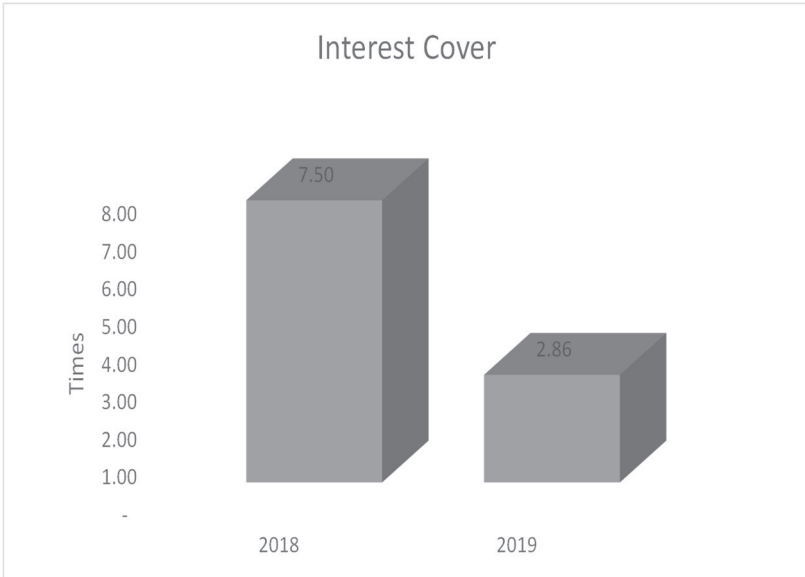


Figure 12 Robin Enterprises: Interest Cover

There was a large decline in the interest cover ratio meaning that the number of times that operating profit covered interest decreased. This shows that the long term solvency of Robin Enterprises got worse. The decline in the interest cover ratio was due to the decrease in operating profit of €170,000 and the increase in finance costs of €168,000.

Investment Potential in Robin Enterprises

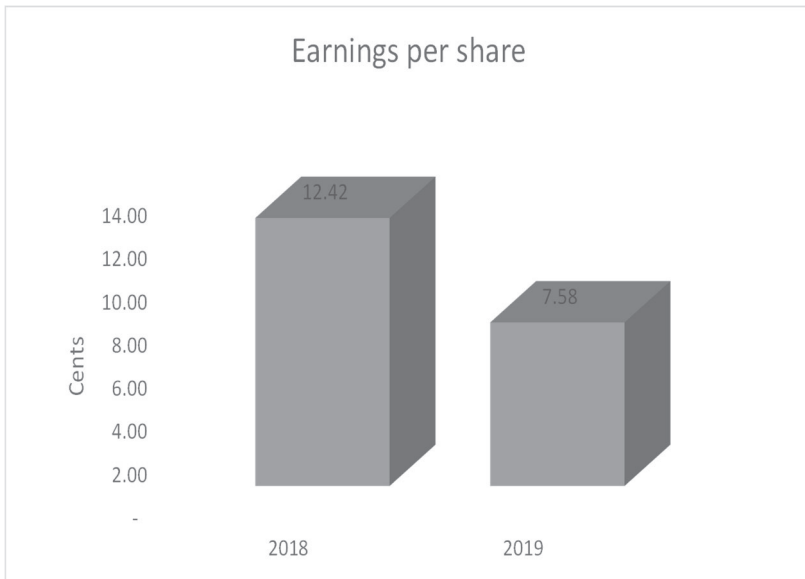


Figure 13 Robin Enterprises: Earnings per share

The 4.84 cents decrease in the earnings per share shows that in 2019 ordinary shareholders had lower potential earnings for every ordinary share bought. This indicates that ordinary shareholders will get a lower return. Therefore, this may push to a decrease in the market share price of Robin Enterprises because the demand to acquire the ordinary shares of the company will decrease. However, the market share price of Robin Enterprises increased by 50 cents per share from 2018 to 2019. This may be due to other factors that simulated an increase in the share price, such as asymmetric information provided by the growth in dividends of €20,000.



Figure 14 Robin Enterprises: Price-Earnings Ratio

There was an increase in the price-earnings ratio, which means that the confidence of investors in the firm's future financial performance has improved. This goes against the weak profitability noted when analysing the profitability ratios.

While describing the price-earnings ratio it was noted that one needs to exercise caution when analysing this ratio. The increase in the price-earnings ratio was due to a rise in the market share price of €0.50. Other factors like the rise in dividends may have resulted in an increase in the firm's share price. This does not necessarily mean better confidence in the organisation's financial performance. Furthermore, the earnings per share of Robin Enterprises decreased, which supported a rise in the price-earnings ratio. A fall in the earnings per share supports the claim that the financial performance of Robin Enterprises worsened. Therefore, it is erroneous to state that the confidence of investors in the company's future financial performance improved.

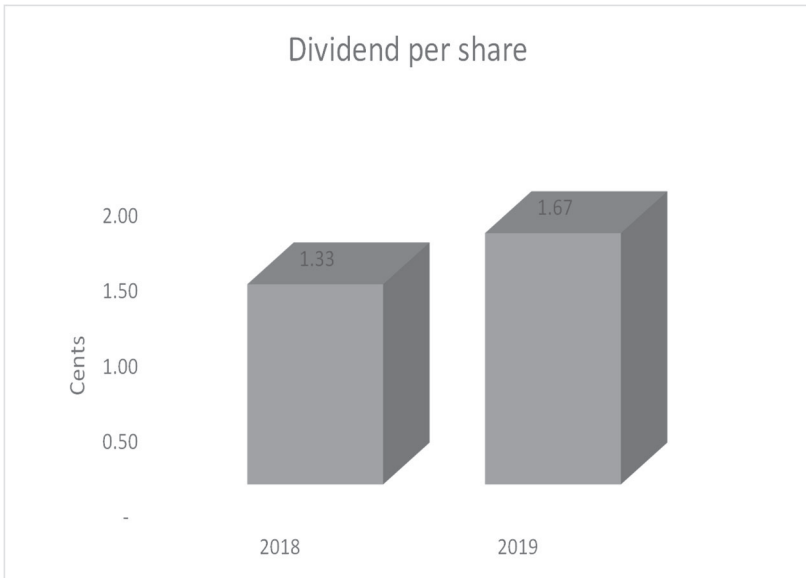


Figure 15 Robin Enterprises: Dividend per share

The rise in the dividend per share of 0.34 cents indicates that the board of directors of Robin Enterprises provided more dividends. In fact, the dividends paid to ordinary shareholders increased by €20,000. It is essential that Robin Enterprises has a solid profitability in order to support this dividend growth policy.

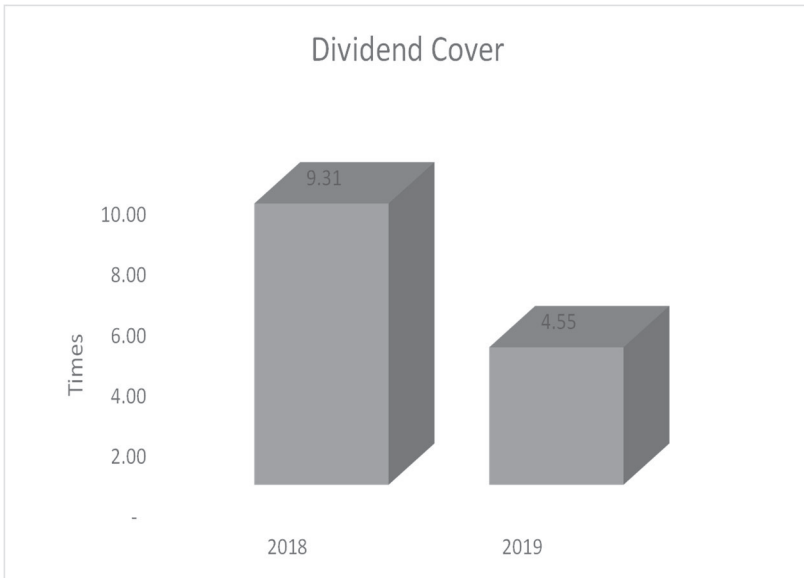


Figure 16 Robin Enterprises: Dividend Cover

The decrease in the dividend cover ratio implies that Robin Enterprises got weaker to cover the dividend provided to ordinary shareholders. This is due to the decline in profit available to ordinary shareholders, which amount to €290,000. Moreover, the top management of Robin Enterprises provided a rise in dividends. Therefore, there is an increase in the risk that the organisation will be unable to support its dividend growth policy.

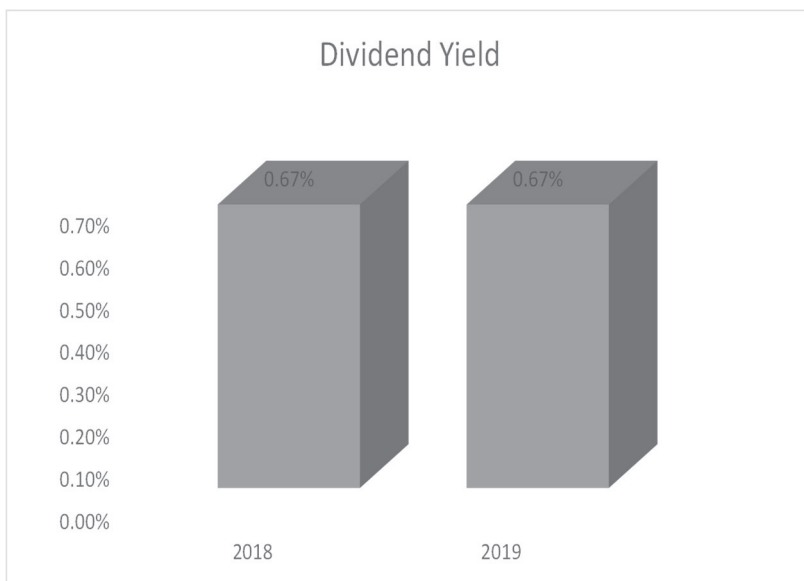


Figure 17 Robin Enterprises: Dividend Yield

The expected return from investors remained the same even though the profitability of Robin Enterprises deteriorated. The dividend yield is lower than 1%. This is significantly low implying that the expectation of investors is weak on the organisation. This conflicts with the increase in the market value of shares. There is the possibility that the market value of shares of Robin Enterprises is overstated. The share price of an organisation in the stock exchange does not necessarily agree with the intrinsic value of the company. There are instances where the market value of shares is overstated or understated.

Overall Evaluation of Robin Enterprises

The profitability ratios show that the profitability of Robin Enterprises got weaker in 2019 due to operational cost inefficiency and a sharp increase in finance costs. The company got in a weaker position to provide a good return to ordinary shareholders and to support the dividend policy. The decline in profitability also deteriorated the long term solvency of Robin Enterprises. The liquidity of the organisation improved, but Robin Enterprises is facing the problem of a low amount of cash. In fact, in 2019 the company had a bank overdraft.

The investment risk of ordinary shareholders is high due to a deterioration in the company's financial health. Moreover, the company was high-g geared in 2019 implying a high financial risk. There is also the possibility that the market value of ordinary shares was overvalued in 2019. Thus, it is better for ordinary shareholders to sell the shares they have in Robin Enterprises and purchase ordinary shares in organisations with a sounder financial performance and financial position.

26.3 Limitations of Ratio Analysis

The calculation of ratios is mainly based on the financial statements of the company. Therefore, the limitations of financial statements noted in the previous chapter are also applicable for accounting ratios. Ratios by themselves are meaningless. They need to be compared with a similar organisation or over time. It is difficult to find similar companies because large firms often diversify their operations and they have different accounting policies.

Additional investigation is also necessary in order to identify financial strengths and weaknesses. Horizontal, vertical and trend analyses help to identify the company's financial strengths and weaknesses, which are flagged by ratio analysis.

Accounting ratios ignore the impact of seasonal variations on the operations of the organisation. Furthermore, ratios focus solely on the financial aspects of the company. It is essential that one also takes into account qualitative aspects relevant to the organisation. Thus, it is recommended that one conducts an analysis of the external environment while examining accounting ratios. This helps to identify opportunities and threats present in the industry that influence the financial performance of the organisation.

Review Questions

Question 1

Describe the following accounting ratios:

- a) Return on capital employed.
- b) Current ratio.
- c) Acid test ratio.
- d) Gearing.
- e) Dividend cover.

Question 2

The financial statements of CompuTech Limited for the past two years are shown below:

CompuTech Ltd. Income Statement for the year ending 31st December	2019		2018	
	€'000	€'000	€'000	€'000
Sales		23,000		18,000
<u>Cost of Sales:</u>				
Opening Inventory	1,800		1,700	
Purchases	<u>12,000</u>		<u>9,000</u>	
	13,800		10,700	
Closing Inventory	<u>3,000</u>	<u>10,800</u>	<u>1,800</u>	<u>8,900</u>
				9,100
<u>Less: Expenses:</u>				
Selling and Distribution	4,000		3,000	
Administrative Expenses	<u>1,400</u>	<u>5,400</u>	<u>1,000</u>	<u>4,000</u>
Operating Profit		6,800		5,100
Interest Payable		<u>1,000</u>		<u>500</u>
Profit before tax		5,800		4,600
Corporate Taxation		<u>1,740</u>		<u>1,380</u>
Profit after tax		4,060		3,220
Less: Dividends Paid		<u>300</u>		<u>200</u>
Retained Profit		<u>3,760</u>		<u>3,020</u>
CompuTech Ltd. Statement of financial position as at 31st December	2019		2018	
	€'000	€'000	€'000	€'000
<u>Non-Current Assets:</u>				
Land and Buildings		12,000		9,000
Equipment		1,400		1,250
Motor Vehicles		<u>1,800</u>		<u>1,100</u>
		15,200		11,350

<u>Current Assets:</u>				
Inventory	2,360		1,800	
Trade Receivables	2,300		1,600	
Cash	<u>500</u>	<u>5,160</u>	<u>750</u>	<u>4,150</u>
Total Assets		<u>20,360</u>		<u>15,500</u>
<u>Equity:</u>				
Ordinary Shares of €1 each		10,000		10,000
Retained Earnings		<u>5,760</u>		<u>2,000</u>
		15,760		12,000
<u>Current Liabilities:</u>				
Trade Payables		1,100		1,500
<u>Non-Current Liabilities:</u>				
6% Debentures		<u>3,500</u>		<u>2,000</u>
		<u>20,360</u>		<u>15,500</u>

Required:

a) Calculate the following accounting ratios for 2018 and 2019:

- i) Return on capital employed.
- ii) Operating profit margin.
- iii) Net profit margin.
- iv) Current ratio.
- v) Acid test ratio.
- vi) Days sales inventory.
- vii) Receivables collection period.
- viii) Payables payment period.
- ix) Gearing.
- x) Interest cover.
- xi) Earnings per share.

b) Examine the profitability, liquidity, efficiency, long term solvency and investment ratios of CompuTech Limited.

Question 3

Stephen works as a plasterer and the capital at 31st December 2018 amounted to €40,000. All sales and purchases were on credit in 2019. The following additional information is available for 2019:

- Inventory at 31st December 2019 amounted to €19,000. This was €5,000 lower than the opening inventory;
- The cost of sales of the organisation were €129,000;
- The mark-up charged by Stephen in 2019 was 25%;
- The selling and distribution expenses of 2019 were 8% of sales;
- Stephen was unable to find the invoices of the overheads paid during the year;
- The net profit margin was 10% during 2019;
- The balance of non-current assets at 31st December 2019 was €32,250;
- Current assets comprise inventories, receivables and bank. The receivables balance at the end of the year was €13,253;
- The total assets of the organisation amounted to €70,000 at the end of 2019;
- The payables of the firm at the end of the year amounted to €21,000. This was the only current liability of the organisation; and
- On 1st January 2017 Stephen took a loan of €10,000. An interest of 4% per annum was paid at the end of the year. This loan matures at the end of 2026.

Required:

- a) Prepare the income statement for the year ended 31st December 2019.
- b) Prepare the statement of financial position as at that date.

MODEL ANSWERS

Part 2: The Double Entry System

Chapter 2 – Accounting for the Organisation’s Assets, Liabilities and Capital

Question 1

	Assets €	Liabilities €	Capital €
1	20,000	5,000	15,000
2	13,500	7,500	6,000
3	14,500	2,500	12,000
4	18,000	3,000	15,000
5	16,900	6,900	10,000
6	11,000	6,000	5,000

Question 2

The assets consist of:

- Motor Vehicles.
- Plant and Equipment
- Premises
- Accounts Receivable
- Inventory
- Cash at Bank

Question 3

Assets	Liabilities
Cash in hand	Accounts Payable
Building	Bank Overdraft
Office Equipment	
Accounts Receivable	
Inventory	

Question 4

Capital reflects the assets provided by the owner to the organisation. Liabilities comprise the financial obligations of the firm to external individuals/organisations for services rendered, money provided to the organisation or other assets acquired from these individuals/entities.

Questions 5

Office Equipment	€3,500
Motor Van	€6,000
Inventory	€4,000
Premises	<u>€100,000</u>
Total Assets	<u>€113,500</u>

Accounts Payable (€4,000 - €1,000)	€3,000
Loan	<u>€60,000</u>
Total Liabilities	<u>€63,000</u>

Assets = Capital + Liabilities

Capital = €113,500 - €63,000 = €50,500

Question 6

Assets €	Capital €	Liabilities €
15,000 (Bank)	15,000 (Owner)	
-500 (Bank) 500 (Cash)		
-3,500 (Bank) 3,500 (Office Equipment)		
-500 (Bank) 500 (Inventory)		
1,000 (Inventory)		1,000 (A. Micallef)
-600 (Inventory) 600 (Cash)		
-1,000 (Bank)	-1,000 (Drawings)	
-2,000 (Inventory) 2,000 (Accounts Receivable)		
-20 (Inventory)		-20 (A. Micallef)

Question 7

Capital Account					
Date	Debit	€	Date	Credit	€
			1 Sep.	Bank	4,000
			15 Sep.	Bank	1,500
Bank Account					
1 Sep.	Capital	4,000	2 Sep.	Office Equipment	300
15 Sep.	Capital	1,500	5 Sep.	Cash	250
			23 Sep.	Motors Inc.	3,000
Cash Account					
5 Sep.	Bank	250	28 Sep.	Office Equipment	200
Office Equipment Account					
2 Sep.	Bank	300			
28 Sep.	Cash	200			
Motor Van Account					
9 Sep.	Motors Inc.	3,000			
Motors Inc. Account					
23 Sep.	Bank	3,000	9 Sep.	Motor Van	3,000

Question 8

Capital Account					
Date	Debit	€	Date	Credit	€
			1 Oct.	Bank	5,000
			24 Oct.	Cash	500
Bank Account					
1 Oct.	Capital	5,000	3 Oct.	Motor Vehicle	2,200
17 Oct.	Felix Blackburn	3,300	4 Oct.	Office Furniture	400
			13 Oct.	Cash	300
			20 Oct.	Machinery	120
			30 Oct.	Novitex	500
Motor Vehicle Account					
3 Oct.	Bank	2,200			
Office Furniture Account					
4 Oct.	Bank	400			
Cash Account					
5 Oct.	Office Furniture	50			
13 Oct.	Bank	300			
15 Oct.	Machinery	100			
24 Oct.	Capital	500			
Machinery Account					
11 Oct.	Novitex	950	15 Oct.	Cash	100
20 Oct.	Bank	120			
Novitex Account					
30 Oct.	Bank	500	11 Oct.	Machinery	950
Felix Blackburn Account					
			17 Oct.	Bank	3,300

Question 9

Capital Account					
Date	Debit	€	Date	Credit	€
			1 Nov.	Cash	3,500
			10 Nov.	Bank	1,200
Cash Account					
1 Nov.	Capital	3,500	2 Nov.	Bank	3,000
19 Nov.	Office Furniture	100	13 Nov.	Drawings	50
Bank Account					
2 Nov.	Cash	3,000	5 Nov.	Machinery	1,000
10 Nov.	Capital	1,200	23 Nov.	Beautiful Furniture Ltd.	400
25 Nov.	Brandon Smith	4,000	28 Nov.	Drawings	120
Office Furniture Account					
4 Nov.	Beautiful Furniture Ltd.	500	8 Nov.	Beautiful Furniture Ltd.	100
			19 Nov.	Cash	100
Beautiful Furniture Ltd. Account					
8 Nov.	Office Furniture	100	4 Nov.	Office Furniture	500
23 Nov.	Bank	400			
Machinery Account					
5 Nov.	Bank	1,000			
Drawings Account					
13 Nov.	Cash	50			
28 Nov.	Bank	120			
Brandon Smith Account					
			25 Nov.	Bank	4,000

Chapter 3 – Accounting for Stock

Question 1

	Account to be Debited	Account to be Credited
Bought €300 goods on credit from B. Supplies.	Purchases €300	B. Supplies €300
Cash sales €350.	Cash €350	Sales €350
Bought goods for cash €200.	Purchases €200	Cash €200
Sold goods on credit of €260 to Alan Clooney.	Alan Clooney €260	Sales €260
Alan Clooney returned faulty goods costing €60.	Returns In €60	Alan Clooney €60
Bought goods on credit of €145 from B. Supplies.	Purchases €145	B. Supplies €145
Returned goods to B. Supplies of €45.	B. Supplies €45	Returns Out €45

Question 2

	Account to be Debited	Account to be Credited
Bought €450 goods on credit from AR Supplies.	Purchases €450	AR Supplies €450
Bought €800 machinery on credit from Volcat.	Machinery €800	Volcat €800
Cash sales €330.	Cash €330	Sales €330
Returned faulty machinery of €500 to Volcat.	Vocat €500	Machinery €500
Sold goods on credit to Martin Smith of €350.	Martin Smith €350	Sales €350
Martin Smith returned faulty goods of €20.	Returns In €20	Martin Smith €20
Bought €150 additional machinery by cheque.	Machinery €150	Bank €150

Question 3

Purchases Account					
Date	Debit	€	Date	Credit	€
1 Oct.	Tiles Supplies	800			
4 Oct.	Bank	650			
18 Oct.	Tiles Supplies	330			
Tiles Supplies Account					
24 Oct.	Returns Out	92	1 Oct.	Purchases	800
			18 Oct.	Purchases	330
Bank Account					
			4 Oct.	Purchases	650
Returns Out Account					
			24 Oct.	Tiles Supplies	92
Cash Account					
6 Oct.	Sales	300			
Sales Account					
			6 Oct.	Cash	300
			12 Oct.	Antoine New	830
Antoine New Account					
12 Oct.	Sales	830	13 Oct.	Returns In	30
Returns In Account					
13 Oct.	Antoine New	30			

Question 4

Purchases Account					
Date	Debit	€	Date	Credit	€
1 Nov.	Hepsub	560			
11 Nov.	Cash	440			
12 Nov.	Hepsub	781			
Sales Account					
			3 Nov.	Jennifer Mujis	870
			8 Nov.	Cash	260
			30 Nov.	Cash	713
Hepsub Account					
14 Nov.	Returns out	81	1 Nov.	Purchases	560
			12 Nov.	Purchases	781
Jennifer Mujis Account					
3 Nov.	Sales	870	6 Nov.	Returns In	90
Returns In Account					
6 Nov.	Jennifer Mujis	90			
Motor Vehicle Account					
7 Nov.	Good Vehicles	9,000			
Good Vehicles Account					
			7 Nov.	Motor Vehicle	9,000
Cash Account					
8 Nov.	Sales	260	11 Nov.	Purchases	440
30 Nov.	Sales	713			
Returns Out Account					
			14 Nov.	Hepsub	81
Machinery Account					
20 Nov.	SA Machinery	2,100	23 Nov.	SA Machinery	480
SA Machinery Account					
23 Nov.	Machinery	480	20 Nov.	Machinery	2,100

Chapter 4 – Accounting for Revenue and Expenses

Question 1

Cash Account					
Date	Debit	€	Date	Credit	€
			1 Feb.	Rent	65
			10 Feb.	Rates	70
Rent Account					
1 Feb.	Cash	65			
Discounts Allowed Account					
3 Feb.	B. Camenzuli	15			
B. Camenzuli Account					
			3 Feb.	Discounts Allowed	15
Bank Account					
20 Feb.	Commission Received	220	8 Feb.	Electricity	120
			27 Feb.	Wages	3,000
Electricity Account					
8 Feb.	Bank	120			
Rates Account					
10 Feb.	Cash	70			
Discounts Received Account					
			17 Feb.	R. Supplies	33
R. Supplies Account					
17 Feb.	Discounts Received	33			
Commission Received Account					
			20 Feb.	Bank	220
Wages Account					
27 Feb.	Bank	3,000			

Question 2

Bank Account					
Date	Debit	€	Date	Credit	€
8 Nov.	Rent Received	140	1 Nov.	Insurance	78
23 Nov.	R. Saliba	824	15 Nov.	Rates	110
			28 Nov.	Salaries	4,880
			30 Nov.	Bank Charges	24
Cash Account					
			7 Nov.	Motor Vehicle Repairs	85
			10 Nov.	Stationery	12
			14 Nov.	Water and Electricity	180
			20 Nov.	Sundry Expenses	89
Insurance Account					
1 Nov.	Bank	78			
Motor Vehicle Repairs Account					
7 Nov.	Cash	85			
Rent Received Account					
			8 Nov.	Bank	140
Stationery Account					
10 Nov.	Cash	12			
Discounts Received Account					
			11 Nov.	D. Smith	45
D. Smith Account					
11 Nov.	Discounts Received	45			

Water and Electricity Account					
14 Nov.	Cash	180			
Rates Account					
15 Nov.	Bank	110			
Sundry Expenses Account					
20 Nov.	Cash	89			
R. Saliba Account					
			23 Nov.	Bank	824
			23 Nov.	Discounts Allowed	18
Discounts Allowed Account					
23 Nov.	R. Saliba	18			
Salaries Account					
28 Nov.	Bank	4,880			
Bank Charges Account					
30 Nov.	Bank	24			

Question 3

a) Capital expenditure reflects the purchase of non-current assets and/or adding value to the present non-current assets of the organisation. Such expenditure is not often done by the firm and it is shown in the statement of financial position. Revenue expenditure reflects expenses necessary to run the operations of the firm. These expenses are frequent and are shown in the income statement.

b) Expenditure	Capital Expenditure	Revenue Expenditure
Purchase of buildings.	X	
Legal costs to buy buildings.	X	
Purchase of motor vehicle.	X	
Motor vehicle fuel.		X
Heating.		X
Rates.		X
Extension to buildings.	X	

Question 4

Capital Expenditure	Revenue Expenditure
Purchase of machinery.	Legal costs on collecting money from trade receivables.
Transportation paid for machinery purchased.	Carriage costs on sales.
Cost of rebuilding warehouse.	Carriage expenditure on purchases.
Purchase of air conditions.	Motor vehicles insurance.
Cost of installing air conditions.	Salaries of office clerks.
Purchase of new computer equipment.	Motor vehicles repaired.
	Bank charges.

Chapter 5 – Balancing Off the Accounts

Question 1

Capital Account					
Date	Debit	€	Date	Credit	€
30 Apr.	Balance c/d	<u>3,900</u>	1 Apr.	Bank	<u>3,900</u>
Bank Account					
1 Apr.	Capital	3,900	2 Apr.	Computer Equipment	850
			5 Apr.	Cash	300
			23 Apr.	Wages	1,000
			28 Apr.	Bank Charges	30
		—	30 Apr.	Balance c/d	<u>1,720</u>
		<u>3,400</u>			<u>3,400</u>
Cash Account					
5 Apr.	Bank	300	15 Apr.	Drawings	50
		—	30 Apr.	Balance c/d	<u>250</u>
		<u>300</u>			<u>300</u>
Computer Equipment Account					
2 Apr.	Bank	<u>850</u>	30 Apr.	Balance c/d	<u>850</u>
Purchases Account					
6 Apr.	AJ Supplies	210	30 Apr.	Balance c/d	490
6 Apr.	Refix	<u>280</u>			—
		<u>490</u>			<u>490</u>
AJ Supplies Account					
30 Apr.	Balance c/d	<u>210</u>	6 Apr.	Purchases	<u>210</u>

Sales Account					
30 Apr.	Balance c/d	1,250	9 Apr.	Ismail Smith	450
		_____	9 Apr.	Anthony Ferry	<u>800</u>
		<u>1,250</u>			<u>1,250</u>
Bank Charges Account					
28 Apr.	Bank	<u>30</u>	30 Apr.	Balance c/d	<u>30</u>
Refix Account					
30 Apr.	Balance c/d	<u>280</u>	6 Apr.	Purchases	<u>280</u>
Ismail Smith Account					
9 Apr.	Sales	<u>450</u>	30 Apr.	Balance c/d	<u>450</u>
Anthony Ferry Account					
9 Apr.	Sales	<u>800</u>	30 Apr.	Balance c/d	<u>800</u>
Drawings Account					
15 Apr.	Cash	<u>50</u>	30 Apr.	Balance c/d	<u>50</u>
Wages Account					
31 Apr.	Bank	<u>1,000</u>	30 Apr.	Balance c/d	<u>1,000</u>

Question 2

Cash Account					
Date	Debit	€	Date	Credit	€
1 Nov.	Sales	300	28 Nov.	Stationery	15
		—	30 Nov.	Balance c/d	<u>285</u>
		<u>300</u>			<u>300</u>
Bank Account					
12 Nov.	Mary Seale	438	8 Nov.	Electricity	55
23 Nov.	Alison Lumby	700	15 Nov.	Insurance	80
25 Nov.	Rent Received	<u>380</u>	30 Nov.	Balance c/d	<u>1,383</u>
		<u>1,518</u>			<u>1,518</u>
Insurance Account					
15 Nov.	Bank	<u>80</u>	30 Nov.	Balance c/d	<u>80</u>
Sales Account					
30 Nov.	Balance c/d	1,500	1 Nov.	Cash	300
			5 Nov.	Mary Seale	500
		—	5 Nov.	Alison Lumby	<u>700</u>
		<u>1,500</u>			<u>1,500</u>
Joseph Smith Account					
30 Nov.	Balance c/d	<u>400</u>	2 Nov.	Purchases	<u>400</u>
Alfred Maringe Account					
3 Nov.	Returns Out	30	2 Nov.	Purchases	390
30 Nov.	Balance c/d	<u>360</u>			—
		<u>390</u>			<u>390</u>
Purchases Account					
2 Nov.	Joseph Smith	400	30 Nov.	Balance c/d	790

2 Nov.	Alfred Maringe	<u>390</u>			—
		<u>790</u>			<u>790</u>
Returns Out Account					
30 Nov.	Balance c/d	<u>30</u>	3 Nov.	Alfred Maringe	<u>30</u>
Mary Seale Account					
5 Nov.	Sales	500	7 Nov.	Returns In	50
			12 Nov.	Bank	438
		—	12 Nov.	Discounts Allowed	<u>12</u>
		<u>500</u>			<u>500</u>
Returns In Account					
7 Nov.	Mary Seale	<u>50</u>	30 Nov.	Balance c/d	<u>50</u>
Alison Lumby Account					
5 Nov.	Sales	<u>700</u>	30 Nov.	Bank	<u>700</u>
Stationery Account					
28 Nov.	Cash	<u>15</u>	30 Nov.	Balance c/d	<u>15</u>
Electricity Account					
8 Nov.	Bank	<u>55</u>	30 Nov.	Balance c/d	<u>55</u>
Rent Received Account					
30 Nov.	Balance c/d	<u>380</u>	25 Nov.	Bank	<u>380</u>
Discounts Allowed Account					
12 Nov.	Mary Seale	<u>12</u>	30 Nov.	Balance c/d	<u>12</u>

Question 3

Capital Account					
Date	Debit	€	Date	Credit	€
31 Jan.	Balance c/d	<u>10,000</u>	1 Jan.	Balance b/d	<u>10,000</u>
Bank Account					
1 Jan.	Balance b/d	8,800	8 Jan.	Rates	150
4 Jan.	Agnes Seguna	412	12 Jan.	RJ Supplies	250
18 Jan.	Jacky Lumby	200	21 Jan.	Electricity	145
			25 Jan.	Cash	200
			26 Jan.	Wages	2,300
			28 Jan.	Bank Charges	50
		_____	31 Jan.	Balance c/d	<u>6,317</u>
		<u>9,412</u>			<u>9,412</u>
Rates Account					
8 Jan.	Bank	<u>150</u>	31 Jan.	Balance c/d	<u>150</u>
Cash Account					
1 Jan.	Balance b/d	350	2 Jan.	Drawings	50
10 Jan.	Commission Received	68	31 Jan.	RJ Supplies	180
16 Jan.	Sales	148	31 Jan.	Balance c/d	536
25 Jan.	Bank	<u>200</u>			_____
		<u>766</u>			<u>766</u>

Agnes Seguna Account					
1 Jan.	Balance b/d	412	4 Jan.	Bank	412
22 Jan.	Sales	<u>400</u>	31 Jan.	Balance c/d	<u>400</u>
		<u>812</u>			<u>812</u>
RJ Supplies Account					
6 Jan.	Returns Out	25	1 Jan.	Balance b/d	300
12 Jan.	Bank	250	5 Jan.	Purchases	250
12 Jan.	Discount Received	23			
31 Jan.	Cash	180			
31 Jan.	Balance c/d	<u>72</u>			—
		<u>550</u>			<u>550</u>
Jacky Lumby Account					
1 Jan.	Balance b/d	516	18 Jan.	Bank	200
		—	31 Jan.	Balance c/d	<u>316</u>
		<u>516</u>			<u>516</u>
Bank Charges Account					
28 Jan.	Bank	<u>50</u>	31 Jan.	Balance c/d	<u>50</u>
Purchases Account					
5 Jan.	RJ Supplies	<u>250</u>	31 Jan.	Balance c/d	<u>250</u>
Drawings Account					
2 Jan.	Cash	<u>50</u>	31 Jan.	Balance c/d	<u>50</u>
Returns Out Account					
31 Jan.	Balance c/d	<u>25</u>	6 Jan.	RJ Supplies	<u>25</u>
Commission Received Account					
31 Jan.	Balance c/d	<u>68</u>	10 Jan.	Cash	<u>68</u>

Discounts Received Account					
31 Jan.	Balance c/d	<u>23</u>	12 Jan.	RJ Supplies	<u>23</u>
Sales Account					
31 Jan.	Balance c/d	736	16 Jan.	Cash	148
			22 Jan.	Agnes Seguna	400
		—	22 Jan.	Francis Lumby	<u>188</u>
		<u>736</u>			<u>736</u>
Electricity Account					
21 Jan.	Bank	<u>145</u>	31 Jan.	Balance c/d	<u>145</u>
Francis Lumby Account					
22 Jan.	Sales	188	23 Jan.	Returns In	8
		—	31 Jan.	Balance c/d	<u>180</u>
		<u>188</u>			<u>188</u>
Returns In Account					
23 Jan.	Francis Lumby	<u>8</u>	31 Jan.	Balance c/d	<u>8</u>
Wages Account					
26 Jan.	Bank	<u>2,300</u>	31 Jan.	Balance c/d	<u>2,300</u>

Chapter 6 – Accounting for VAT

Question 1

Capital Account					
Date	Debit	€	Date	Credit	€
			1 Nov.	Bank	50,000
Bank Account					
1 Nov.	Capital	50,000	3 Nov.	Purchases	250
			3 Nov.	VAT	45
			5 Nov.	Supplies Ltd.	1,180
			20 Nov.	Telephone Expenses	212
			20 Nov.	VAT	38
			20 Nov.	Bank Charges	30
			20 Nov.	Wages	500
Purchases Account					
2 Nov.	Supplies Ltd.	1,000			
3 Nov.	Bank	250			
VAT Account					
2 Nov.	Supplies Ltd.	180	10 Nov.	Evans Smith	216
3 Nov.	Bank	45	12 Nov.	Cash	54
20 Nov.	Bank	38			
Supplies Ltd Account					
5 Nov.	Bank	1,180	2 Nov.	Purchases	1,000
			2 Nov.	VAT	180

Telephone Expenses Account					
20 Nov.	Bank	212			
Sales Account					
			10 Nov.	Evans Smith	1,200
			12 Nov.	Cash	300
Evans Smith Account					
10 Nov.	Sales	1,200			
10 Nov.	VAT	216			
Cash account					
12 Nov.	Sales	300			
12 Nov.	VAT	54			
Bank Charges Account					
20 Nov.	Bank	30			
Wages Account					
20 Nov.	Bank	500			

Workings:

$$2 \text{ Nov. Vat on Purchases} = \text{€}1,180 \times \frac{18\%}{118\%} = \text{€}180$$

$$3 \text{ Nov. Vat on Purchases} = \text{€}295 \times \frac{18\%}{118\%} = \text{€}45$$

$$10 \text{ Nov. Vat on Sales} = \text{€}1,416 \times \frac{18\%}{118\%} = \text{€}216$$

$$12 \text{ Nov. Vat on Cash Sales} = \text{€}354 \times \frac{18\%}{118\%} = \text{€}54$$

$$20 \text{ Nov. Vat on Telephone Expenses} = \text{€}250 \times \frac{18\%}{118\%} = \text{€}38$$

Question 2

Capital Account					
Date	Debit	€	Date	Credit	€
			1 Nov.	Bank	25,000
Bank Account					
1 Nov.	Capital	25,000	3 Nov.	Purchases	339
			3 Nov.	VAT	61
			5 Nov.	Repairs and Maintenance	847
			5 Nov.	VAT	153
			15 Nov.	Motor Vehicle	10,000
			15 Nov.	VAT	1,800
			20 Nov.	Fuel	85
			20 Nov.	VAT	15
			20 Nov.	Bank Charges	25
			20 Nov.	Insurance	700
Purchases Account					
2 Nov.	Extra Stock Ltd.	1,230			
3 Nov.	Bank	339			
VAT Account					
2 Nov.	Extra Stock Ltd.	270	10 Nov.	Alex Brincat	302
3 Nov.	Bank	61	12 Nov.	Cash	86
5 Nov.	Bank	153			

15 Nov.	Bank	1,800			
20 Nov.	Bank	15			
Extra Stock Ltd Account					
			2 Nov.	Purchases	1,230
			2 Nov.	VAT	270
Repairs and Maintenance Account					
5 Nov.	Bank	847			
Sales Account					
			10 Nov.	Alex Brincat	1,378
			12 Nov.	Cash	394
Alex Brincat Account					
10 Nov.	Sales	1,378			
10 Nov.	VAT	302			
Cash account					
12 Nov.	Sales	394			
12 Nov.	VAT	86			
Motor Vehicle Account					
15 Nov.	Bank	10,000			
Fuel Account					
20 Nov.	Bank	85			
Bank Charges Account					
20 Nov.	Bank	25			
Insurance Account					
20 Nov.	Bank	700			

Workings:

$$2 \text{ Nov. Vat on Purchases} = \text{€}1,500 \times \frac{18\%}{100\%} = \text{€}270$$

$$3 \text{ Nov. Vat on Purchases} = \text{€}400 \times \frac{18\%}{118\%} = \text{€}61$$

$$5 \text{ Nov. Vat on Repairs and Maintenance} = \text{€}1,000 \times \frac{18\%}{118\%} = \text{€}153$$

$$10 \text{ Nov. Vat on Sales} = \text{€}1,680 \times \frac{18\%}{100\%} = \text{€}302$$

$$12 \text{ Nov. Vat on Cash Sales} = \text{€}480 \times \frac{18\%}{100\%} = \text{€}86$$

$$15 \text{ Nov. Vat on Motor Vehicle} = \text{€}10,000 \times \frac{18\%}{100\%} = \text{€}1,800$$

$$20 \text{ Nov. Vat on Fuel} = \text{€}100 \times \frac{18\%}{118\%} = \text{€}15.$$

Question 3

a)					
VAT Account					
31 Dec.	Cash	20,700	1 Oct.	Balance b/d	560
31 Dec.	Cash	7,200	31 Dec.	Cash	36,000
31 Dec.	Cash	8,000	31 Dec.	Accounts Payable	414
31 Dec.	Balance c/d	<u>1,074</u>			_____
		<u>36,974</u>			<u>36,974</u>

Workings:

$$\text{Vat on Sales} = \text{€}236,000 \times \frac{18\%}{118\%} = \text{€}36,000$$

$$\text{Vat on Purchases} = \text{€}115,000 \times \frac{18\%}{100\%} = \text{€}20,700$$

$$\text{Discounts Received} = \text{€}115,000 \times 2\% = \text{€}2,300$$

$$\text{Vat on Discounts Received} = \text{€}2,300 \times \frac{18\%}{100\%} = \text{€}414$$

$$\text{Expenses Subject to VAT} = \frac{\text{€}80,000}{2} = \text{€}40,000$$

$$\text{Vat on Expenses} = \text{€}40,000 \times \frac{18\%}{100\%} = \text{€}7,200$$

b) Income Statement for quarter ending 31st December 2019	€	€
Sales (€236,000 - €36,000)		200,000
<u>Cost of Sales:</u>		
Opening Stock	15,000	
Purchases	<u>115,000</u>	
	130,000	
Closing Stock	<u>20,500</u>	109,500
Gross Profit		90,500
<u>Revenue:</u>		
Discounts Received		2,300
		92,800
Expenses		<u>80,000</u>
Net Profit		<u>12,800</u>

c) The pending VAT balance of €1,074 is a current liability because it represents VAT payable to the government.

Part 3: Preparing the Final Accounts

Chapter 7 – The Trial Balance

Question 1

Capital Account					
Date	Debit	€	Date	Credit	€
30 Apr.	Balance c/d	<u>3,000</u>	1 Apr.	Cash	<u>3,000</u>
Cash Account					
1 Apr.	Capital	3,000	2 Apr.	Bank	2,000
25 Apr.	Sales	120	22 Apr.	B. Jones	350
28 Apr.	Ales	<u>280</u>	30 Apr.	Balance c/d	<u>1,050</u>
		<u>3,400</u>			<u>3,400</u>
Bank Account					
2 Apr.	Cash	2,000	9 Apr.	Office Equipment	300
15 Apr.	James	540	11 Apr.	F. Maringe	495
			20 Apr.	Rent	100
		—	30 Apr.	Balance c/d	<u>1,645</u>
		<u>2,540</u>			<u>2,540</u>
Purchases Account					
4 Apr.	F. Maringe	500	30 Apr.	Balance c/d	1,150
4 Apr.	B. Jones	<u>650</u>			—
		<u>1,150</u>			<u>1,150</u>
F. Maringe Account					
11 Apr.	Bank	495	4 Apr.	Purchases	500
11 Apr.	Discount Received	<u>5</u>			—
		<u>500</u>			<u>500</u>

B. Jones Account					
22 Apr.	Cash	350	4 Apr.	Purchases	650
30 Apr.	Balance c/d	<u>300</u>			—
		<u>650</u>			<u>650</u>
Sales Account					
30 Apr.	Balance c/d	1,450	5 Apr.	James	550
			5 Apr.	Alex	780
		—	25 Apr.	Cash	<u>120</u>
		<u>1,450</u>			<u>1,450</u>
Discounts Received Account					
30 Apr.	Balance c/d	<u>5</u>	11 Apr.	F. Maringe	<u>5</u>
James Account					
5 Apr.	Sales	550	15 Apr.	Bank	540
		—	15 Apr.	Discount Allowed	<u>10</u>
		<u>550</u>			<u>550</u>
Alex Account					
5 Apr.	Sales	780	28 Apr.	Cash	280
		—	30 Apr.	Balance c/d	<u>500</u>
		<u>780</u>			<u>780</u>
Office Equipment Account					
9 Apr.	Bank	<u>300</u>	30 Apr.	Balance c/d	<u>300</u>
Discounts Allowed Account					
15 Apr.	James	<u>10</u>	30 Apr.	Balance c/d	<u>10</u>
Rent Account					
20 Apr.	Bank	<u>100</u>	30 Apr.	Balance c/d	<u>100</u>

Trial Balance as at 30th April 2019	€	€
Capital		3,000
Cash	1,050	
Bank	1,645	
Purchases	1,150	
B. Jones		300
Sales		1,450
Discounts Received		5
Alex	500	
Office Equipment	300	
Discounts Allowed	10	
Rent	100	
	<u>4,755</u>	<u>4,755</u>

Question 2

Capital Account					
Date	Debit	€	Date	Credit	€
31 May	Balance c/d	2,140	1 May	Bank	2,000
		_____	30 May	Cash	<u>140</u>
		<u>2,140</u>			<u>2,140</u>
Bank Account					
1 May	Capital	2,000	2 May	Cash	200
			11 May	Rates	15
			18 May	K. Allen	500
			18 May	Smith Supplies	650
			20 May	Insurance	90
		_____	31 May	Balance c/d	<u>545</u>
		<u>2,000</u>			<u>2,000</u>
Cash Account					
2 May	Bank	200	15 May	Drawings	50
23 May	Amanda	200	24 May	Stationery	30
25 May	Sales	85	28 May	Wages	110
30 May	Capital	<u>140</u>	31 May	Balance c/d	<u>435</u>
		<u>625</u>			<u>625</u>
Purchases Account					
6 May	K. Allen	800	31 May	Balance c/d	1,800
6 May	Smith Supplies	<u>1,000</u>			_____
		<u>1,800</u>			<u>1,800</u>

K. Allen Account					
18 May	Bank	500	6 May	Purchases	800
31 May	Balance c/d	<u>300</u>			—
		<u>800</u>			<u>800</u>
Smith Supplies Account					
10 May	Returns Out	100	6 May	Purchases	1,000
18 May	Bank	650			
31 May	Balance c/d	<u>250</u>			—
		<u>1,000</u>			<u>1,000</u>
Returns Out Account					
31 May	Balance c/d	<u>100</u>	10 May	Smith Supplies	<u>100</u>
Sales Account					
31 May	Balance c/d	555	10 May	Harry	150
			10 May	Amanda	320
		—	25 May	Cash	<u>85</u>
		<u>555</u>			<u>555</u>
Harry Account					
10 May	Sales	150	13 May	Returns In	50
		—	31 May	Balance c/d	<u>100</u>
		<u>150</u>			<u>150</u>
Amanda Account					
10 May	Sales	320	23 May	Cash	200
			23 May	Discount Allowed	8
		—	31 May	Balance c/d	<u>112</u>
		<u>320</u>			<u>320</u>

Rates Account					
11 May	Bank	<u>15</u>	31 May	Balance c/d	<u>15</u>
Returns In Account					
13 May	Harry	<u>50</u>	31 May	Balance c/d	<u>50</u>
Drawings Account					
15 May	Cash	<u>50</u>	31 May	Balance c/d	<u>50</u>
Insurance Account					
20 May	Bank	<u>90</u>	31 May	Balance c/d	<u>90</u>
Discounts Allowed Account					
23 May	Amanda	<u>8</u>	31 May	Balance c/d	<u>8</u>
Stationery Account					
24 May	Cash	<u>30</u>	31 May	Balance c/d	<u>30</u>
Wages Account					
28 May	Cash	<u>110</u>	31 May	Balance c/d	<u>110</u>
Trial Balance as at 31 st May 2019		€		€	
Capital				2,140	
Cash		435			
Bank		545			
Purchases		1,800			
K. Allen				300	
Smith Supplies				250	
Returns Out				100	
Sales				555	
Harry		100			
Amanda		112			
Rates		15			
Returns In		50			
Drawings		50			
Insurance		90			
Discounts Allowed		8			
Stationery		30			
Wages		<u>110</u>			
		<u>3,345</u>		<u>3,345</u>	

Question 3

Capital Account					
Date	Debit	€	Date	Credit	€
30 June	Balance c/d	2,400	1 June	Bank	1,500
		_____	1 June	Cash	<u>900</u>
		<u>2,400</u>			<u>2,400</u>
Bank Account					
1 June	Capital	1,500	12 June	Motor Vehicle	950
9 June	Rent Received	140	18 June	R. Smith	260
16 June	A. Camenzuli	1,000	18 June	B. Hall	450
			24 June	Computer	280
		_____	30 June	Balance c/d	<u>700</u>
		<u>2,640</u>			<u>2,640</u>
Computer Account					
24 June	Bank	<u>280</u>	30 June	Balance c/d	<u>280</u>
Rent Received Account					
30 June	Balance c/d	<u>140</u>	9 June	Bank	<u>140</u>
Cash Account					
1 June	Capital	900	11 June	Drawings	80
7 June	Sales	350	20 June	Stationery	24
23 June	Sales	135	25 June	Cleaning Fees	65
28 June	Richard	200	30 June	Purchases	410
28 June	Antoine	<u>260</u>	30 June	Balance c/d	<u>1,266</u>
		<u>1,845</u>			<u>1,845</u>

Drawings Account					
11 June	Cash	<u>80</u>	30 June	Balance c/d	<u>80</u>
Purchases Account					
2 June	R. Smith	660	30 June	Balance c/d	1,570
2 June	B. Hall	500			
30 June	Cash	<u>410</u>			_____
		<u>1,570</u>			<u>1,570</u>
R. Smith Account					
8 June	Returns Out	60	2 June	Purchases	660
18 June	Bank	260			
30 June	Balance c/d	<u>340</u>			_____
		<u>660</u>			<u>660</u>
B. Hall Account					
18 June	Bank	450	2 June	Purchases	500
30 June	Balance c/d	<u>50</u>			_____
		<u>500</u>			<u>500</u>
Sales Account					
30 June	Balance c/d	1,785	7 June	Cash	350
			10 June	Alfred	450
			10 June	Richard	290
			23 June	Cash	135
		_____	27 June	Antoine	<u>560</u>
		<u>1,785</u>			<u>1,785</u>

Returns Out Account					
30 June	Balance c/d	<u>60</u>	8 June	R. Smith	<u>60</u>
Discounts Allowed Account					
28 June	Antoine	<u>5</u>	30 June	Balance c/d	<u>5</u>
Alfred Account					
10 June	Sales	<u>450</u>	30 June	Balance c/d	<u>450</u>
Richard Account					
10 June	Sales	290	13 June	Returns In	45
			28 June	Cash	200
		—	30 June	Balance c/d	<u>45</u>
		<u>290</u>			<u>290</u>
Motor Vehicle Account					
12 June	Bank	<u>950</u>	30 June	Balance c/d	<u>950</u>
Returns In Account					
13 June	Richard	<u>45</u>	30 June	Balance c/d	<u>45</u>
A. Camenzuli Account					
30 June	Balance c/d	<u>1,000</u>	16 June	Bank	<u>1,000</u>
Stationery Account					
20 June	Cash	<u>24</u>	30 June	Balance c/d	<u>24</u>
Cleaning Fees Account					
25 June	Cash	<u>65</u>	30 June	Balance c/d	<u>65</u>
Antoine Account					
27 June	Sales	560	28 June	Cash	260
			28 June	Discount Allowed	5
		—	30 June	Balance c/d	<u>295</u>
		<u>560</u>			<u>560</u>

Trial Balance as at 30th June 2019	€	€
Capital		2,400
Cash	1,266	
Bank	700	
Computer	280	
Rent Received		140
Purchases	1,570	
R. Smith		340
B. Hall		50
Returns Out		60
Sales		1,785
Alfred	450	
Richard	45	
Motor Vehicle	950	
Antoine	295	
Returns In	45	
Drawings	80	
A. Camenzuli		1,000
Discounts Allowed	5	
Stationery	24	
Cleaning Fees	65	
	<u>5,775</u>	<u>5,775</u>

Chapter 8 – The Final Accounts of a Sole Trader

Question 1

Income Statement for the year ended 31 st December 2019	€	€
Sales		130,000
Less: Cost of Goods Sold:		
Opening Stock	7,500	
Add: Purchases	<u>99,000</u>	
	106,500	
Less: Closing Stock	<u>17,000</u>	<u>89,500</u>
Gross Profit		40,500
Add: Revenue:		
Discount received	18	
Commission received	<u>650</u>	<u>668</u>
		41,168
Less: Expenses:		
Rent	4,000	
Water and electricity	3,300	
Office expenses	578	
Telephone expenses	220	
Discounts Allowed	198	
Repairs	<u>350</u>	<u>8,646</u>
Net Profit		<u>32,522</u>

Question 2

Income Statement for the year ended 31st December 2019	€	€
Sales		240,000
Less: Returns In		<u>700</u>
		239,300
<u>Less: Cost of Goods Sold:</u>		
Opening Stock	15,600	
Add: Purchases	195,000	
Less: Returns Out	<u>680</u>	
	209,920	
Less: Closing Stock	<u>14,450</u>	<u>195,470</u>
Gross Profit		43,830
<u>Add: Revenue:</u>		
Discounts received		<u>350</u>
		44,180
<u>Less: Expenses:</u>		
Rent	540	
Motor Expenses	600	
Insurance	1,200	
Telephone Expenses	180	
Discounts Allowed	220	
General Expenses	<u>1,100</u>	<u>3,840</u>
Net Profit		<u>40,340</u>

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Buildings		48,000
Motor Vehicles		<u>12,000</u>
		60,000
<u>Current Assets:</u>		
Stock	14,450	
Accounts Receivable	7,900	
Bank	1,450	
Cash	<u>150</u>	<u>23,950</u>
Total Assets		<u>83,950</u>
<u>Financed By:</u>		
Capital		45,000

Add: Net Profit		40,340
		85,340
Less: Drawings		4,590
		80,750
<u>Current Liabilities:</u>		
Accounts Payable		3,200
Total Capital and Liabilities		83,950

Question 3

Income Statement for the year ended 30th April 2019	€	€
Sales		287,130
Less: Returns In		1,130
		286,000
<u>Less: Cost of Goods Sold:</u>		
Opening Stock	17,440	
Add: Purchases	217,000	
Less: Returns Out	830	
Add: Carriage In	410	
	234,020	
Less: Closing Stock	18,100	215,920
Gross Profit		70,080
<u>Add: Revenue:</u>		
Discounts Received	1,450	
Rent Received	7,800	
Interest Received	120	9,370
		79,450
<u>Less: Expenses:</u>		
Fuel Costs	980	
Water and electricity	755	
Carriage Out	650	
Office Expenses	3,880	
Repairs and Maintenance	2,070	
Wages and Salaries	7,050	
Discounts Allowed	1,480	
Sundry Expenses	720	
Rates	465	18,050
Net Profit		61,400

Statement of Financial Position as at 30th April 2019	€	€
<u>Non-Current Assets:</u>		
Buildings		65,000
Office Equipment		4,100
Motor Vehicles		<u>10,700</u>
		79,800
<u>Current Assets:</u>		
Stock	18,100	
Accounts Receivable	12,000	
Bank	<u>7,400</u>	<u>37,500</u>
Total Assets		<u>117,300</u>
<u>Financed By:</u>		
Capital		48,200
Add: Net Profit		<u>61,400</u>
		109,600
Less: Drawings		<u>1,200</u>
		108,400
<u>Current Liabilities:</u>		
Accounts Payable		<u>8,900</u>
Total Capital and Liabilities		<u>117,300</u>

Question 4

Income Statement for year ended 30th November 2019	€	€
Sales		147,800
Less: Returns In		<u>1,450</u>
		146,350
<u>Less: Cost of Goods Sold:</u>		
Opening Stock	21,200	
Add: Purchases	94,600	
Less: Returns Out	1,000	
Add: Carriage In	<u>800</u>	
	115,600	
Less: Closing Stock	<u>24,000</u>	<u>91,600</u>
Gross Profit		54,750
<u>Add: Revenue:</u>		
Discounts Received	950	
Commission Received	<u>1,550</u>	<u>2,500</u>
		57,250
<u>Less: Expenses:</u>		
Rent	1,200	
Water and electricity	2,300	
Carriage Out	1,050	
Office Expenses	1,440	
Repairs and Maintenance	300	
Transportation Expenses	1,760	
Wages and Salaries	8,560	
Interest Expense	70	
Legal Fees	900	
Insurance	850	
Discounts Allowed	1,064	
General Expenses	740	
Rates	<u>506</u>	<u>20,740</u>
Net Profit		<u>36,510</u>

Statement of Financial Position as at 30th November 2019	€	€
<u>Non-Current Assets:</u>		
Warehouse		90,000
Motor Vehicles		<u>14,000</u>
		104,000
<u>Current Assets:</u>		
Stock	24,000	
Accounts Receivable	18,700	
Cash	410	43,110
Total Assets		<u>147,110</u>
<u>Financed By:</u>		
Capital		100,000
Add: Net Profit		<u>36,510</u>
		136,510
Less: Drawings		<u>5,400</u>
		131,110
<u>Current Liabilities:</u>		
Bank Overdraft	1,400	
Accounts Payable	<u>14,600</u>	
Total Current Liabilities		16,000
Total Capital and Liabilities		<u>147,110</u>

Part 4: The Books of Original Entry and Accounting Controls

Chapter 9 – The Books of Original Entry

Question 1

Sales Journal		
Date	Customer	€
1 April	E. Micallef	152
14 April	E. Mendoza	220
14 April	R. Aquilina	300
24 April	F. Felix	361
30 April	N. Magrin	<u>80</u>
Transfer to the Sales Account		<u>1,113</u>

Question 2

Purchases Journal		
Date	Supplier	€
1 May	Supplies Ltd.	170
19 May	E. Poulton	190
19 May	R. Spiteri	310
23 May	D. Valencia	400
31 May	AK Supplies	<u>110</u>
Transfer to the Purchases Account		<u>1,180</u>

Question 3

Returns Inwards Journal		
Date	Customer	€
8 June	R. Debono	20
11 June	B. Lumby	20
18 June	R. Debono	36
24 June	B. Lumby	<u>23</u>
Transfer to the Returns Inwards Account		<u>99</u>

Returns Outwards Journal		
Date	Supplier	€
14 June	H. Mendez	20
29 June	L. Smith	<u>40</u>
Transfer to the Returns Outwards Account		<u>60</u>

Question 4

Sales Journal		
Date	Customer	€
3 July	T. Kelly	300
3 July	H. Taylor	178
18 July	T. Kelly	<u>250</u>
Transfer to the Sales Account		<u>728</u>

Purchases Journal		
Date	Supplier	€
1 July	K. Camilleri	420
1 July	Supplies Ltd.	350
9 July	Supplies Ltd.	500
9 July	B. Mohammed	418
9 July	T. Buhagiar	40
30 July	K. Camilleri	402
30 July	S. Kumar	<u>47</u>
Transfer to the Purchases Account		<u>2,177</u>

Returns Inwards Journal		
Date	Customer	€
5 July	T. Kelly	30
5 July	H. Taylor	8
23 July	T. Kelly	<u>45</u>
Transfer to the Returns Inwards Account		<u>83</u>

Returns Outwards Journal		
Date	Supplier	€
11 July	Supplies Ltd.	80
11 July	B. Mohammed	<u>18</u>
Transfer to the Returns Outwards Account		<u>98</u>

Chapter 10 – The Cash Book and the Petty Cash Book

Question 1

Cash Book

Date	Debit	Bank	Cash	Date	Credit	Bank	Cash
1 June	Balance b/d	8,100	590	14 June	Stationery		80
2 June	Sales		201	21 June	Ferramenta	1,900	
17 June	Lucas Azzopardi	260		26 June	Electricity		110
				30 June	Wages	1,050	
				30 June	Balance c/d	5,410	601
		8,360	791			8,360	791

Question 2

a) The purpose of a cash book is to outline the receipts and payments made by bank or cash during a particular period. This is useful to assess liquidity by looking at the bank or cash balance and the amount of receipts and payments made.

b) The main difference is that the three-column cash book includes two memorandum accounts, which are the discounts allowed and the discounts received.

c) Three-Column Cash Book

Date	Debit	Disc. allow.	Bank	Cash	Date	Credit	Disc. rec.	Bank	Cash
1 July	Balance b/d		14,600	350	3 July	Rent		600	
5 July	B. Jones	20	180		7 July	Andor Supplies	10	470	
10 July	Sales			250	15 July	Office Exp.			60
18 July	Bank			812	18 July	Cash		812	
20 July	R. Mang.	20		370	21 July	Drawing			125
					28 July	J. Garreth	12	500	
					31 July	Balance c/d		12,398	1,597
		40	14,780	1,782			22	14,780	1,782

Question 3

Petty Cash Book

Dr Receipts	Date	Details	Cr			
			Total	Travel	Cleaning Expenses	Stationery
€			€	€	€	€
12	1 Nov.	Balance b/d				
88	1 Nov.	Imprest: Cash Book				
	4 Nov.	Stationery	5			5
	5 Nov.	Cleaning Expenses	24		24	
	6 Nov.	Plastic Folders	3			3
	8 Nov.	Petrol	20	20		
	11 Nov.	Pencils	2			2
	17 Nov.	Parking Fee	5	5		
	23 Nov.	Motor Repairs	15	15		
	29 Nov.	Cleaning Expenses	<u>24</u>		<u>24</u>	
			98	40	48	10
—	30 Nov.	Balance c/d	<u>2</u>			
<u>100</u>			<u>100</u>			
2	1 Dec.	Balance b/d				
98	1 Dec.	Imprest: Cash Book				

Chapter 11 – The Bank Reconciliation Statement

Question 1

Bank Account

Date	Debit	€	Date	Credit	€
30 June	Balance b/d	1,110	30 June	Bank Charges	28
		—	30 June	Balance c/d	<u>1,082</u>
		<u>1,110</u>			<u>1,110</u>

Bank reconciliation statement as at 30 th June 2019	€
Balance as per cash book	1,082
<u>Add back: Unpresented Cheques:</u>	
C. Taylor	110
<u>Less: Bank Lodgements:</u>	
B. Yukl	<u>230</u>
Balance as per bank statement	<u>962</u>

Question 2

Bank Account

Date	Debit	€	Date	Credit	€
31 July	Balance b/d	820	31 July	P. Taylor	135
			31 July	Bank Charges	31
		—	31 July	Balance c/d	<u>654</u>
		<u>820</u>			<u>820</u>

Bank reconciliation statement as at 31st July 2019	€	€
Balance as per cash book		654
<u>Add back: Unpresented Cheques:</u>		
J. Masters	55	
U. Green	<u>105</u>	160
<u>Less: Bank Lodgements:</u>		
R. Lumby		98
Balance as per bank statement		<u>716</u>

Question 3

Bank Account

Date	Debit	€	Date	Credit	€
31 July	Balance b/d	660	31 July	R. Marcus	57
			31 July	Bank Charges	28
			31 July	K. Allen	70
		—	31 July	Balance c/d	<u>505</u>
		<u>660</u>			<u>660</u>

Bank reconciliation statement as at 31st July 2019	€	€
Balance as per cash book		505
<u>Add back: Unpresented Cheques:</u>		
R. Smith	83	
B. Maringe	<u>24</u>	107
<u>Less: Bank Lodgements:</u>		<u>63</u>
Balance as per bank statement		<u>549</u>

Question 4

Bank Account

Date	Debit	€	Date	Credit	€
31 Sep.	Balance c/d	839	30 Sep.	Balance b/d	439
			30 Sep.	JR Supplies	230
			30 Sep.	Toshi Supplies	48
			30 Sep.	Dishonoured Cheque	51
			30 Sep.	Bank Charges	33
		—	30 Sep.	Interest	<u>38</u>
		<u>839</u>			<u>839</u>

Bank reconciliation statement as at 30 th Sep- tember 2019	€	€
Balance as per cash book		(839)
Add back: Unpresented Cheques:		
Y. Yukl	88	
D. Atrill	<u>130</u>	218
Less: Bank Lodgements:		
V. Seale		<u>100</u>
Balance as per bank statement		<u>(721)</u>

Chapter 12 – Control Accounts

Question 1

Sales Ledger Control Account

Date	Debit	€	Date	Credit	€
1 June	Balance b/d	5,100	30 June	Returns In	450
30 June	Sales	37,100	30 June	Bank	34,800
			30 June	Discounts Allowed	120
		_____	30 June	Balance c/d	<u>6,830</u>
		<u>42,200</u>			<u>42,200</u>

Question 2

Purchases Ledger Control Account

Date	Debit	€	Date	Credit	€
30 June	Returns Out	284	1 June	Balance b/d	3,800
30 June	Bank	21,450	30 June	Purchases	29,900
30 June	Discounts Received	86			
30 June	Balance c/d	<u>11,880</u>			_____
		<u>33,700</u>			<u>33,700</u>

Question 3

Sales Ledger Control Account

Date	Debit	€	Date	Credit	€
1 July	Balance b/d	8,900	31 July	Returns In	410
31 July	Sales	40,400	31 July	Bank	36,100
31 July	Bank	55	31 July	Discounts Allowed	135
31 July	Bad Debts Recovered	170	31 July	Bad Debts	120
31 July	Balance c/d	89	31 July	Set Off	75
		_____	31 July	Balance c/d	<u>12,774</u>
		<u>49,614</u>			<u>49,614</u>

Purchases Ledger Control Account

Date	Debit	€	Date	Credit	€
31 July	Returns Out	312	1 July	Balance b/d	6,100
31 July	Bank	30,220	31 July	Purchases	36,750
31 July	Discounts Received	97	31 July	Balance c/d	67
31 July	Set Off	75			
31 July	Balance c/d	<u>12,213</u>			_____
		<u>42,917</u>			<u>42,917</u>

Question 4

Sales Ledger Control Account

Date	Debit	€	Date	Credit	€
1 Aug.	Balance b/d	10,000	1 Aug.	Balance b/d	55
31 Aug.	Sales	38,800	31 Aug.	Returns In	189
31 Aug.	Bank (Dishonoured cheque)	48	31 Aug.	Bank	25,600
31 Aug.	Balance c/d	76	31 Aug.	Discounts Allowed	201
			31 Aug.	Bad Debts	201
		_____	31 Aug.	Balance c/d	<u>22,678</u>
		<u>48,924</u>			<u>48,924</u>

Purchases Ledger Control Account

Date	Debit	€	Date	Credit	€
1 Aug.	Balance b/d	91	1 Aug.	Balance b/d	8,770
31 Aug.	Returns Out	106	31 Aug.	Purchases	29,100
31 Aug.	Bank	15,150	31 Aug.	Balance c/d	37
31 Aug.	Discounts Received	113			
31 Aug.	Balance c/d	<u>22,447</u>			_____
		<u>37,907</u>			<u>37,907</u>

Part 5: Year-End Adjustments

Chapter 13 – Accounting Concepts

Question 1

a) The prudence concept states that management need to take estimates in a cautious manner by reflecting any doubtful losses in the accounts. This accounting concept also requires that doubtful profits are not shown in the accounts. Such measures ensure that the profit figure is derived in a very prudent manner and it is not inflated.

b) The prudence concept is applied when one accounts for the provision for doubtful debts.

c) The consistency concept states that an organisation is required to comply with the accounting policies set. A change in accounting policies is permitted by this concept provided that such change will provide a more realistic figure of the account/s affected.

d) Objectivity means that the financial figure is based on facts. For example, the value of a machine is based on the cost incurred to purchase this machine. Subjectivity implies that the financial figure is not entirely based on facts. For example, the loss in the value of tangible non-current assets, which is reflected by the provision for depreciation is based on subjective estimates.

Question 2

a) The accruals concept is based on the premise that revenue and expenses are not shown when cash is received or paid. This concept states that revenue and expenditure need to be recorded in the accounts when they occur.

b) The accruals concept is applied when unpaid wages that occurred at the end of the financial year are added to the wages expense. For example, wages of €10,000 were paid in 2019. At the end of the financial year there are still €500 unpaid wages. These should be added with the wages paid leading to a total expense of €10,500.

c) International Financial Reporting Standards are prepared in order to provide guidance to the accountants who prepare the financial statements. These standards help to improve the understandability, comparability and relevance of the financial statements.

d) The materiality concept basically implies that only material items need to be show separately in the financial statements. Immaterial items need to be aggregated together. There is no exact figure for a material item because this depends on the size of the organisation. An item is deemed material if its non-disclosure affects the economic decision of users of financial statements.

Question 3

a) The substance over form concept implies that when recording a business transaction one looks at the substance of this transaction rather than its legal form. Thus, the organisation can record certain resources as its assets even though it does not have the ownership of such assets.

b) This concept is used when leases are recorded as assets of the organisation despite these are not owned by the firm.

c) The going concern concept reflects an assumption that management needs to take about the ability of the organisation to continue operating in the future.

d) Management cannot consider the organisation as a going concern when they intend to close the firm in the future; and the firm has financial problems, such as shortage of cash.

Chapter 14 – Accounting for Depreciation

Question 1

a) Depreciation of non-current assets arises due to wear and tear, obsolescence and depletion. Wear and tear reflect the physical deterioration of the non-current asset from its use. For example, the value of motor vehicles decreased due to their usage, which led to a physical deterioration of its engine. Obsolescence occurs when the non-current asset becomes outdated. For example, technological innovations decrease the value of computer equipment that the organisation presently owns. Depletion reflects the consumption of the resource present in the non-current asset. For example, the extraction of oil from earth.

b) Depreciation charge for 2016 = €15,000/5 = €3,000

Provision for Depreciation Account

Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	<u>3,000</u>	31 Dec.	Income Statement	<u>3,000</u>

Question 2

a) Acquisition 1 st January 2017	€20,000
Depreciation (€20,000 x 20%)	<u>€4,000</u>
Net book value 31 st December 2017	€16,000
Depreciation (€16,000 x 20%)	<u>€3,200</u>
Net book value 31 st December 2018	<u>€12,800</u>

b)

Provision for Depreciation Account

Date	Debit	€	Date	Credit	€
<u>2016</u>			<u>2016</u>		
31 Dec.	Balance c/d	<u>4,000</u>	31 Dec.	Income Statement	<u>4,000</u>
<u>2017</u>			<u>2017</u>		
31 Dec.	Balance c/d	7,200	1 Jan.	Balance b/d	4,000
		_____	31 Dec.	Income Statement	<u>3,200</u>
		<u>7,200</u>			<u>7,200</u>

Question 3

Motor Vehicle Account

Date	Debit	€	Date	Credit	€
<u>2016</u>			<u>2016</u>		
1 Jan.	Bank	<u>25,000</u>	31 Dec.	Balance c/d	<u>25,000</u>
<u>2017</u>			<u>2017</u>		
1 Jan.	Balance b/d	25,000	31 Dec.	Balance c/d	57,000
1 Jan.	Bank	20,000			
30 June.	Cash	<u>12,000</u>			_____
		<u>57,000</u>			<u>57,000</u>
<u>2018</u>			<u>2018</u>		
1 Jan.	Balance b/d	57,000	30 June	Disposal	25,000
		_____	31 Dec.	Balance c/d	<u>32,000</u>
		<u>57,000</u>			<u>57,000</u>

b)

Provision for Depreciation Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2016</u>			<u>2016</u>		
31 Dec.	Balance c/d	<u>2,500</u>	31 Dec.	Income Statement	<u>2,500</u>
<u>2017</u>			<u>2017</u>		
31 Dec.	Balance c/d	7,500	1 Jan	Balance b/d	2,500
		—	31 Dec.	Income Statement	<u>5,000</u>
		<u>7,500</u>			<u>7,500</u>
<u>2018</u>			<u>2018</u>		
30 June	Disposal	6,250	1 Jan	Balance b/d	7,500
31 Dec.	Balance c/d	<u>5,500</u>	31 Dec.	Income Statement	<u>4,250</u>
		<u>11,750</u>			<u>11,750</u>

Calculation of Depreciation:

Depreciation 2016:Asset bought 1st January 2016: (€25,000/10) €2,500**Depreciation 2017:**

Asset bought last year: (€25,000/10) €2,500

Asset bought 1st January 2017: (€20,000/10) €2,000Asset bought 30th June 2017: ((€12,000 - €2,000)/10 x 6/12) €500Total Depreciation Charge €5,000**Depreciation 2018:**Asset sold 30th June 2018: ((€25,000/10) x 6/12) €1,250

Remaining Balance:

Bought 1st January 2017: (€20,000/10) €2,000Bought 30th June 2017: ((€12,000 - €2,000)/10) €1,000Total Depreciation Charge €4,250

Accumulated Depreciation on Non-Current Asset Sold:

2016	€2,500
2017	€2,500
2018	<u>€1,250</u>
	<u>€6,250</u>

c)

Disposal Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2018</u>			<u>2018</u>		
30 June	Motor Vehicle	25,000	30 June	Provision for depreciation	6,250
			30 June	Cash	8,000
		———	30 June	Income Statement	<u>10,750</u>
		<u>25,000</u>			<u>25,000</u>

Question 4

a)

Motor Vehicle Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2016</u>			<u>2016</u>		
1 Jan.	Bank	<u>25,000</u>	31 Dec.	Balance c/d	<u>25,000</u>
<u>2017</u>			<u>2017</u>		
1 Jan.	Balance b/d	25,000	31 Dec.	Balance c/d	57,000
1 Jan.	Bank	20,000			
30 June	Cash	<u>12,000</u>			———
		<u>57,000</u>			<u>57,000</u>
<u>2018</u>			<u>2018</u>		
1 Jan.	Balance b/d	57,000	30 June	Disposal	25,000
		———	31 Dec.	Balance c/d	<u>32,000</u>
		<u>57,000</u>			<u>57,000</u>

b)

Provision for Depreciation Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2016</u>			<u>2016</u>		
31 Dec.	Balance c/d	<u>2,500</u>	31 Dec.	Income Statement	<u>2,500</u>
<u>2017</u>			<u>2017</u>		
31 Dec.	Balance c/d	6,750	1 Jan	Balance b/d	2,500
		—	31 Dec.	Income Statement	<u>4,250</u>
		<u>6,750</u>			<u>6,750</u>
<u>2018</u>			<u>2018</u>		
30 June	Disposal	5,763	1 Jan	Balance b/d	6,750
31 Dec.	Balance c/d	<u>4,300</u>	31 Dec.	Income Statement	<u>3,313</u>
		<u>10,063</u>			<u>10,063</u>

Calculation of Depreciation:

Acquisition 1 st January 2016	€25,000
Depreciation (€25,000 x 10%)	<u>€2,500</u>
Net book value 31 st December 2016	€22,500
Acquisition 1 st January 2017	€20,000
Depreciation ((€22,500 + €20,000) x 10%)	<u>€4,250</u>
Net book value 31 st December 2017	<u>€38,250</u>

Accumulated Depreciation on Asset Sold:

2016: (€25,000 x 10%)	€2,500
2017: ((€25,000 - €2,500) x 10%)	€2,250
2018: ((€25,000 - €2,500 - €2,250) x 10% x 6/12)	<u>€1,013</u>
Total Accumulated Depreciation	<u>€5,763</u>

Depreciation Charge 2018:

Depreciation on asset sold:	€1,013
Depreciation on asset bought:	
((€12,000 - €2,000) x 10% x 6/12)	€500
Remaining asset: ((€20,000 - €2,000) x 10%)	<u>€1,800</u>
Total Depreciation Charge	<u>€3,313</u>

c)

Disposal Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2018</u>			<u>2018</u>		
30 June	Motor Vehicle	25,000	30 June	Provision for depreciation	5,763
			30 June	Cash	8,000
		_____	30 June	Income Statement	<u>11,237</u>
		<u>25,000</u>			<u>25,000</u>

Question 5

a)

Computer Equipment Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2016</u>			<u>2016</u>		
1 Mar.	Bank	7,000	31 Dec.	Balance c/d	17,000
1 Oct.	Bank	<u>10,000</u>			_____
		<u>17,000</u>			<u>17,000</u>
<u>2017</u>			<u>2017</u>		
1 Jan.	Balance b/d	17,000	31 Dec.	Balance c/d	37,000
1 June	Bank	<u>20,000</u>			_____
		<u>37,000</u>			<u>37,000</u>
<u>2018</u>			<u>2018</u>		
1 Jan.	Balance b/d	37,000	30 June	Disposal	7,000
30 June	Bank	8,000	31 Dec.	Balance c/d	40,000
30 June	Disposal	<u>2,000</u>			_____
		<u>47,000</u>			<u>47,000</u>

b)

Provision for Depreciation Account

<u>Date</u>	<u>Debit</u>	<u>€</u>	<u>Date</u>	<u>Credit</u>	<u>€</u>
<u>2016</u>			<u>2016</u>		
31 Dec.	Balance c/d	<u>1,667</u>	31 Dec.	Income Statement	<u>1,667</u>
<u>2017</u>			<u>2017</u>		
31 Dec.	Balance c/d	7,400	1 Jan	Balance b/d	1,667
		—	31 Dec.	Income Statement	<u>5,733</u>
		<u>7,400</u>			<u>7,400</u>
<u>2018</u>			<u>2018</u>		
30 June	Disposal	3,267	1 Jan	Balance b/d	7,400
31 Dec.	Balance c/d	<u>11,833</u>	31 Dec.	Income Statement	<u>7,700</u>
		<u>15,100</u>			<u>15,100</u>

Depreciation for 2016:

Acquisition 1st March 2016: ($€7,000 \times 20\% \times 10/12$) €1,167Acquisition 1st October 2016: ($€10,000 \times 20\% \times 3/12$) €500Total Depreciation Charge €1,667

Depreciation for 2017:

Opening Balance: ($€17,000 \times 20\%$) €3,400Acquisition 1st June 2017: ($€20,000 \times 20\% \times 7/12$) €2,333Total Depreciation Charge €5,733

Depreciation for 2018:

On asset sold: ($€7,000 \times 20\% \times 6/12$) €700Remaining opening balance: ($(€37,000 - €7,000) \times 20\%$) €6,000Acquisition 30th June 2018: ($€10,000 \times 20\% \times 6/12$) €1,000Total Depreciation Charge €7,700

Accumulated Depreciation on Non-Current Asset Sold:

2016 €1,167

2017 ($€7,000 \times 20\%$) €1,4002018 €700Total Accumulated Depreciation €3,267

c)

Disposal Account

Date	Debit	€	Date	Credit	€
2018			2018		
30 June	Computer Equipment	7,000	30 June	Provision for depreciation	3,267
			30 June	Computer Equipment	2,000
		_____	30 June	Income Statement	<u>1,733</u>
		<u>7,000</u>			<u>7,000</u>

Chapter 15 – Accounting for Bad Debts and Provision for Doubtful Debts

Question 1

a) Bad debts reflect receivables who were unable to pay and were declared bankrupt. The provision for doubtful debts is an estimate of future receivables who will be unable to pay. This is done to comply with the prudence concept.

b)					
Bad Debts Account					
Date	Debit	€	Date	Credit	€
13 Mar.	James Wood	230	31 Dec.	Income Statement	580
30 June	Alex Smith	50			
8 Nov.	Eve Said	<u>300</u>			—
		<u>580</u>			<u>580</u>
James Wood Account					
			13 Mar.	Bad Debts	230
Alex Smith Account					
			30 June	Bad Debts	50
Eve Said Account					
			8 Nov.	Bad Debts	300

Question 2

a) Provision for Doubtful Debts = $(€30,000 - €800) \times 2\% = €584$

b)					
Provision for Doubtful Debts Account					
Date	Debit	€	Date	Credit	€
31 Dec.	Balance c/d	<u>584</u>	31 Dec.	Income Statement	<u>584</u>
c)					
Bad Debts Account					
31 Dec.	Accounts Receivable	<u>800</u>	31 Dec.	Income Statement	<u>800</u>

d) Income Statement Extract for the year ended 31st December 2018		€
<u>Expenses:</u>		
Provision for Doubtful Debts		584
Bad Debts		<u>800</u>
Total Expenses		<u>1,384</u>

e) Statement of Financial Position Extract as at 31st December 2018		€
<u>Current Assets:</u>		
Accounts Receivable (€30,000 - €800)		29,200
Provision for Doubtful Debts		<u>584</u>
Total Current Assets		<u>28,616</u>

Question 3

a)					
Bad Debts Account					
Date	Debit	€	Date	Credit	€
31 Dec. 16	Accounts Rec	<u>1,000</u>	31 Dec. 16	Income Statement	<u>1,000</u>
31 Dec. 17	Accounts Rec.	<u>1,500</u>	31 Dec. 17	Income Statement	<u>1,500</u>
31 Dec. 18	Accounts Rec.	<u>600</u>	31 Dec. 18	Income Statement	<u>600</u>

- b) 2016 Provision for Doubtful Debts = $(€40,000 - €1,000) \times 3\% = €1,170$
 2017 Provision for Doubtful Debts = $(€50,000 - €1,500) \times 3\% = €1,455$
 2018 Provision for Doubtful Debts = $(€55,000 - €600) \times 1\% = €544$

c)

Provision for Doubtful Debts Account					
Date	Debit	€	Date	Credit	€
31 Dec. 16	Balance c/d	<u>1,170</u>	31 Dec. 16	Income Statement	<u>1,170</u>
31 Dec. 17	Balance c/d	1,455	1 Jan. 17	Balance b/d	1,170
		_____	31 Dec. 17	Income Statement	<u>285</u>
		<u>1,455</u>			<u>1,455</u>
31 Dec. 18	Income Statement	911	1 Jan. 18	Balance b/d	1,455
31 Dec. 18	Balance c/d	<u>544</u>			_____
		<u>1,455</u>			<u>1,455</u>

d) Income Statement Extract for the year ended 31st December 2016	€
<u>Expenses:</u>	
Provision for Doubtful Debts	1,170
Bad Debts	<u>1,000</u>
Total Expenses	<u>2,170</u>
Income Statement Extract for the year ended 31st December 2017	€
<u>Expenses:</u>	
Provision for Doubtful Debts	285
Bad Debts	<u>1,500</u>
Total Expenses	<u>1,785</u>
Income Statement Extract for the year ended 31st December 2018	€
<u>Revenue:</u>	
Decrease in Provision for Doubtful Debts	911
<u>Expenses:</u>	
Bad Debts	600

e) Statement of Financial Position Extract as at 31st December 2016	€
<u>Current Assets:</u>	
Accounts Receivable (€40,000 - €1,000)	39,000
Provision for Doubtful Debts	<u>1,170</u>
Total Current Assets	<u>37,830</u>
Statement of Financial Position Extract as at 31st December 2017	€
<u>Current Assets:</u>	
Accounts Receivable (€50,000 - €1,500)	38,500
Provision for Doubtful Debts	<u>1,455</u>
Total Current Assets	<u>37,045</u>
Statement of Financial Position Extract as at 31st December 2018	€
<u>Current Assets:</u>	
Accounts Receivable (€55,000 - €600)	54,400
Provision for Doubtful Debts	<u>544</u>
Total Current Assets	<u>53,856</u>

Question 4

a)

Bad Debts Account					
Date	Debit	€	Date	Credit	€
31 Dec. 17	Accounts Rec.	<u>1,900</u>	31 Dec. 17	Income Statement	<u>1,900</u>
31 Dec. 18	Accounts Rec.	<u>1,100</u>	31 Dec. 18	Income Statement	<u>1,100</u>

b) 2017 Provision for Doubtful Debts = €65,000 x 4% = €2,600

2018 Provision for Doubtful Debts = €50,000 x 4% = €2,000

c)					
Provision for Doubtful Debts Account					
Date	Debit	€	Date	Credit	€
31 Dec. 17	Balance c/d	<u>2,600</u>	31 Dec. 17	Income Statement	<u>2,600</u>
31 Dec. 18	Income Statement	600	1 Jan. 18	Balance b/d	2,600
31 Dec. 18	Balance c/d	<u>2,000</u>			—
		<u>2,600</u>			<u>2,600</u>

d) Income Statement Extract for the year ended 31 st December 2017	€
<u>Expenses:</u>	
Provision for Doubtful Debts	2,600
Bad Debts	<u>1,900</u>
Total Expenses	<u>4,500</u>
Income Statement Extract for the year ended 31 st December 2018	€
<u>Revenue:</u>	
Decrease in Provision for Doubtful Debts	600
<u>Expenses:</u>	
Bad Debts	1,100

e) Statement of Financial Position Extract as at 31 st December 2017	€
<u>Current Assets:</u>	
Accounts Receivable	65,000
Provision for Doubtful Debts	<u>2,600</u>
Total Current Assets	<u>62,400</u>
Statement of Financial Position Extract as at 31 st December 2018	€
<u>Current Assets:</u>	
Accounts Receivable	50,000
Provision for Doubtful Debts	<u>2,000</u>
Total Current Assets	<u>48,000</u>

Chapter 16 – Accounting for Accruals and Prepayments

Question 1

a) Accrual reflects an expenditure incurred but not yet paid or money not yet received for a revenue that was incurred. For example, in the month of December the organisation had to receive rent of €1,000. This has not yet been paid by the lessee.

b) Prepayments mean payments made in advance for expenditure or cash received for income before it is incurred. For example, in November paid insurance of €12,000, which covers one year. In this case there are 10 months prepaid insurance at 31st December.

c) Accrued expenditure decreases the net profit generate by the organisation because it is added to the relevant expense. For example, accrued wages of €300 are added to the wages expense.

d)					
Wages Account					
Date	Debit	€	Date	Credit	€
31 Dec.	Bank	11,500	31 Dec.	Income Statement	11,800
31 Dec.	Balance c/d	<u>300</u>			_____
		<u>11,800</u>			<u>11,800</u>

Question 2

a)					
Insurance Account					
Date	Debit	€	Date	Credit	€
1 Jan.	Prepayment b/d	1,000	31 Dec.	Prepayment c/d	2,000
31 Dec.	Bank	<u>12,000</u>	31 Dec.	Income Statement	<u>11,000</u>
		<u>13,000</u>			<u>13,000</u>

b)					
Wages Account					
Date	Debit	€	Date	Credit	€
31 Dec.	Bank	23,500	31 Dec.	Accrual b/d	300
31 Dec.	Accrual c/d	<u>250</u>	31 Dec.	Income Statement	<u>23,450</u>
		<u>23,750</u>			<u>23,750</u>

c) Statement of Financial Position Extract as at 31 st December 2019	€
<u>Current Assets:</u>	
Prepaid Insurance	<u>2,000</u>
<u>Current Liabilities:</u>	
Accrued Wages	<u>250</u>

Question 3

a)					
Rent Account					
Date	Debit	€	Date	Credit	€
1 Jan.	Prepayment b/d	800	31 Dec.	Prepayment c/d	1,000
31 Dec.	Bank	<u>9,800</u>	31 Dec.	Income Statement	<u>9,600</u>
		<u>10,600</u>			<u>10,600</u>

b)					
Royalties Received Account					
Date	Debit	€	Date	Credit	€
1 Jan.	Accrual b/d	180	31 Dec.	Bank	890
31 Dec.	Income Statement	<u>940</u>	31 Dec.	Accrual c/d	<u>230</u>
		<u>1,120</u>			<u>1,120</u>

c) Statement of Financial Position Extract as at 31 st December 2019	€
<u>Current Assets:</u>	
Prepaid Rent	1,000
Accrued Royalties Received	<u>230</u>
Total Current Assets	<u>1,230</u>

Chapter 17 – Errors not Identified by the Trial Balance

Question 1

- a) The trial balance should agree because for every debit entry there is a corresponding credit entry.
- b) An error of commission arises when a transaction is reflected in the wrong personal account.
- c) For example, bought goods worth €800 from K. Allen. This transaction was erroneously posted to K. Marcus account.
- d) A transposition error occurs when the wrong sequence of the individual characters within a number are posted in both accounts.
- e) For example, paid insurance of €1,300 by cheque. This transaction was erroneously posted as €3,100 in the insurance and bank accounts.

Question 2

- a) i) This is an error of omission where the transaction needs to be posted both in Marija Spiteri and the purchases accounts.
- ii) This is an error of principle where the transaction needs to be removed from the rent account and posted in the insurance account.
- iii) This is a transposition error. An additional €9 was posted in the cash account and stationary account, which needs to be removed.
- iv) This is a complete reversal of entries. Therefore, double the amount (€400) needs to be posted in Olivia Ferry and sales accounts in order to correct the error and post the transaction.
- v) This is an error of commission where the transaction needs to be removed from Antoine Mifsud account and posted in Alfred Micallef account.

b)					
Purchases Account					
Date	Debit	€	Date	Credit	€
31 Mar.	Marija Spiteri	650			
Marija Spiteri Account					
			31 Mar.	Purchases	650
Rent Account					
			31 Mar.	Insurance	320
Insurance Account					
31 Mar.	Rent	320			
Stationary Account					
			31 Mar.	Cash	9
Cash Account					
31 Mar.	Stationary	9			
Olivia Ferry Account					
31 Mar.	Sales	400			
Sales Account					
			31 Mar.	Olivia Ferry	400
Antoine Mifsud Account					
31 Mar.	Alfred Micallef	150			
Alfred Micallef Account					
			31 Mar.	Antoine Mifsud	150

Question 3

Journal as at 31st March 2019	€	€
Purchases	650	
Marija Spiteri		650
Being a correction of an error of omission.		
Insurance	320	
Rent		320
Being a correction of an error of principle.		
Cash	9	
Stationery		9
Being a correction of a transposition error.		
Olivia Ferry	400	
Sales		400
Being a correction of complete reversal of entries.		
Antoine Mifsud	150	
Alfred Micallef		150
Being a correction of an error of commission.		

Chapter 18 – The Suspense Account

Question 1

a) The suspense account is opened when the debit side of the trial balance does not agree with the credit side. This account serves to temporarily balance the trial balance.

b) Profit before adjustments	€12,000
Discount allowed	(€300)
Understated purchases	(€123)
General expenses (error of principle)	€800
Overstated sales	<u>(€160)</u>
Correct net profit	<u>€12,217</u>

The second error is an error of principle, but it reflects accounts that do not affect the profit figure.

Question 2

a)					
Suspense Account					
Date	Debit	€	Date	Credit	€
30 Apr.	Balance b/d	2,490	30 Apr.	Stationery	110
30 Apr.	Purchases	1,500	30 Apr.	Sales	4,250
30 Apr.	Insurance	270			
30 Apr.	Discounts Received	<u>100</u>			—
		<u>4,360</u>			<u>4,360</u>
Purchases Account					
			30 Apr.	Suspense	1,500
Insurance Account					
			30 Apr.	Suspense	270
Stationery Account					
30 Apr.	Suspense	110			

Sales Account					
30 Apr.	Suspense	4,250			
Discounts Received Account					
			30 Apr.	Suspense	100

b) Profit before adjustments	€8,950
Overstated purchases	€1,500
Overstated insurance	€270
Omitted in stationery	(€110)
Overstated sales	(€4,250)
Omitted discounts received	<u>€100</u>
Corrected net profit	<u>€6,460</u>

Question 3

a)					
Suspense Account					
Date	Debit	€	Date	Credit	€
31 May	Returns In	30	31 May	Balance b/d	740
31 May	Sales	2,500	31 May	Returns Out	50
31 May	Discounts Allowed	30	31 May	Cash	1,800
31 May	Discounts Received	<u>30</u>			_____
		<u>2,590</u>			<u>2,590</u>
Returns In Account					
			31 May	Suspense	30
Returns Out Account					
31 May	Suspense	50			
Cash Account					
31 May	Suspense	1,800			
Sales Account					

			31 May	Suspense	2,500
Discounts Received Account					
			31 May	Suspense	30
Discounts Allowed Account					
			31 May	Suspense	30

b) Journal as at 31st May 2019	€	€
Equipment	300	
Purchases		300
Correction of an error of principle		
L. Mangion	230	
L. Abela		230
Correction of an error of commission		
Suspense	30	
Returns In		30
Adjustment of overstated returns in.		
Returns Out	50	
Suspense		50
Correction of overstated returns out.		
Cash	1,800	
Suspense		1,800
Excessive amount posted in the cash account.		
Suspense	2,500	
Sales		2,500
Adjusted the understated sales account.		
Suspense	60	
Discounts Allowed		30
Discounts Received		30
Discounts received incorrectly posted in the discounts allowed account.		

c) Profit before adjustments	€7,500
Equipment wrongly posted in purchases	€300
Overstated returns in	€30
Overstated returns out	(€50)
Discounts received wrongly posted in discounts allowed	€60
Understated sales	<u>€2,500</u>
Corrected net profit	<u>€10,340</u>

Part 6: Final Accounts of Different Types of Organisations

Chapter 19 – Final Accounts of a Departmental Organisation

Question 1

Income Statement for the year ended 31 st December 2019	Toys		Electricals	
	€	€	€	€
Sales		273,100		390,000
<u>Cost of Sales:</u>				
Opening Stock	17,500		21,000	
Purchases	<u>130,000</u>		<u>204,000</u>	
	147,500		225,000	
Closing Stock	<u>18,000</u>	<u>129,500</u>	<u>20,000</u>	<u>205,000</u>
Gross Profit		143,600		185,000
<u>Less: Expenses:</u>				
Rent	7,200		3,600	
Insurance	710		2,840	
Discount Allowed	50		500	
Advertising	20,200		30,310	
Administration Expenditure	5,000		45,000	
Repairs and Maintenance	200		800	
Fuel Costs	400		1,600	
Salaries and Wages	12,000		28,000	
General Expenses	<u>1,500</u>	<u>42,760</u>	<u>1,500</u>	<u>114,150</u>
Net Profit		<u>96,340</u>		<u>70,850</u>

Workings:

Apportionment of Rent (Floor Area):

Toys = (€12,000 x 800/1,200) – €800 = €7,200

Electricals = (€12,000 x 400/1,200) - €400 = €3,600

Apportionment of Insurance (Number of Motor Vehicles):

Toys = €3,550 x 1/5 = €710

Electricals = €3,550 x 4/5 = €2,840

Apportionment of Advertising (Table Given):

Toys = (€50,000 x 40%) + €200 = €20,200

Electricals = (€50,000 x 60%) + €310 = €30,310

Apportionment of Administration Expenditure (Table Given):

Toys = €50,000 x 10% = €5,000

Electricals = €50,000 x 90% = €45,000

Apportionment of Repairs and Maintenance (Table Given):

Toys = €1,000 x 20% = €200

Electricals = €1,000 x 80% = €800

Apportionment of Fuel Costs (Number of Motor Vehicles):

Toys = €2,000 x 1/5 = €400

Electricals = €2,000 x 4/5 = €1,600

Apportionment of Salaries and Wages (Number of Staff):

Toys = €40,000 x 3/10 = €12,000

Electricals = €40,000 x 7/10 = €28,000

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Premises		200,000
Machinery		10,000
Office Equipment		2,500
Motor Vehicles		<u>3,000</u>
		215,500
<u>Current Assets:</u>		
Stock (€18,000 + €20,000)	38,000	
Trade Receivables	14,000	
Prepaid Rent (€800 + €400)	1,200	
Bank	<u>10,000</u>	<u>63,200</u>
Total Assets		<u>278,700</u>
<u>Financed By:</u>		
Capital		110,000
Add: Net Profit (€96,340 + €70,850)		<u>167,190</u>
		277,190
Less: Drawings		<u>9,000</u>
		268,190

Current Liabilities:		
Trade Payables	10,000	
Accrued Advertising (€200 + €310)	<u>510</u>	
Total Current Liabilities		<u>10,510</u>
Total Capital and Liabilities		<u>278,700</u>

Question 2

Income Statement for the year ended 31 st December 2019	X		Y		Z	
	€	€	€	€	€	€
Sales		100,000		60,000		55,000
Cost of Sales:						
Opening Stock	10,000		2,000		7,500	
Purchases	<u>55,000</u>		<u>30,000</u>		<u>32,000</u>	
	65,000		32,000		39,500	
Closing Stock	5,500	59,500	5,400	26,600	5,800	33,700
Gross Profit		40,500		33,400		21,300
Less: Expenses:						
Insurance	1,880		1,880		940	
Stationery and Printing	100		100		100	
Salaries and Wages	750		625		1,125	
Carriage Out	200		200		200	
Rent and Rates	160		80		160	
Administration Expense	2,320		1,160		2,320	
Discounts Allowed			80		20	
Selling and Distribution	1,250		2,000		1,750	
Repairs and Maintenance	125		200		175	
Fuel Costs	<u>1,150</u>	<u>7,935</u>	<u>1,840</u>	<u>8,165</u>	<u>1,610</u>	<u>8,400</u>
Net Profit		<u>32,565</u>		<u>25,235</u>		<u>12,900</u>

Workings:

$$\text{Insurance} = \text{€}4,800 - \text{€}100 = \text{€}4,700$$

Apportionment of Insurance (Ratio Provided):

$$X = \text{€}4,700 \times 4/10 = \text{€}1,880$$

$$Y = \text{€}4,700 \times 4/10 = \text{€}1,880$$

$$Z = \text{€}4,700 \times 2/10 = \text{€}940$$

$$\text{Salaries and Wages} = \text{€}2,000 + \text{€}500 = \text{€}2,500$$

Apportionment of Salaries and Wages (Number of Employees):

$$X = \text{€}2,500 \times 30/100 = \text{€}750$$

$$Y = \text{€}2,500 \times 25/100 = \text{€}625$$

$$Z = \text{€}2,500 \times 45/100 = \text{€}1,125$$

Apportionment of Rent and Rates (Ratio Given):

$$X = \text{€}400 \times 2/5 = \text{€}160$$

$$Y = \text{€}400 \times 1/5 = \text{€}80$$

$$Z = \text{€}400 \times 2/5 = \text{€}160$$

Apportionment of Administration Expenses (Ratio Given):

$$X = \text{€}5,800 \times 2/5 = \text{€}2,320$$

$$Y = \text{€}5,800 \times 1/5 = \text{€}1,160$$

$$Z = \text{€}5,800 \times 2/5 = \text{€}2,320$$

Apportionment of Selling and Distribution (Number of Motor Vehicles):

$$X = \text{€}5,000 \times 5/20 = \text{€}1,250$$

$$Y = \text{€}5,000 \times 8/20 = \text{€}2,000$$

$$Z = \text{€}5,000 \times 7/20 = \text{€}1,750$$

Apportionment of Repairs and Maintenance (Number of Motor Vehicles):

$$X = \text{€}500 \times 5/20 = \text{€}125$$

$$Y = \text{€}500 \times 8/20 = \text{€}200$$

$$Z = \text{€}500 \times 7/20 = \text{€}175$$

Apportionment of Fuel Costs (Number of Motor Vehicles):

$$X = \text{€}4,600 \times 5/20 = \text{€}1,150$$

$$Y = \text{€}4,600 \times 8/20 = \text{€}1,840$$

$$Z = \text{€}4,600 \times 7/20 = \text{€}1,610$$

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Premises		98,000
Fixtures and Fittings		25,500
Motor Vehicles		<u>32,400</u>
		155,900
<u>Current Assets:</u>		
Stock (€5,500 + €5,400 + €5,800)	16,700	
Trade Receivables	8,000	
Prepaid Insurance	100	
Bank	<u>10,000</u>	34,800
Total Assets		<u>190,700</u>
<u>Financed By:</u>		
Capital		120,000
Add: Net Profit (€32,565 + €25,235 + €12,900)		<u>70,700</u>
		190,700
Less: Drawings		<u>8,000</u>
		182,700
<u>Current Liabilities:</u>		
Trade Payables	7,500	
Accrued Salaries and Wages	<u>500</u>	
Total Current Liabilities		8,000
Total Capital and Liabilities		<u>190,700</u>

Question 3

Income Statement for the year ended 30 th April 2019	A		B		C	
	€	€	€	€	€	€
Sales		330,000		289,000		140,000
Returns In		<u>230</u>				<u>300</u>
		329,770		289,000		139,700
<u>Cost of Sales:</u>						
Opening Stock	25,500		42,600		11,800	
Purchases	<u>145,000</u>		<u>62,000</u>		<u>90,000</u>	
	170,500		104,600		101,800	
Closing Stock	<u>23,000</u>	<u>147,500</u>	<u>32,000</u>	<u>72,600</u>	<u>13,000</u>	<u>88,800</u>
Gross Profit		182,270		216,400		50,900
<u>Add:</u> <u>Revenue:</u>						
Discount Received		<u>250</u>		<u>120</u>		<u>60</u>
		182,520		216,520		50,960
<u>Less:</u> <u>Expenses:</u>						
Depreciation Fixtures and Fittings	1,000		1,000		1,000	
Depreciation Motor Vehicles	750		250		250	
Stationery and Postage	300		300		300	
Salaries and Wages	8,400		4,200		8,400	
Light and Heat	350		700		1,050	
Rent	283		567		850	
Rates	1,500		1,500		1,500	
Bad Debts	522		457		221	
General Expenses	1,067		1,067		1,066	
Repairs and Maintenance	<u>3,000</u>	<u>17,172</u>	<u>3,000</u>	<u>13,041</u>	<u>3,000</u>	<u>17,637</u>
Net Profit		<u>165,348</u>		<u>203,479</u>		<u>33,323</u>

Workings:

Depreciation Fixtures and Fittings = €30,000 x 10% = €3,000 (€1,000 each department)

Depreciation Motor Vehicles: €25,000 x 5% = €1,250

A = €1,250 x 6/10 = €750

B = €1,250 x 2/10 = €250

C = €1,250 x 2/10 = €250

Salaries and Wages = €20,000 + €1,000 = €21,000

Apportionment of Salaries and Wages (Number of Employees):

A = €21,000 x 20/50 = €8,400

B = €21,000 x 10/50 = €4,200

C = €21,000 x 20/50 = €8,400

Light and Heat = €2,000 + €100 = €2,100

Apportionment of Light and Heat (Floor Area):

A = €2,100 x 100/600 = €350

B = €2,100 x 200/600 = €700

C = €2,100 x 300/600 = €1,050

Apportionment of Rent (Floor Area):

A = €1,700 x 100/600 = €283

B = €1,700 x 200/600 = €567

C = €1,700 x 300/600 = €850

Apportionment of Bad Debts (Sales Revenue):

A = €1,200 x 330/759 = €522

B = €1,200 x 289/759 = €457

C = €1,200 x 140/759 = €221

Statement of Financial Position as at 30th April 2019	€	€
<u>Non-Current Assets:</u>		
Premises		275,000
Fixtures and Fittings	30,000	
Accumulated Depreciation (€6,000 + €3,000)	<u>9,000</u>	21,000
Motor Vehicles	25,000	
Accumulated Depreciation (€900 + €1,250)	<u>2,150</u>	22,850
		<u>318,850</u>
<u>Current Assets:</u>		
Stock (€23,000 + €32,000 + €13,000)	68,000	
Trade Receivables	18,000	
Bank	20,000	
Cash	<u>1,500</u>	107,500
Total Assets		<u>426,350</u>
<u>Financed By:</u>		
Capital		50,000
Add: Net Profit (€165,348 + €203,479 + €33,323)		<u>402,150</u>
		452,150
Less: Drawings		<u>35,800</u>
		<u>416,350</u>
<u>Current Liabilities:</u>		
Trade Payables	8,900	
Accrued Light and Heat	100	
Accrued Salaries and Wages	<u>1,000</u>	
Total Current Liabilities		<u>10,000</u>
Total Capital and Liabilities		<u>426,350</u>

Chapter 20 – Final Accounts of a Manufacturing Firm

Question 1

a) The manufacturing account is prepared in order to determine the production cost of goods completed, which is a key figure necessary to calculate the net profit or loss made during the financial year. The manufacturing account can also be used to examine the manufacturing costs and assess the level of efficiency in the firm's production process.

b) Direct costs are costs performed in the production process that can be related to a specific product. Indirect costs are costs incurred in the production process but cannot be related to a particular product.

c)

Manufacturing Account	Income Statement
Direct Wages	Advertising
Factory Light and Heat	Administrative Staff Salaries
Direct Materials	

d) The stocks of a manufacturing organisation are raw materials, work in progress and finished goods.

Question 2

Manufacturing account for the year ended 31st December 2019	€	€
Opening stock of raw materials		12,000
Purchases of raw materials		81,000
Less: Returns of raw materials		<u>450</u>
		92,550
Less: Closing stock of raw materials		<u>12,500</u>
Cost of raw materials consumed		80,050
Direct labour		21,300
Prime Cost		101,350
<u>Add: Factory Overheads:</u>		
Factory Insurance (€5,600 – €600)	5,000	
Depreciation of plant and machinery (€20,000 x 10%)	<u>2,000</u>	<u>7,000</u>
		108,350
Opening stock of work in progress		<u>3,000</u>
		111,350
Less: Closing stock of work in progress		<u>2,000</u>
Production cost of goods completed		<u>109,350</u>

Income Statement for the year ended 31st December 2019	€	€
Sales		205,500
Less: Returns In		<u>1,000</u>
		204,500
<u>Less: Cost of Sales:</u>		
Opening stock of finished goods	8,500	
Production cost of goods completed	<u>109,350</u>	
	117,850	
Less: Closing stock of finished goods	<u>10,000</u>	<u>107,850</u>
Gross profit		96,650
<u>Less: Operating Expenses:</u>		
Wages and Salaries (30,000 + 650)	30,650	
Bad Debts	650	
Advertising	16,000	
Discount Allowed	100	
Carriage Out	800	
Depreciation of office equipment (5,000 x 5%)	<u>250</u>	<u>48,450</u>
Net Profit		<u>48,200</u>

Statement of financial position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Factory		95,000
Plant and Machinery	20,000	
Accumulated depreciation (€4,000 + €2,000)	<u>6,000</u>	<u>14,000</u>
Office Equipment	5,000	
Accumulated depreciation (€1,000 + €250)	<u>1,250</u>	<u>3,750</u>
		112,750
<u>Current Assets:</u>		
Stocks:		
Raw materials	12,500	
Work in progress	2,000	
Finished goods	10,000	
Prepaid Factory Insurance	<u>600</u>	<u>25,100</u>
Total Assets		<u>137,850</u>
<u>Financed By:</u>		
Capital		105,000
Net profit		<u>48,200</u>
		153,200
Less: Drawings		<u>16,000</u>
		137,200
<u>Less: Current Liabilities:</u>		
Accrued Wages and Salaries		<u>650</u>
Total Capital and Liabilities		<u>137,850</u>

Question 3

Manufacturing account for the year ended 30th June 2019	€	€
Opening stock of raw materials		10,800
Purchases of raw materials		265,000
Add: Carriage In		<u>500</u>
		276,300
Less: Closing stock of raw materials		<u>11,000</u>
Cost of raw materials consumed		265,300
Direct Wages		<u>52,000</u>
Prime Cost		317,300
<u>Add: Factory Overheads:</u>		
Heat and Light (€12,000 x 40%)	4,800	
Machinery Repairs	6,500	
Depreciation of plant and machinery (€30,000 x 10%)	<u>3,000</u>	<u>14,300</u>
		331,600
Opening stock of work in progress		<u>6,500</u>
		338,100
Less: Closing stock of work in progress		<u>8,000</u>
Production cost of goods completed		<u>330,100</u>

Income Statement for the year ended 30th June 2019	€	€
Sales		480,100
<u>Less: Cost of Sales:</u>		
Opening stock of finished goods	28,000	
Production cost of goods completed	<u>330,100</u>	
	358,100	
Less: Closing stock of finished goods	<u>30,000</u>	328,100
Gross profit		152,000
<u>Less: Operating Expenses:</u>		
Selling and Distribution (€18,000 – €500)	17,500	
Heat and Light (€12,000 x 60%)	7,200	
Royalties	2,300	
Office Salaries	11,000	
Insurance	11,000	
Discount Allowed	100	
Administration Expenses	25,000	
Depreciation of motor vehicles ((€20,000 – €3,700) x 10%)	<u>1,630</u>	<u>75,730</u>
Net Profit		<u>76,270</u>

Statement of financial position as at 30th June 2019	€	€
<u>Non-Current Assets:</u>		
Administration Building		60,000
Plant and Machinery	30,000	
Accumulated depreciation (€6,000 + €3,000)	<u>9,000</u>	21,000
Motor Vehicles	20,000	
Accumulated depreciation (€3,700 + €1,630)	<u>5,330</u>	<u>14,670</u>
		95,670
<u>Current Assets:</u>		
Stocks:		
Raw materials	11,000	
Work in progress	8,000	
Finished goods	30,000	
Trade Receivables	15,000	
Cash	<u>300</u>	<u>64,300</u>
Total Assets		<u>159,970</u>
<u>Financed By:</u>		
Capital		80,000
Net profit		<u>76,270</u>
		156,270
Less: Drawings		<u>7,500</u>
		148,770
<u>Less: Current Liabilities:</u>		
Bank Overdraft	1,400	
Trade Payables	<u>9,800</u>	
Total Current Liabilities		<u>11,200</u>
Total Capital and Liabilities		<u>159,970</u>

Chapter 21 – Final Accounts of a Partnership

Question 1

- a) In a partnership the organisation is normally managed by more than one individual and capital in the organisation is not made by one person. In a sole trade only one person contributes to the firm's capital and manages the business enterprise.
- b) The main advantages are that there is a higher amount of capital since more than one person invests in the firm and responsibilities can be shared between the partners. This can increase effectiveness in decision making. There are three key disadvantages, which are unlimited liability; disagreement between partners may deteriorate the level of efficiency in the organisation; and profits must be shared between partners, which makes this type of firm less desirable.
- c) The five main variables present in the current account of a partner are: interest on drawings, interest on capital, drawings, salaries and profits shared between partners.
- d) In the capital account one includes only the assets that the partner has invested in the organisation.

Question 2

Profit and Loss and Appropriation Account for the year ended 31st December 2019	€	€
Net Profit		80,000
Add: <u>Interest on Drawings:</u> Alfred (€6,000 x 10%) Felix (€14,000 x 10%) Tony (€7,000 x 10%)	600 1,400 <u>700</u>	<u>2,700</u>
		82,700
Less: <u>Interest on Capital:</u> Alfred (€30,000 x 5%) Felix (€30,000 x 5%) Tony (€20,000 x 5%)	1,500 1,500 <u>1,000</u>	4,000
Less: <u>Salary:</u> Alfred Tony	15,000 <u>15,000</u>	<u>30,000</u>
		<u>48,700</u>
<u>Profits Shared:</u> Alfred (€48,700 x 40%) Felix (€48,700 x 40%) Tony (€48,700 x 20%)	19,480 19,480 <u>9,740</u>	<u>48,700</u>

Partners' Current Accounts							
Debit	Alfred	Felix	Tony	Credit	Alfred	Felix	Tony
Balance b/d		180		Balance b/d	4,000		2,800
Int. on drawings	600	1,400	700	Int. on capital	1,500	1,500	1,000
Drawings	6,000	14,000	7,000	Salaries	15,000		15,000
Balance c/d	<u>33,380</u>	<u>5,400</u>	<u>20,840</u>	Profits shared	<u>19,480</u>	<u>19,480</u>	<u>9,740</u>
	<u>39,980</u>	<u>20,980</u>	<u>28,540</u>		<u>39,980</u>	<u>20,980</u>	<u>28,540</u>

Question 3

Income Statement and Profit and Loss and Appropriation Account for the year ended 31st Dec 2019	€	€
Sales		178,000
Less: <u>Cost of Sales:</u>		
Opening Stock	3,600	
Purchases	<u>60,000</u>	
	63,600	
Less: Closing Stock	<u>4,500</u>	<u>59,100</u>
Gross Profit		118,900
<u>Add: Revenue:</u>		
Discount Received		<u>450</u>
		119,350
Less: <u>Expenses:</u>		
Rent (€6,000 – €500)	5,500	
Administration Expenditure (€20,000 + €1,000)	21,000	
General Expenses	8,000	
Bad Debts	1,500	
Increase in provision for doubtful debts	50	
Advertising	15,000	
Repairs and Maintenance	650	
Fuel Costs	<u>1,800</u>	<u>61,500</u>
Net Profit		57,850
Add: <u>Interest on Drawings:</u>		
Peter (€8,000 x 15%)	1,200	
Martin (€4,500 x 15%)	675	
Frank (€16,000 x 15%)	<u>2,400</u>	<u>4,275</u>
		62,125
Less: <u>Interest on Capital:</u>		
Peter (€80,000 x 10%)	8,000	
Martin (€100,000 x 10%)	10,000	
Frank (€60,000 x 10%)	<u>6,000</u>	24,000
Less: <u>Salary:</u>		
Peter	8,000	
Martin	<u>8,000</u>	<u>16,000</u>
		<u>22,125</u>
<u>Profits Shared:</u>		
Peter (€22,125 x 30%)	6,638	
Martin (€22,125 x 50%)	11,062	
Frank (€22,125 x 20%)	<u>4,425</u>	<u>22,125</u>

Workings:

Provision for Doubtful Debts Account

Debit	€	Credit	€
Balance c/d	350	Balance b/d	300
		Income Statement	<u>50</u>
	<u>350</u>		<u>350</u>

Provision for doubtful debts = €10,000 x 3.5% = €350

Partners' Current Accounts							
Debit	Peter	Martin	Frank	Credit	Peter	Martin	Frank
Balance b/d			500	Balance b/d	2,000	2,500	
Int. on drawings	1,200	675	2,400	Int. on capital	8,000	10,000	6,000
Drawings	8,000	4,500	16,000	Salaries		8,000	8,000
Balance c/d	7,438	26,387		Profits shared	6,638	11,062	4,425
	—	—	—	Balance c/d	—	—	<u>475</u>
	<u>16,638</u>	<u>31,562</u>	<u>18,900</u>		<u>16,638</u>	<u>31,562</u>	<u>18,900</u>

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Premises		230,000
Motor Vehicles		<u>31,000</u>
		261,000
<u>Current Assets:</u>		
Stock	4,500	
Trade Receivables	10,000	
Less: Provision for Doubtful Debts	350	
Prepaid Rent	500	
Bank	<u>5,600</u>	<u>20,250</u>
Total Assets		<u>281,250</u>
<u>Financed By:</u>		
Capital: Peter		80,000
Martin		100,000
Frank		<u>60,000</u>
		240,000
Current Account: Peter	7,438	
Martin	26,387	
Frank	<u>(475)</u>	<u>33,350</u>
		273,350
<u>Current Liabilities:</u>		
Trade Payables	6,900	
Accrued Administration Expenses	<u>1,000</u>	
Total Current Liabilities		<u>7,900</u>
Total Capital and Liabilities		<u>281,250</u>

Chapter 22 – Financial Statements of Companies

Question 1

- a) A company is a business enterprise that holds a separate legal entity. The owners of a company are the ordinary shareholders and they have a voting power, which depends on the number of shares they have. A company is formed by a memorandum of association.
- b) The main difference between a limited company and a partnership is that a limited company holds limited liability. There is unlimited liability for a partnership, which means that the partners are personally liable to unpaid liabilities if these are not settled when the partnership is liquidated. The maximum shares issued by a company depend on the authorised share capital. In a partnership the capital invested by the partners depends on the partnership agreement. Corporate taxation is charged on the profits generated by a company. The progressive rate of taxation is used for the profits made in a partnership.
- c) A private company is a firm that is formed through a limited number of individuals who agree to invest a specified amount of money. A private company is not listed in the stock exchange. On the contrary, a public company is listed in the stock exchange and it can sell shares to the public.
- d) The company is owned by the ordinary shareholders and it is managed by the board of directors.

Question 2

- a) Non-cumulative preference shareholders face the risk of not receiving dividends when the company is unable to generate sufficient profits. This is the opposite of cumulative preference shares.
- b) Revenue reserves are created according to the discretion of the board of directors and can be used to provide dividends to investors. Capital reserves are developed in order to comply with an accounting standard and/or legislation. Capital reserves cannot be used for the distribution of dividends.
- c) Interim dividends are paid to ordinary shareholders during the financial year end. Proposed dividends consist of the dividends proposed by the

board of directors at the end of the financial year end. Proposed dividends are included as a current liability because these have not yet been paid to investors at the end of the year.

d) First one needs to determine the number of shares issued by the company, which is computed below:

$$\text{Number of Shares} = \frac{\text{€}100,000}{0.25} = 400,000 \text{ shares}$$

$$\text{Dividend proposed} = 400,000 \times 0.10 = \text{€}40,000$$

Question 3

Computation of Retained Earnings	€	€	€
Net Profit			25,000
Transfer to the general reserve		3,600	
<u>Dividends Paid and Proposed:</u>			
Preference Dividend (€30,000 x 10%)	3,000		
Ordinary Dividend (€170,000 x 10%)	<u>17,000</u>	<u>20,000</u>	<u>23,600</u>
Retained profits for the year			1,400
Retained earnings brought forward			<u>40,000</u>
Retained earnings carried forward			<u>41,400</u>

Statement of Financial Position as at 31st December 2019	€	€	€
<u>Non-Current Assets:</u>			
Premises			250,000
Motor Vehicles		40,000	
Accumulated Depreciation		<u>14,000</u>	<u>26,000</u>
			276,000
<u>Current Assets:</u>			
Stock		11,000	
Trade Receivables		5,000	
Bank		<u>15,200</u>	<u>31,200</u>
Total Assets			<u>307,200</u>
<u>Share Capital and Reserves:</u>			
<u>Authorised Share Capital:</u>			
300,000 Ordinary Shares of €1 each			300,000
200,000 10% Preference Shares			<u>200,000</u>
			<u>500,000</u>
<u>Issued and Fully Paid:</u>			
Ordinary Share Capital			170,000
10% Preference Shares			<u>30,000</u>
<u>Reserves:</u>			200,000
General Reserve (€3,600 + €18,000)		21,600	
Retained Earnings		<u>41,400</u>	<u>63,000</u>
			263,000
<u>Current Liabilities:</u>			
Trade Payables	8,000		
Accrued Debenture Interest	1,200		
Preference Dividend Proposed	3,000		
Ordinary Dividend Proposed	<u>17,000</u>	29,200	
<u>Non-Current Liabilities:</u>			
8% Debentures		<u>15,000</u>	
Total Liabilities			<u>44,200</u>
Total Equity and Liabilities			<u>307,200</u>

Question 4

Income Statement for the year ended 30th June 2019	€	€	€
Sales			790,000
Less: Returns In			770
			789,230
<u>Cost of Sales:</u>			
Opening Stock		17,000	
Purchases		480,000	
Less: Returns Out		415	
Carriage In		<u>2,100</u>	
		498,685	
Closing Stock		<u>21,500</u>	<u>477,185</u>
Gross profit			312,045
<u>Revenue:</u>			
Commission Received		710	
Discount Received		350	
Decrease in Provision for Doubtful Debts		<u>145</u>	<u>1,205</u>
			313,250
<u>Selling and Distribution Expenses:</u>			
Commission		690	
Depreciation Motor Vehicles (40,500 – 3,500) x 5%		<u>1,850</u>	2,540
<u>Administration Costs:</u>			
Administrative Expenses		7,125	
Wages and Salaries (35,000 + 560)		35,560	
Bad Debts		1,490	
General Expenses		7,600	
Depreciation Equipment (55,000 x 10%)		5,500	
Repairs and Maintenance		<u>2,200</u>	59,475
<u>Financial Charges:</u>			
Interest on Debentures			1,600
Profit for the year			249,635
Transfer to the General Reserve		4,280	
<u>Dividends Paid and Proposed:</u>			
Preference Dividend Proposed	1,500		
Ordinary Dividend Proposed	<u>16,000</u>	<u>17,500</u>	<u>21,780</u>
Retained profits for the year			227,855
Retained profits brought forward			<u>65,000</u>
Retained profits carried forward			<u>292,855</u>

Workings:

Provision for Doubtful Debts Account

Date	Debit	€	Date	Credit	€
30 June	Profit and Loss	145	1 July	Balance b/d	2,000
30 June	Balance c/d	<u>1,855</u>			<u> </u>
		<u>2,000</u>			<u>2,000</u>

Preference Dividend Proposed = €30,000 x 5% = €1,500

Ordinary Dividend Proposed = $\frac{€100,000}{0.50} \times 0.08 = €16,000$

Statement of Financial Position as at 30th June 2019	€	€	€
<u>Non-Current Assets:</u>			
Premises			330,000
Equipment		55,000	
Accumulated Depreciation (€5,000 + €5,500)		<u>10,500</u>	44,500
Motor Vehicles		40,500	
Accumulated Depreciation (€3,500 + €1,850)		<u>5,350</u>	<u>35,150</u>
			409,650
<u>Current Assets:</u>			
Stock		21,500	
Trade Receivables		26,500	
Less: Provision for Doubtful Debts		1,855	
Bank		<u>30,900</u>	<u>77,045</u>
Total Assets			<u>486,695</u>
<u>Share Capital and Reserves:</u>			
<u>Issued and Fully Paid:</u>			
Ordinary Share Capital			10,000
5% Preference Shares			<u>30,000</u>
			130,000
<u>Reserves:</u>			
General Reserve		4,280	
Retained Earnings		<u>292,855</u>	<u>297,135</u>
			427,135
<u>Current Liabilities:</u>			
Trade Payables	19,900		
Accrued Wages and Salaries	560		
Accrued Debenture Interest	1,600		
Preference Dividend Proposed	1,500		
Ordinary Dividend Proposed	<u>16,000</u>	39,560	
<u>Non-Current Liabilities:</u>			
8% Debentures		<u>20,000</u>	
Total Liabilities			<u>59,560</u>
Total Equity and Liabilities			<u>486,695</u>

Chapter 23 – Accounting for Non-Profit Making Organisations

Question 1

Statement of Affairs as at 1 st January 2019	€	€
<u>Non-Current Assets:</u>		
Bar Premises		36,000
<u>Current Assets:</u>		
Bar Stocks	480	
Prepaid Rent	90	
Accrued Subscriptions	120	
Bank	<u>1,550</u>	<u>2,240</u>
Total Assets		<u>38,240</u>
<u>Financed By:</u>		
Accumulated Fund (missing figure)		37,785
<u>Current Liabilities:</u>		
Accounts Payable	250	
Prepaid Subscriptions	95	
Accrued Wages	<u>110</u>	
Total Current Liabilities		<u>455</u>
Total Capital and Liabilities		<u>38,240</u>

Question 2

- a) The main objective of clubs is not to generate profits but to provide a service to its members in line to the reason/s why the club was developed. The central aim of a sole trader is to generate profits in order to enhance his/her financial wealth.
- b) It is accumulated fund.
- c) The bar trading account and the statement of financial position.
- d) Subscriptions received from the members are the club's main source of income.
- e) The term used is surplus of income over expenditure.

Question 3

Statement of Affairs as at 1st January 2019	€	€
<u>Non-Current Assets:</u>		
Bar Premises		150,000
Equipment		<u>10,000</u>
		160,000
<u>Current Assets:</u>		
Bar Stocks	750	
Accrued Subscriptions	210	
Bank	<u>5,000</u>	<u>5,960</u>
Total Assets		<u>165,960</u>
<u>Financed By:</u>		
Accumulated Fund (missing figure)		164,950
<u>Current Liabilities:</u>		
Accounts Payable	700	
Prepaid Subscriptions	<u>310</u>	
Total Current Liabilities		<u>1,010</u>
Total Capital and Liabilities		<u>165,960</u>

Income and Expenditure Account for the year ended 31st December 2019	€	€
<u>Income:</u>		
Subscriptions (refer to subscriptions account)		2,970
Profit from Bar		12,090
Donation		<u>500</u>
		15,560
<u>Expenditure:</u>		
Depreciation on Equipment	1,130	
Bad Debts	40	
Repairs	900	
Light and Heat	<u>350</u>	<u>2,420</u>
Surplus of Income over Expenditure		<u>13,140</u>

Workings:

Subscriptions Account

Date	Debit	€	Date	Credit	€
1 Jan.	Balance b/d	210	1 Jan.	Balance b/d	310
31 Dec.	Income and Expenditure	2,970	31 Dec.	Bank	3,000
31 Dec.	Balance c/d	350	31 Dec.	Bad Debts	40
		_____	31 Dec.	Balance c/d	<u>180</u>
		<u>3,530</u>			<u>3,530</u>

Bar Trading Account for the year ended 31st December 2019		€	€
Sales			13,800
<u>Cost of Sales:</u>			
Opening Stock	750		
Purchases	<u>1,460</u>		
	2,210		
Closing Stock	<u>500</u>		<u>1,710</u>
Profit from Bar			<u>12,090</u>

Payables Account

Date	Debit	€	Date	Credit	€
31 Dec.	Bank	1,510	1 Jan.	Balance b/d	700
31 Dec.	Balance c/d	<u>650</u>	31 Dec.	Purchases	<u>1,460</u>
		<u>2,160</u>			<u>2,160</u>

Depreciation on Equipment = (€10,000 + €1,300) x 10% = €1,130

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Bar Premises		150,000
Equipment (€10,000 + €1,300)	11,300	
Accumulated Depreciation	<u>1,130</u>	<u>10,170</u>
		160,170
<u>Current Assets:</u>		
Bar Stocks	500	
Accrued Subscriptions	180	
Bank	<u>18,240</u>	<u>18,920</u>
Total Assets		<u>179,090</u>
<u>Financed By:</u>		
Accumulated Fund (missing figure)		164,950
Surplus of Income over Expenditure		<u>13,140</u>
		178,090
<u>Current Liabilities:</u>		
Accounts Payable	650	
Prepaid Subscriptions	<u>350</u>	
Total Current Liabilities		<u>1,000</u>
Total Capital and Liabilities		<u>179,090</u>

Workings:

Opening Bank Balance	€5,000
Receipts (13,800 + 3,000 + 500)	€17,300
Payments (1,300 + 900 + 1,510 + 350)	<u>€4,060</u>
Closing Bank Balance	<u>€18,240</u>

Question 4

Statement of Affairs as at 1st May 2018	€	€
<u>Non-Current Assets:</u>		
Equipment		1,320
<u>Current Assets:</u>		
Bar Stocks	900	
Accrued Subscriptions	110	
Bank	<u>1,300</u>	<u>2,310</u>
Total Assets		<u>3,630</u>
<u>Financed By:</u>		
Accumulated Fund (missing figure)		2,890
<u>Current Liabilities:</u>		
Accounts Payable	550	
Accrued Wages	30	
Prepaid Subscriptions	<u>160</u>	
Total Current Liabilities		<u>740</u>
Total Capital and Liabilities		<u>3,630</u>

Income and Expenditure Account for the year ended 30th April 2019	€	€
<u>Income:</u>		
Subscriptions (refer to subscriptions account)		1,330
Profit from Bar		2,915
Annual Raffle		<u>760</u>
		5,005
<u>Expenditure:</u>		
Depreciation on Equipment	450	
Treasurer's Wages (€320 – €30)	290	
Bad Debts	50	
Raffle Expenses	260	
Printing and Postage	440	
Light and Heat	<u>490</u>	<u>1,980</u>
Surplus of Income over Expenditure		<u>3,025</u>

Workings:

Subscriptions Account

Date	Debit	€	Date	Credit	€
1 May	Balance b/d	110	1 May	Balance b/d	160
30 Apr.	Income and Expenditure	1,330	30 Apr.	Bank	1,250
30 Apr.	Balance c/d	150	30 Apr.	Bad Debts	50
		_____	30 Apr.	Balance c/d	<u>130</u>
		<u>1,590</u>			<u>1,590</u>

Bar Trading Account for year ended 30 th April 2019		€	€
Sales			3,600
<u>Cost of Sales:</u>			
Opening Stock		900	
Purchases		<u>650</u>	
		1,550	
Closing Stock		<u>1,000</u>	<u>550</u>
Gross Profit			3,050
<u>Expenditure:</u>			
Barman Wages			<u>135</u>
Profit from Bar			<u>2,915</u>

Payables Account

Date	Debit	€	Date	Credit	€
30 Apr.	Bank	980	1 May	Balance b/d	550
30 Apr.	Balance c/d	<u>220</u>	30 Apr.	Purchases	<u>650</u>
		<u>1,200</u>			<u>1,200</u>

Depreciation on Equipment = (€1,320 + €1,680) x 15% = €450

Statement of Financial Position as at 30th April 2019	€	€
<u>Non-Current Assets:</u>		
Equipment (€1,320 + €1,680)		3,000
Accumulated Depreciation		<u>450</u>
		2,550
<u>Current Assets:</u>		
Bar Stocks	1,000	
Accrued Subscriptions	130	
Bank	<u>2,605</u>	<u>3,735</u>
Total Assets		<u>6,285</u>
<u>Financed By:</u>		
Accumulated Fund (missing figure)		2,890
Surplus of Income over Expenditure		<u>3,025</u>
		5,915
<u>Current Liabilities:</u>		
Accounts Payable	220	
Prepaid Subscriptions	<u>150</u>	
Total Current Liabilities		<u>370</u>
Total Capital and Liabilities		<u>6,285</u>

Chapter 24 – Firms with Incomplete Accounting Records

Question 1

- a) Incomplete records occur when an organisation is unable to provide the financial reports necessary to prepare the final accounts, such as the trial balance. These firms only keep information that the owner of the business sees necessary.
- b) The statement of affairs is usually used to determine the opening capital.
- c) The receivables control account is normally used to calculate the sales.
- d) The payables control account is usually utilised to compute the purchases.

Question 2

Income Statement for the year ended 31st December 2019	€	€
Sales (€9,700 + €3,150)		12,850
<u>Less: Cost of Sales:</u>		
Opening Stock	15,000	
Purchases	<u>7,300</u>	
	22,300	
Closing Stock	<u>18,000</u>	<u>4,300</u>
Gross profit		8,550
<u>Less: Expenses:</u>		
Expenses	7,070	
Depreciation of Motor Vehicles	<u>800</u>	<u>7,870</u>
Net Profit		<u>680</u>

Workings:

Trade Receivables Account

Date	Debit	€	Date	Credit	€
1 Jan.	Balance b/d	5,600	31 Dec.	Bank	12,300
31 Dec.	Sales	<u>9,700</u>	31 Dec.	Balance c/d	<u>3,000</u>
		<u>15,300</u>			<u>15,300</u>

Trade Payables Account

Date	Debit	€	Date	Credit	€
31 Dec.	Bank	8,500	1 Jan.	Balance b/d	5,000
31 Dec.	Balance c/d	<u>3,800</u>	31 Dec.	Purchases	<u>7,300</u>
		<u>12,300</u>			<u>12,300</u>

Bank Account

Date	Debit	€	Date	Credit	€
1 Jan	Balance b/d	3,900	31 Dec.	Payables	8,500
31 Dec.	Receivables	12,300	31 Dec.	Drawings	850
31 Dec.	Sales	3,150	31 Dec.	Equipment	300
			31 Dec.	Expenses (missing figure)	6,950
		———	31 Dec.	Balance c/d	<u>2,750</u>
		<u>19,350</u>			<u>19,350</u>

Expenses Paid	€6,950
Accrued Expenses	<u>€120</u>
Total Expenditure	<u>€7,070</u>

Motor Vehicles at 1 st January 2019	€9,800
Motor Vehicles at 31 st December 2019	<u>€9,000</u>
Depreciation	<u>€800</u>

Question 3

Statement of Affairs as at 1st April 2017	€	€
<u>Non-Current Assets:</u>		
Premises		45,000
Equipment		<u>5,000</u>
		50,000
<u>Current Assets:</u>		
Stock	18,100	
Trade Receivables	8,000	
Bank	<u>10,000</u>	<u>36,100</u>
Total Assets		<u>86,100</u>
<u>Financed By:</u>		
Capital (missing figure)		79,000
<u>Current Liabilities:</u>		
Trade Payables	6,950	
Accrued Wages	<u>150</u>	
Total Current Liabilities		<u>7,100</u>
Total Capital and Liabilities		<u>86,100</u>

Income Statement for the year ended 31st March 2018	€	€
Sales		20,500
<u>Less: Cost of Sales:</u>		
Opening Stock	18,100	
Purchases	<u>10,050</u>	
	28,150	
Closing Stock	<u>20,500</u>	<u>7,650</u>
Gross profit		12,850
<u>Less: Expenses:</u>		
Loss on Disposal	400	
Wages	1,560	
Electricity	350	
General Expenses	360	
Bank Charges	<u>50</u>	<u>2,720</u>
Net Profit		<u>10,130</u>

Trade Receivables Account

Date	Debit	€	Date	Credit	€
1 Apr.	Balance b/d	8,000	31 Mar.	Bank	17,000
31 Mar.	Sales	<u>20,500</u>	31 Mar.	Balance c/d	<u>11,500</u>
		<u>28,500</u>			<u>28,500</u>

Trade Payables Account

Date	Debit	€	Date	Credit	€
31 Mar.	Bank	8,000	1 Apr.	Balance b/d	6,950
31 Mar.	Balance c/d	<u>9,000</u>	31 Mar.	Purchases	<u>10,050</u>
		<u>17,000</u>			<u>17,000</u>

Disposal of Equipment Account

Date	Debit	€	Date	Credit	€
31 Mar.	Equipment	900	31 Mar.	Bank	500
		—	31 Mar.	Profit and Loss	<u>400</u>
		<u>900</u>			<u>900</u>

Wages Account

Date	Debit	€	Date	Credit	€
31 Mar.	Bank	1,500	1 Apr.	Balance b/d	150
31 Mar.	Balance c/d	<u>210</u>	31 Mar.	Profit and Loss	<u>1,560</u>
		<u>1,710</u>			<u>1,710</u>

Statement of Financial Position as at 31st March 2019	€	€
<u>Non-Current Assets:</u>		
Premises		45,000
Equipment		<u>6,200</u>
		51,200
<u>Current Assets:</u>		
Stock	20,500	
Trade receivables	11,500	
Bank	<u>13,940</u>	45,940
Total Assets		<u>97,140</u>
<u>Financed By:</u>		
Capital		79,000
Add: Net profit		<u>10,130</u>
		89,130
Less: Drawings		<u>1,200</u>
		87,930
<u>Current Liabilities:</u>		
Trade Payables	9,000	
Accrued Wages	<u>210</u>	
Total Current Liabilities		9,210
Total Capital and Liabilities		<u>97,140</u>

Part 7: Interpretation of Accounts

Chapter 25 – The Annual Report and the Financial Statements

Question 1

a) The main financial statements present in the annual report consist of the profit or loss statement, the comprehensive income statement, the statement of financial position, the statement of changes in equity and the statement of cash flows.

b) The independent auditor's report serves to provide reasonable assurance to shareholders and stakeholders that the financial statements comply with accounting standards and relevant laws. This helps to increase the reliability of the financial statements.

c) Organisations are required to comply with the Combined Code, which outlines eight key disclosure requirements that need to be present in the annual report with respect to corporate governance. These disclosure requirements are: the board of directors are required to state if they are complying with the principles present in the Combined Code; provide details of the chairman, deputy chairman, chief executive officer, senior independent director/s, independent non-executive director/s, and members of the nomination, audit and remuneration committees; an assessment of the performance of the board of directors and committees during the year; a description of the measures adopted by the nomination committee, audit committee and remuneration committee during the year; responsibilities of the board of directors with respect to the preparation of the financial statements; the going concern assumption; an evaluation of the internal control procedures present in the organisation; and an explanation of the non-audit services provided by the external auditor.

Question 2

a) The statement of changes in equity provides an illustration of the variables that led to a change in the balance of equity components, such as ordinary share capital and retained earnings.

b) The financial statements help to evaluate the stewardship of the board of directors because they show the financial performance and financial position of the firm. This indicates the increase in financial wealth provided to the ordinary shareholders, the liquidity of the organisation and its long term solvency.

c) The financial statements show past events. Shareholders and stakeholders are interested in the future financial performance and financial position of the company. Qualitative factors like staff morale are not outlined in the financial statements. The statement of financial position highlights the balances of assets, liabilities and equity at the financial year end. Such figures may be significantly different during the year implying a diverse financial position than what is show in the financial statements. The financial statements provide an approximation of the true financial performance and financial position of the firm. For example, property, plant and equipment are recorded at historical cost, which may be materially different than their true market value.

Question 3

a) The statement of cash flows highlights the variables that led to a change in cash and cash equivalents. These cash/bank movements are classified into operating, investing and financing activities.

b) The directors' report may take different formats depending on the directors' discretion. The main factors that are normally present in the directors' report are: a description of the company's strategy and key business risks; an assessment of the main achievements of the organisation and its influence on the firm's financial performance and financial position; an explanation of the firm's policies relevant to environmental sustainability, employees and community issues; highlight specific financial figures like sales revenue; and measures adopted by top management with the external auditor in order to give him/her sufficient information to prepare the audit report.

c) The chairman's statement is usually normative in style and financial figures are used in order to support key claims highlighted in this statement. The main contents of the chairman's statement consist of the following: key financial figures like turnover and net income; an assessment of the business environment by considering political and economic factors; the dividends provided by the company to shareholders; and the measures adopted by the organisation in order to motivate employees.

Chapter 26 – Accounting Ratios

Question 1

- a) The return on capital employed calculates the operating profit made from the company's capital employed. An increase in this primary profitability ratio indicates that managers were more effective in the use of the firm's capital employed.
- b) The current ratio is used to examine liquidity by showing the ability of the current assets to cover the current liabilities. An increase in the current ratio indicates a stronger liquidity.
- c) The acid test ratio is also used to evaluate liquidity by determining the ability of the liquid assets to cover the current liabilities. The liquid assets are the current assets less inventories.
- d) The gearing ratio involves a comparison of the company's long term debt with equity. The higher the gearing ratio the larger the financial risk of the company.
- e) The dividend cover helps to see the ability of the company to sustain its dividend policy. The dividend cover ratio calculates the number of times profits cover the dividends paid to ordinary shareholders. The greater the dividend cover ratio the stronger the organisation to support its dividend policy.

Question 2

a) i) Capital Employed = Long Term Debt + Equity

Capital Employed (2019) = €3,500 + €15,760 = €19,260

Capital Employed (2018) = €2,000 + €12,000 = €14,000

$$\text{Return on Capital Employed} = \frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

$$\text{Return on Capital Employed (2019)} = \frac{€6,800}{€19,260} \times 100 = 35.31\%$$

$$\text{Return on Capital Employed (2018)} = \frac{€5,100}{€14,000} \times 100 = 36.43\%$$

ii)

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

$$\text{Operating Profit Margin (2019)} = \frac{€6,800}{€23,000} \times 100 = 29.57\%$$

$$\text{Operating Profit Margin (2018)} = \frac{€5,100}{€18,000} \times 100 = 28.33\%$$

iii)

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

$$\text{Net Profit Margin (2019)} = \frac{€3,760}{€23,000} \times 100 = 16.35\%$$

$$\text{Net Profit Margin (2018)} = \frac{€3,020}{€18,000} \times 100 = 16.78\%$$

iv)

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Current Ratio (2019)} = \frac{€5,160}{€1,100} = 4.69:1$$

$$\text{Current Ratio (2018)} = \frac{€4,150}{€1,500} = 2.77:1$$

v)

$$\text{Acid Test Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

$$\text{Acid Test Ratio (2019)} = \frac{€5,160 - €2,360}{€1,100} = 2.55:1$$

$$\text{Acid Test Ratio (2018)} = \frac{€4,150 - €1,800}{€1,500} = 1.57:1$$

vi)

$$\text{Days Sales Inventory} = \frac{\text{Inventories}}{\text{Cost of Sales}} \times 365$$

$$\text{Days Sales Inventory (2019)} = \frac{€2,360}{€10,800} \times 365 = 80 \text{ days}$$

$$\text{Days Sales Inventory (2018)} = \frac{€1,800}{€8,900} \times 365 = 74 \text{ days}$$

vii)

$$\text{Receivables Collection Period} = \frac{\text{Trade Receivables}}{\text{Sales}} \times 365$$

$$\text{Receivables Collection Period (2019)} = \frac{€2,300}{€23,000} \times 365 = 37 \text{ days}$$

$$\text{Receivables Collection Period (2018)} = \frac{€1,600}{€18,000} \times 365 = 32 \text{ days}$$

viii)

$$\text{Payables Payment Period} = \frac{\text{Trade Payables}}{\text{Cost of Sales}} \times 365$$

$$\text{Payables Payment Period (2019)} = \frac{€1,100}{€10,800} \times 365 = 37 \text{ days}$$

$$\text{Payables Payment Period (2018)} = \frac{€1,500}{€8,900} \times 365 = 62 \text{ days}$$

ix)

$$\text{Gearing} = \frac{\text{Long Term Debt}}{\text{Equity}} \times 100$$

$$\text{Gearing (2019)} = \frac{€3,500}{€15,760} \times 100 = 22.21\%$$

$$\text{Gearing (2018)} = \frac{€2,000}{€12,000} \times 100 = 16.67\%$$

x)

$$\text{Interest Cover} = \frac{\text{Operating Profit}}{\text{Interest}}$$

$$\text{Interest Cover (2019)} = \frac{€6,800}{€1,000} = 6.80 \text{ times}$$

$$\text{Interest Cover (2018)} = \frac{€5,100}{€500} = 10.20 \text{ times}$$

xi)

$$\begin{aligned} \text{Earnings per share} \\ = \frac{\text{Profit available to ordinary shareholders}}{\text{Number of ordinary shares issued}} \times 100 \end{aligned}$$

$$\text{Earnings per share (2019)} = \frac{€4,060}{€10,000} \times 100 = 40.60 \text{ cents}$$

$$\text{Earnings per share (2018)} = \frac{€3,220}{€10,000} \times 100 = 32.20 \text{ cents}$$

Profitability of CompuTech Limited

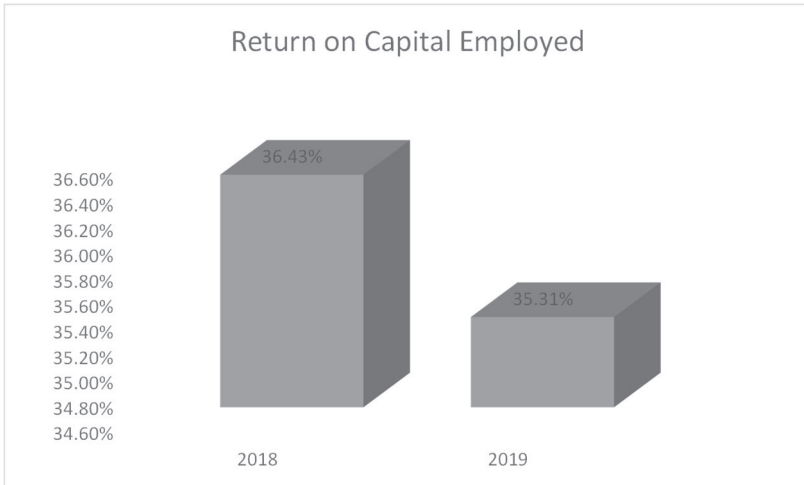


Figure 18 CompuTech Limited: Return on Capital Employed

The decrease in the return on capital employed shows that the management of CompuTech Limited failed to effectively use the company's capital employed, which increased by 37.57% in 2019. The rise in the company's operating profit of 33.33% was lower than the increase in the return on capital employed. This led to a decrease in this ratio.

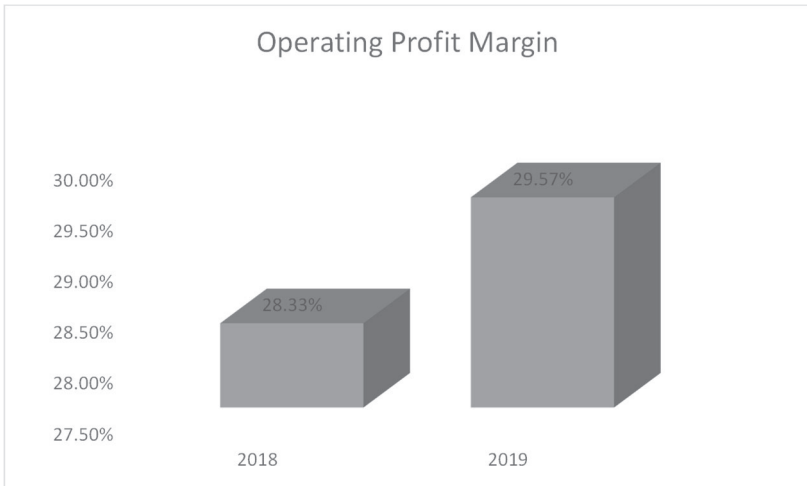


Figure 19 CompuTech Limited: Operating Profit Margin

The operating profit margin of CompuTech Limited increased meaning that more operating profit was generated from sales. The increase in this ratio implies better efficiency in the company's operating expenses.

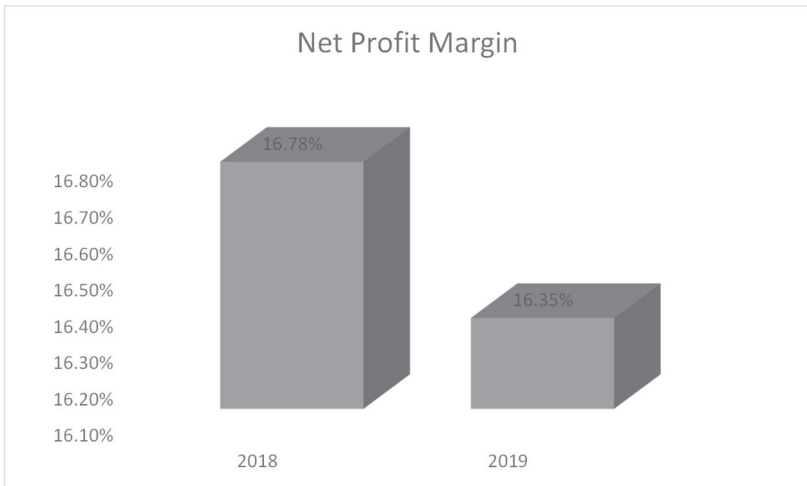


Figure 20 CompuTech Limited: Net Profit Margin

The net profit margin of CompuTech Limited decreased showing that there was a deterioration in the profitability of the company. This ratio conflicts with the operating profit margin, which increased in 2019. The net profit margin decreased due to the interest expenditure, which doubled from 2018 to 2019. The interest expenditure increased substantially due to the issue of €1.5 million debentures.

Liquidity of CompuTech Limited

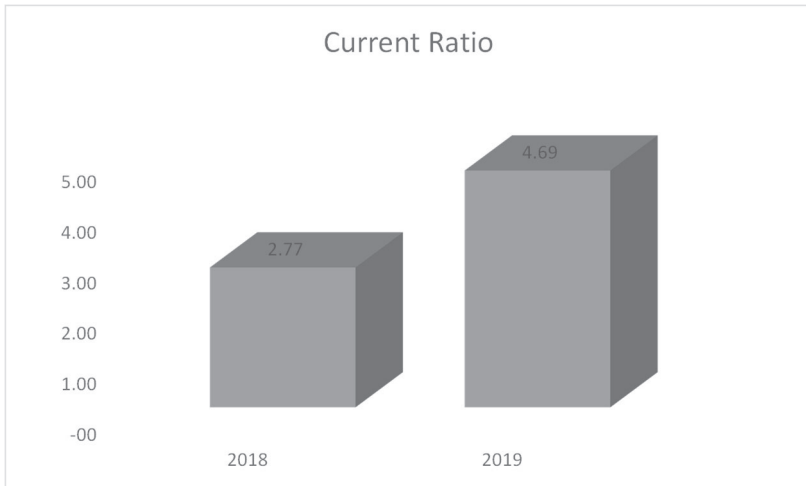


Figure 21 CompuTech Limited: Current Ratio

The substantial increase in the current ratio shows that the liquidity of CompuTech Limited improved considerably. The current assets increased by 24.34%, which helped the current ratio to increase. The decrease in the trade payables of 26.67% also helped the current ratio to increase.

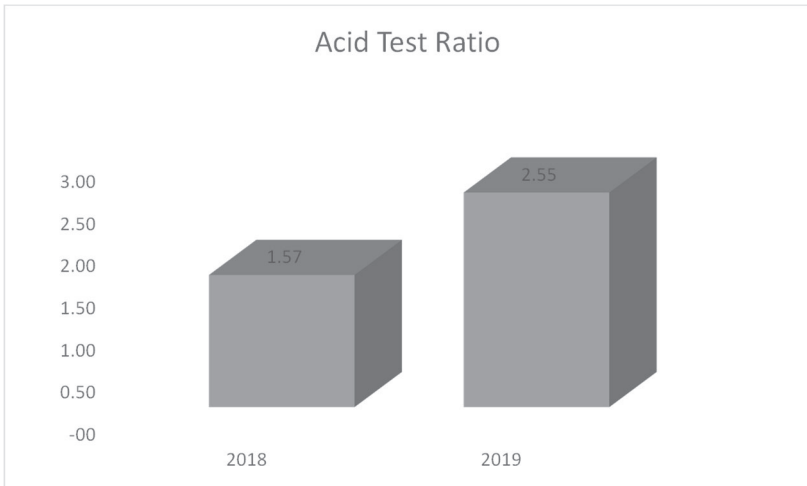


Figure 22 CompuTech Limited: Acid Test Ratio

The increase in the acid test ratio further supports the claim that the liquidity of CompuTech Limited improved in 2019. The increase in the current assets was due to higher inventory and trade receivables. The rise in trade receivables positively affected the acid test ratio. Furthermore, the fall in the trade payables resulted in a larger acid test ratio.

Efficiency of CompuTech Limited

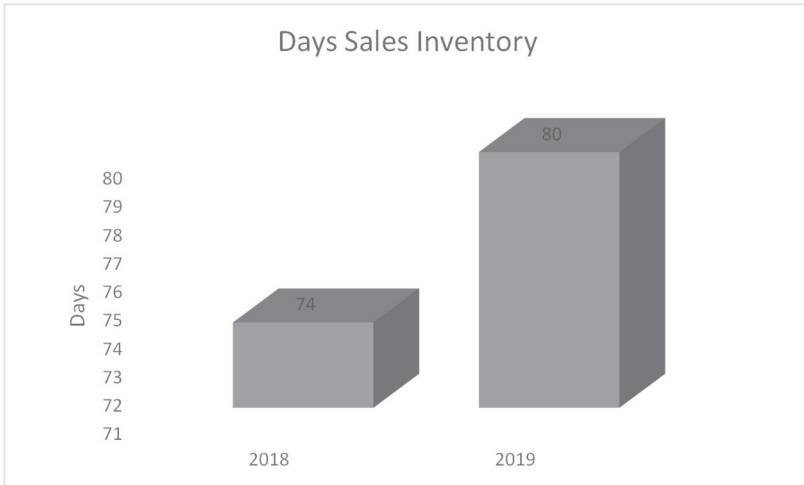


Figure 23 CompuTech Limited: Days Sales Inventory

The increase in days sales inventory of 6 days shows that the inventory management of CompuTech Limited got worse. This led to an increase in the inventory holding expenditure, which negatively impacted the profitability of CompuTech Limited. It also led to higher payments, which adversely affected the liquidity of the organisation.

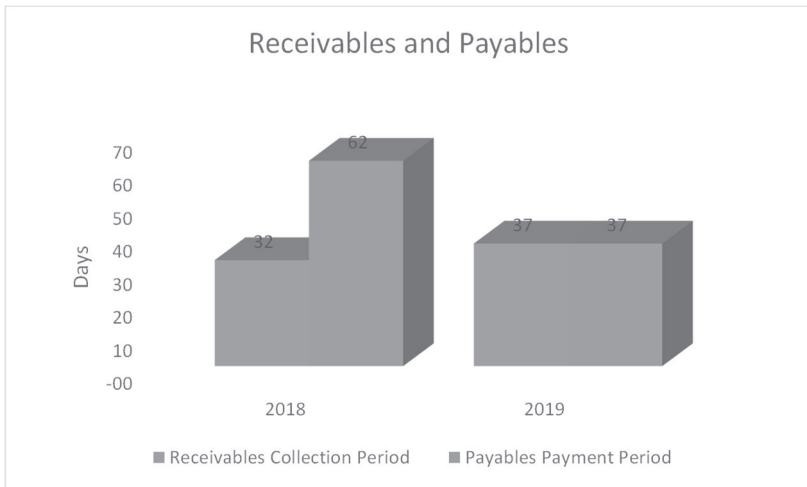


Figure 24 CompuTech Limited: Receivables and Payables

The 5 days increase in the receivables collection period and the 25 days decrease in the payables payment period adversely affected the cash flow of the company. In fact, the cash balance of CompuTech Limited decreased by €250,000 from 2018 to 2019. In 2019 the average time take to receive money from trade receivables was the same as the time CompuTech Limited takes to pay trade payables. Ideally, the receivables collection period should be lower than the payables payment period in order to decrease the company's liquidity risk.

Long Term Solvency of CompuTech Limited

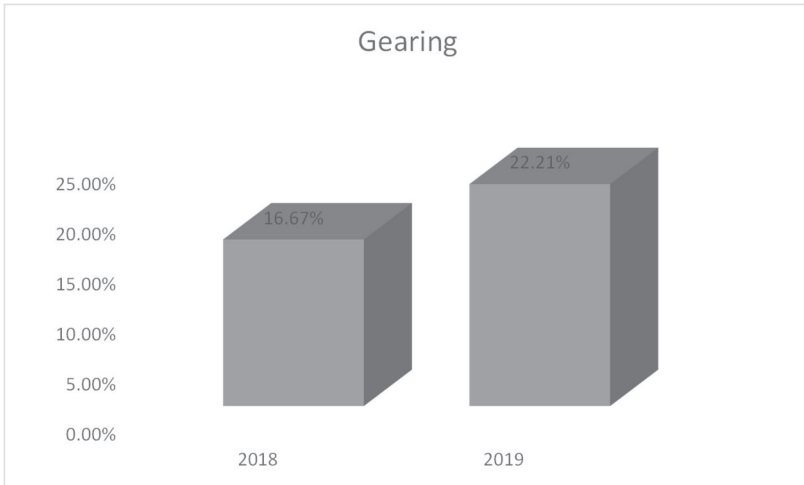


Figure 25 CompuTech Limited: Gearing

CompuTech Limited is a low-g geared company meaning that it is financed by a higher percentage of equity in comparison to long term borrowings. The firm's gearing increased mainly due to the issue of €1.5 million 6% debentures. This increased the company's financial risk. However, the firm's financial risk is still low because this is a low-g geared organisation.

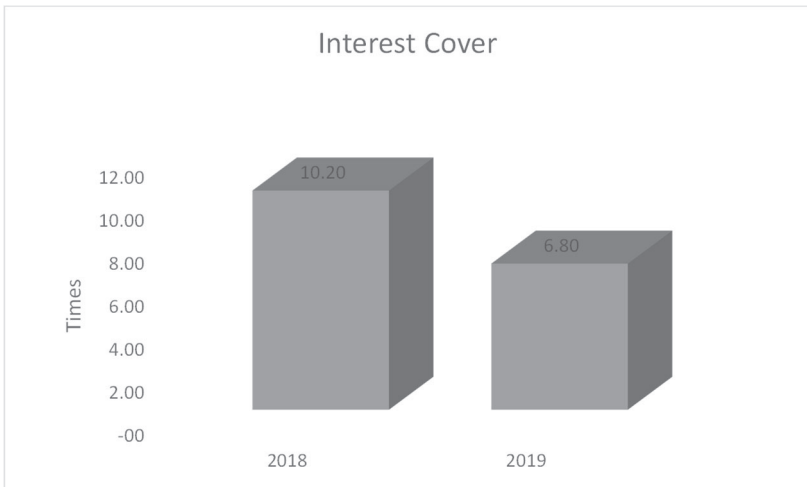


Figure 26 CompuTech Limited: Interest Cover

The decrease in the interest cover ratio means that the long term solvency of CompuTech Limited got weaker in 2019. The 33.33% increase in operating profit was lower than the 100% increase in interest.

Investment Potential in CompuTech Limited

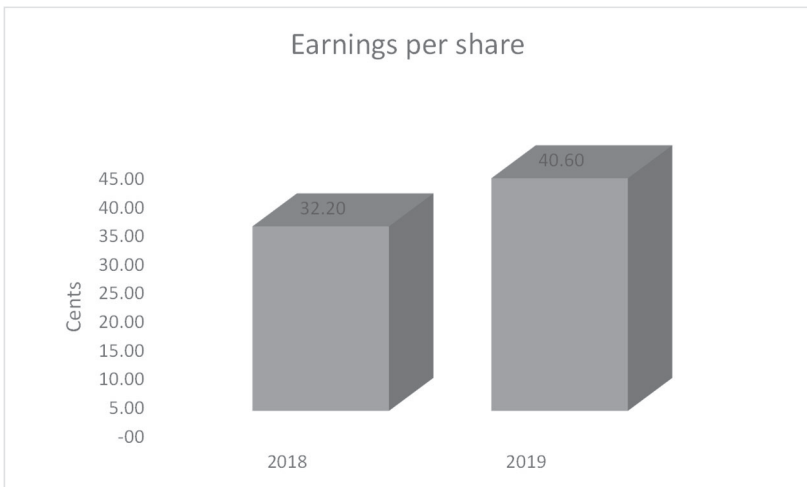


Figure 27 CompuTech Limited: Earnings per share

The €840,000 increase in net profit led to a rise in the earnings per share ratio. This implies that CompuTech Limited is able to provide a bigger return to ordinary shareholders. Furthermore, the dividends paid to ordinary shareholders increased by €100,000 from 2018 to 2019. This makes CompuTech Limited an attractive company to invest in.

Overall Evaluation of CompuTech Limited

The financial health of CompuTech Limited got worst in 2019 due to a fall in profitability and long term solvency. The liquidity of the company improved and its financial risk is low. In addition, investors have the potential to get a higher return from the organisation. This outweighs the higher investment risk arising from the deterioration in the firm's financial performance and financial position. Ideally, the market share price of the organisation should be investigated by looking at the price-earnings ratio and dividend yield. This helps to assess if the company's market share price is overvalued or undervalued. From the information provided one can state that CompuTech Limited is still a feasible investment for ordinary shareholders.

Question 3

a) Income Statement for year ended 31st December 2019	€	€
Sales (Missing Figure)		161,250
<u>Less: Cost of Sales:</u>		
Opening Stock (€19,000 + €5,000)	24,000	
Purchases		
Closing Stock	<u>19,000</u>	<u>129,000</u>
Gross profit (Note 1)		32,250
<u>Less: Expenses:</u>		
Selling and Distribution (€161,250 x 8%)	12,900	
Overheads (Missing Figure)	2,825	
Interest (€10,000 x 4%)	<u>400</u>	<u>16,125</u>
Net Profit (Note 2)		<u>16,125</u>

Workings:

Note 1 – Calculation of the Gross Profit:

$$\text{Mark - Up} = \frac{\text{Gross Profit}}{\text{Cost of Sales}} \times 100$$

Gross Profit = Mark-Up x Cost of Sales

Gross Profit = 25% x €129,000 = €32,250

Note 2 – Determination of the Net Profit:

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

Net Profit = 10% x €161,250 = €16,125

Statement of Financial Position as at 31st December 2019	€	€
<u>Non-Current Assets:</u>		
Property, plant and equipment		32,250
<u>Current Assets:</u>		
Stock	19,000	
Trade receivables	13,253	
Bank (Missing Figure)	<u>5,497</u>	<u>37,750</u>
Total Assets		<u>70,000</u>
<u>Financed By:</u>		
Capital (Missing Figure)		22,875
Add: Net profit		<u>16,125</u>
		39,000
<u>Current Liabilities:</u>		
Trade Payables	21,000	
<u>Non-Current Liabilities:</u>		
Loan	<u>10,000</u>	
Total Liabilities		<u>31,000</u>
Total Capital and Liabilities		<u>70,000</u>

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