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Introduction to accounting

The Institute of
Chartered Accountants
of Pakistan

CA
PAKISTAN

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Introduction to business and accounting

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1 TYPES OF BUSINESS

Section overview

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

1.1 Types of business entity

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

Definitions: Business

Business is an integrated set of activates and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investor or other owners, members or participants.

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

Definitions: A business entity

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

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

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

Characteristics of business

All businesses share certain characteristics.

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

There are three main types of business entity:

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

Sole proprietor or Sole trader

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

Important features of a sole trader business are as follows.

- There is no legal distinction between the proprietor and the business.
  - The owner of the business is personally liable for any unpaid debts and other obligations of the business.

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

Example:

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

Partnership

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

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

Definition: Partnership

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

Important features of a partnership are as follows:

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

Example:

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

Company (limited liability)

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

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

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

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

1.2 Advantages and disadvantages of different types of business entity

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

Business structure	Sole trader	Partnership	Company
Owned by…	One person	Several individuals working together	Shareholders
Liability for the unpaid debts and other obligations of the business	Personal liability of owner	Personal liability of partners	Limited
Management	Business managed by its owner	Business managed by its owners	Larger companies are managed by professional managers

Business structure	Sole trader	Partnership	Company
Raising capital	Capital for the business is provided by its sole owner. Likely to be limited in amount.	Capital for the business is provided by its owners. Often limited in amount	Capital for the business is provided by its shareholders. Public companies can raise new capital from investors in the stock market. Most very large businesses are companies.
Financial accounting and auditing	Some financial accounts needed for tax purposes.	Financial accounts needed for the benefit of the partners and for tax purposes.	Fairly strict regulation of financial reporting by companies. Also legal requirements for audit.

2 INTRODUCTION TO FINANCIAL ACCOUNTING

Section overview

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

2.1 The purpose of financial accounting

Financial accounting is a term that describes:

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

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

2.2 Accounting systems

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

2.3 Chart of accounts

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

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

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

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

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

Illustration: Chart of accounts

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

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

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

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

The organisation will maintain appropriate chart of accounts in order to cater the present and future monetary transactions with an objective of coming up with timely, accurate and meaningful financial reporting. The chart of accounts will act as a guiding and referring tool to the finance personnel while they post accounting entries to their respective heads of accounts. In order to keep a vigilant control over accounting framework of the organization, no accounting personnel is allowed to make amendment (including opening a new head of account) in the chart of accounts unless specific written approval thereof is duly sanctioned by the Head of Finance.

Vouchers and Forms

The finance personnel will be responsible to record and maintain financial records, related correspondence, accounts, statements, supports, etc. pertaining to the organization. For effective and accurate maintenance of accounting records, a set of internal documents, forms have been designed which will be used for initiating and recording financial transactions.

a) Payment Voucher

   i. Payment can be made after approval of payment voucher. Payment voucher will be supported with bills or other relevant supporting documents. Such supports will be scrutinized by the finance department prior to their submission for sanction of payment before the approving authority.

   ii. All cash payments will be recorded through cash payment vouchers and all bank payments will be recorded through bank payment vouchers.

b) Receipt Voucher

   i. Receipt voucher will be prepared to record the receipts and collections in bank accounts.

   ii. Cash receipt transactions will be recorded through cash receipts.

c) Journal Voucher

   Journal voucher (JV) is prepared to evidence the authorization to record non-cash transactions. A non-cash transaction is one which does not involve the actual receipt and payment of cash but the recognition of which in the books of account is fundamental to properly reflect the operating results and financial position of the organization. As a pre-requisite of the accrual basis of accounting, all accruals will be recorded on a monthly basis. Such accounting entries will be routed through JVs.

Books of Accounts / Records

In addition to the above mentioned different types of vouchers, the organization will keep and maintain the following information / record:

1. Cash / Bank Book
2. General Ledger
3. Salary Register
4. Bank Statements & Reconciliation’s
5. Fixed Assets Register
6. Employee Personal Files
7. Invoices
8. Bank Deposit Slips
9. Cheque Books
10. Purchase Orders and invoices
11. Sale Orders
12. Invoices
13. Any other record and information considered necessary.

Pre numbered entries

All entries will be allotted sequential numbers so as to ensure completeness and proper authorization thereof. Any entry recorded out of the prescribed sequence would require immediate and thorough scrutiny to dispel the impression of any deliberate event. A written report of such inquiry will need to be submitted to the Head of Finance, who would then decide future course of action.

Review of accounting entries

All accounting entries will be submitted to the Head of Finance for his approval. Such entries will not be considered unless they are supported through documentary evidences originating such transaction(s). After necessary approval, such entries should be posted in their relevant head of account. If this is not possible due to peculiar nature of the transaction, the matter should be referred to the superior personnel for proper guidance.

Segregation of Duties

In order to keep a meaningful check over the affairs of organization, segregation of duties is a must, whenever practicable. Segregation of duties means distributing the execution of one activity over more than one person in order to ensure that no single individual is capable of handling the whole of a transaction individually. If it is not practical to segregate any duty due to its operational nature and / or limited staff members, the management should ensure that all transactions are duly authorized and supported with all necessary documents and properly recorded in books of account in a timely manner.

Correction of entries

Ensure that in case of omission, error of disposition / classification, etc. the correction should always be routed through JV. To confirm this procedure in the computerized accounting software, access controls have been placed which prohibits and restricts the individual responsible for data entry from re-entering and accessing the recorded data.

Audit Trail

At the time of approving the accounting entry, the Head of Finance will ensure that adequate and reliable audit trial of the subject transaction exists and that the entry would be easily auditable at the time of internal or external audit. Such audit trial would, ideally, start from the financial statements and end up at the related source document(s).

Custody of Accounting Records

All the accounting records, including but not limited to ledgers, statements, accounts, vouchers, invoices, banking records, record of procurement and sales, etc. should be in the custody of the accounting personnel. The Head of Finance should ensure that adequate facilities exist for custody of accounting records. Such records should be kept and maintained for a minimum 5 years from the relevant year-end.

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

2.4 Financial statements

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

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

- ☐ a statement of financial position; and
- ☐ a statement of comprehensive income The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

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

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

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

The business entity concept

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

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

Illustration:

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

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

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

Responsibility for preparing financial statements

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

Financial reporting by sole traders and partnerships

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

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

Financial reporting by companies

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

Company Act requires that every company shall send its financial statements to every member and every person who is entitled to receive notice of general meeting and are filed with a registrar, where they can be accessed and read by any shareholder / members. Moreover, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statements for every financial year which give a true and fair view of the state of the affairs of the company

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

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

2.5 Regulation of financial reporting

Generally accepted accounting principles

Financial reporting is regulated and controlled for every company who are required to file it. Regulations help to ensure that information reported in financial statements has the required qualities and content.

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

The main sources of GAAP in a jurisdiction are:

- ☐ Company Act, 2017; and
- ☐ IFRS / Specialised Financial Statements (for banks, insurance, mutual funds / IPSAS / SMEs)

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

IFRS

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

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

3 THE NEEDS OF USERS

Section overview

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

3.1 The objective of financial reporting

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

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

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

3.2 Informational needs of those who use financial statements

Investors

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

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

Lenders

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

Suppliers and other trade creditors

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

Government

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

The public

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

Employees

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

Customers

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

Managers

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

Employees, managers and directors are called internal users of financial statements. All other users are external users of financial statements.

4 BUSINESS TRANSACTIONS

Section overview

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

4.1 Introduction

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

There are many different types of business transaction including:

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

There are many mores examples.

Classification of business transactions

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

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

Simple or complex

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

One-off and ongoing transactions

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

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

4.2 The difference between capital and revenue transactions

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

- It spends money for both the long term, for example, by investing in machinery etc. It also spends money on day-to-day expenses, such as paying for supplies and services and paying salaries to employees etc.
- It receives income from its business operations. It might also receive income from other sources, such as a new capital invested by its owners (shareholders).

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

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

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

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

4.3 Capital and revenue expenditure

Capital expenditure is expenditure made to acquire or improve long term assets that are used by the business for a number of years:

Examples include:

- purchase of property, plant and equipment;
- improvements and additions to existing non-current assets (for example, building extensions, installation of air-conditioning etc.)

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

- To pay fees associated with raising long term finance

A ‘capital asset’ is a ‘**non-current asset**’

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

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

Examples include:

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

Revenue expenditure is reported as expenditure in the statement of comprehensive income. It is not always easy to distinguish between capital and revenue transactions.

Illustration:

A business has two identical vehicles each with engine problems.

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

Vehicle B engine is replaced – this is capital expenditure.

4.4 Revenue and capital receipts

Revenue receipts arise from the normal operations of a business from its operations. They are generally of a short term nature.

Examples include:

☐ Revenue from the sale of goods.

☐ Commissions and fees received and receivable from the provision of a service.

☐ Interest received and receivable from savings.

☐ Rent received and receivable from letting out property.

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

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

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

Illustration:

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

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

A business has two identical vehicles each with engine problems.

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

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

Practice question: User Group **1**

Different user groups are interested in an entity's financial statements for different reasons.

Identify any four potential user groups and briefly describe the information which they may be interested in.

Practice question **2**

Explain the following and give one example in each case:

(i) Capital and revenue expenditure

(ii) Accrued and unearned revenue.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

User Groups

Management needs detailed information in order to control their business and plan for the future. Financial results allow the management to compare actual results with its plans (budgets) to assess its performance. Information is also needed about the profitability of individual departments, products and locations etc.

Investors require information to assess risk and the ability of an entity to earn profits and to pay dividends. Principally, they need to decide whether to buy, hold or sell shares.

Employees and their representative groups (e.g. trade unions), require information to assess the ability of an entity to provide remuneration, retirement benefits and employment opportunities.

Lenders are interested in information that enable them to determine whether their loans and interest entitlements will be paid when due.

Suppliers require information which will enable them to assess whether the entity has the ability <u>in the short term to pay amounts</u> owed when they fall due.

Customers are interested in assessing the continuance of an entity where they have a <u>long-term involvement</u> with them and/or are <u>dependent on them</u> for supplies.

Government and their agencies require information for a variety of purposes. These include resource allocation decisions (e.g. government grants), to assess taxable capacity and for regional and national planning purposes.

Public is interested in variety of ways which include employment potential, patronage of local suppliers, and for environment assessment purposes.

Solutions **2**

(a) (i) **Capital expenditure:**

Capital expenditure consists of expenditure resulting in the acquisition or improvement of an asset or increase in the earning capacity of a business. Usually it includes expenditure, the benefit of which is spread over several accounting periods.

Examples: Purchase of new plant and its installation, purchase of motor vehicles, furniture etc.

Revenue expenditure:

Revenue expenditure means the day to day expenditure which is necessary for running the business including the upkeep of non-current assets and the costs involved in selling and administration and also includes the cost of goods and services of the business.

Examples: Repairs and maintenance, utilities, rent, salaries, interest etc.

(ii) **Accrued Income/Revenue:**

Accrued income means income which has been earned but not received at the statement of financial position date. Such income is shown as a current asset, on the statement of financial position.

Examples: Interest on securities accrued but not received, rent accrued but not received etc.

Unearned Income/Revenue:

Unearned income means amount received/collected in advance for services to be rendered in the next period. It appears as a current liability on the statement of financial position.

Examples: Insurance premium, subscriptions, rents etc. received in advance of the period they pertain to.

5 OBJECTIVE BASED QUESTIONS

01. Which of the following statements is correct?

- **(a)** The directors of a company are liable for any losses of the company.
- **(b)** A sole trader business is owned by shareholders and operated by the proprietor.
- **(c)** Partners are liable for losses in a partnership equally regardless of their profit-sharing ratio.
- **(d)** A company is run by directors on behalf of its members.

02. Which of the following best explains why employees are interested in the financial statements of their employer?

- **(a)** To compare the business with its competitors in order to decide whether to seek employment with one of those competitors.
- **(b)** To assess the effect of the business on the local economy, community and environment.
- **(c)** To assess whether the business will continue into the foreseeable future.
- **(d)** To assess the profitability of the business in order to decide whether to invest in it.

03. Which of the following user groups require the most detailed financial information?

- **(a)** The management
- **(b)** Investors and potential investors
- **(c)** Government agencies
- **(d)** Employees

04. Which of the following statements are true?

1. Accounting can be described as the recording and summarizing of transactions

2. Financial accounting describes the production of a statement of financial position and Statement of Profit or Loss for internal use

- **(a)** 1 only
- **(b)** 2 only
- **(c)** 1 and 2 both
- **(d)** Neither 1 nor 2

05. The main aim of financial accounting is to:

- **(a)** Record all transactions in the books of account.
- **(b)** Provide management with detailed analyses of costs.
- **(c)** Present the financial results to the organization by mean of recognized statements.
- **(d)** Calculate profit.

06. The capital of a business would change as a result of:

- **(a)** A supplier being paid by cheque
- **(b)** Raw material being purchased on credit
- **(c)** Non-current assets being purchased on credit
- **(d)** Wages being paid in cash

07. Which of the following explains why lenders are interested in financial statements of a business?

- **(a)** Lenders need information about financial stability of business
- **(b)** Lenders need information about profitability of business
- **(c)** Lenders want to assess the employer's capacity to pay interest and repay loan on time
- **(d)** All of the above

08. Which of the following is not a user of financial statements as per IASB framework?

- **(a)** Investor
- **(b)** Lender
- **(c)** Government
- **(d)** Manager

09. Who is responsible to prepare financial statements in a company?

- **(a)** Shareholders
- **(b)** Managers
- **(c)** Directors
- **(d)** All of the above

10. Who is responsible to prepare financial statements of a partnership?

- **(a)** Partner
- **(b)** There may be no obligation to prepare financial statements of a partnership (other than for tax purpose)
- **(c)** Manager
- **(d)** Accountant

11. Liability of a partner towards unpaid debts of partnership is?

- **(a)** Limited
- **(b)** Primary
- **(c)** Unlimited
- **(d)** None

12. Which of the following business entity is a "legal person" in the eye of law?

- **(a)** Sole trader
- **(b)** Company
- **(c)** Partnership
- **(d)** All of the above

13. Which of the following is not a feature of partnership business?

- **(a)** There must be an association of two or more persons
- **(b)** Liability of partners towards unpaid debts of partnership is unlimited

(c) Partners can make drawings

(d) Profits of the business belong to one partner only

14. Assets of the business belong to owners;
Which of the following business does not possess this characteristic?

(a) Sole trader

(b) Partnership

(c) Company

(d) Service organization

15. Which of the following is characteristic of a limited liability company?

(a) A company is legal owner of business assets

(b) A company is taxed separate from its owners

(c) A company is liable for its own debts

(d) All of the above

16. A business has incurred following costs for the year ended 31 December 2018:

	Rs. million
Extension in building	1.5
Repairs to building	0.5
Overhaul to machinery that increased production capacity	1.2

What is the amount of capital expenditure incurred during the year?

Rs. ___________

17. A business has incurred following costs for the year ended 31 December 2018:

	Rs. million
Extension in building	1.5
Repairs to building	0.5
Overhaul to machinery that increased production capacity	1.2

What is the amount of revenue expenditure incurred during the year?

Rs. ___________

18. A business has incurred following information for the year ended 31 December 2018:

	Rs. million
Cost of building – Opening	15.5
Cost of machinery – Opening	10.2
Extension in building – during the year	1.5
Repairs to building – during the year	0.5
Overhaul to machinery that increased production capacity	1.2

What is the cost of building after incorporating the above costs?

Rs. ___________

19. A business has incurred following information for the year ended 31 December 2018:

	Rs. million
Cost of building – Opening	15.5
Cost of machinery – Opening	10.2
Extension in building – during the year	1.5
Repairs to building – during the year	0.5
Overhaul to machinery that increased production capacity	1.2

What is the cost of machinery after incorporating the above costs?

Rs. __________

20. A business has incurred following costs for the year ended 31 December 2018:

	Rs. million
Extension in building	1.5
Repairs to building	0.5
Overhaul to machinery that increased production capacity	1.2

Profit for the year before incorporating the above adjustments is Rs. 5.6 million. What will be the profit for year after charging the above repairs?

Rs. ___________

21. A company is owned by;

- **(a)** Directors
- **(b)** Managers
- **(c)** Shareholders
- **(d)** Employees

22. Which of the following is not a business transaction?

- **(a)** Incurring interest on a business loan
- **(b)** Hiring a new employee
- **(c)** Purchasing office supplies
- **(d)** Receiving fees for services

23. The goods which are purchased for the purpose of resale are called

- **(a)** Inventory
- **(b)** Purchases
- **(c)** Merchandise
- **(d)** Traded goods

24. Cash invested in the business by the owner is called

- **(a)** Current asset
- **(b)** Non-current asset
- **(c)** Liabilities
- **(d)** Capital

25. Cash or goods taken away by the proprietor is called

- **(a)** Drawings
- **(b)** Sales
- **(c)** Charity
- **(d)** Expense

26. Which of the following is an element of the statement of financial position?

- **(a)** Income
- **(b)** Expense
- **(c)** Gains
- **(d)** Liabilities

27. Which from the following is not a current asset?

- **(a)** Equipment
- **(b)** Inventory
- **(c)** Cash
- **(d)** Trade receivables

28. Which from the following is not a non-current asset?

- **(a)** Intangibles
- **(b)** Property
- **(c)** Inventory
- **(d)** Equipment

29. Which one of the following not an external user of financial statements?

- **(a)** Lender
- **(b)** Investor
- **(c)** Customer
- **(d)** Management

30. Which one of the following not an internal user of financial statements?

- **(a)** Employees
- **(b)** Management
- **(c)** Supplier
- **(d)** Executive Director

31. Expenditures which provide benefit in future period are called:

- **(a)** Revenue expenditure
- **(b)** Outstanding expenditure
- **(c)** Current expenditure
- **(d)** Capital expenditure

32. Which one is a capital transaction?

- **(a)** Purchase of goods
- **(b)** Payment of wages
- **(c)** Sale of goods
- **(d)** Purchase of machinery

33. Financial statements are prepared mainly for:

- **(a)** Directors
- **(b)** Shareholders
- **(c)** Employees
- **(d)** Managers

5 OBJECTIVE BASED ANSWERS

01.	**(d)**	
02.	**(c)**	
03.	**(b)**	
04.	**(a)**	
05.	**(c)**	
06.	**(d)**	
07.	**(c)**	
08.	**(d)**	
09.	**(c)**	
10.	**(b)**	
11.	**(b)**	
12.	**(b)**	
13.	**(d)**	
14.	**(c)**	
15.	**(d)**	
16.	**Rs. 2.7 million**	= Rs. 1.5+1.2 = Rs. 2.7
17.	**Rs. 0.5 million**	Repairs to building
18.	**Rs. 17 million**	= Rs. 15.5 + 1.5 = 17
19.	**Rs. 11.4 million**	= Rs. 10.2 +1.2 = Rs. 11.4 million
20.	**Rs. 5.1 million**	Profit = Rs. 5.6 – 0.5 = Rs. 5.1
21.	**(c)**	
22.	**(b)**	
23.	**(a)**	
24.	**(d)**	
25.	**(a)**	
26.	**(d)**	
27.	**(a)**	
28.	**(c)**	

29.	**(d)**	
30.	**(c)**	
31.	**(d)**	
32.	**(d)**	
33.	**(b)**	

CHAPTER

2

Financial Reporting

Contents

1 THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Section overview

- Introduction
- Objective
- Scope
- Objective of general purpose financial statements
- Financial statements
- The statement of financial position
- The statement of comprehensive income
- Relationship between the statement of comprehensive income and the statement of financial position

1.1 Introduction

Financial Statements are prepared and presented for external users by many entities around the world. These financial reports are based on estimates, judgements and models rather than exact depictions. The Conceptual Framework establishes the concepts that underlie those estimates, judgements and models.

Financial statements are prepared in accordance with approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) and Islamic Financial Accounting Standards (IFAS) issued by the Institute of Chartered Accountants of Pakistan (ICAP) as are notified under the Companies Act, 2017. In case requirements of IFRS differ with Companies Act, 2017 the provisions or directives of the Companies Act, 2017 shall prevail. However, since CAF 1 is an introductory subject, therefore, requirements of Companies Act are not discussed.

1.2 Objective

The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. Its purpose is:

☐ to assist the IASB in the development of future IFRSs and in its review of existing IFRSs;

☐ to assist the IASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;

☐ to assist national standard-setting bodies in developing national standards;

☐ to assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;

☐ to assist auditors in forming an opinion on whether financial statements comply with IFRSs; and

☐ to assist users of financial statements in making sound economic decisions;

☐ This Conceptual Framework is not an IFRS and nothing in the Conceptual Framework overrides any specific IFRS.

On very rare occasions there may be a conflict between the Conceptual Framework and an IFRS. In those cases, the requirements of the IFRS prevail over those of the Conceptual Framework.

1.3 Scope

The Conceptual Framework deals with:

- the objective of financial reporting;
- the qualitative characteristics of useful financial information;
- the definition, recognition and measurement of the elements from which financial statements are constructed; and
- concepts of capital and capital maintenance.

1.4 Objective of general purpose financial statements

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

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

- In order to make these decisions the users need information to help them assess the prospects for future net cash inflows to an entity.
- In order to assess an entity's prospects for future net cash inflows, users need information about:
  - the resources of the entity;
  - claims against the entity; and
  - how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources. (This information is also useful for decisions by those who have the right to vote on or otherwise influence management performance).

1.5 Financial statements

A full set of financial statements would include the following:

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

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

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

1.6 The statement of financial position

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

A statement of financial position (formerly called a balance sheet) reports the financial position of an entity as at a particular date, usually the end of a financial year.

Assets

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

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

- **Current assets**: assets that are expected to provide economic benefit in the short term (within twelve months from the balance sheet date).
- **Non-current assets**: assets that have a long useful life and are expected to provide future economic benefits for the entity over a period of several years.

Example: Current assets

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

Example: Non-current assets

Property, plant and equipment, Intangibles

Liabilities

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

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

- **Current liabilities**: Amounts payable by the company within 12 months from the balance sheet date
- **Non-current liabilities**: Amounts payable beyond 12 months from the balance sheet date

Example: Liabilities

Trade payables (amounts owed to suppliers for goods purchased)

Accrued expenses

Bank loans

Equity

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

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

This can be represented as the accounting equation.

Formula: Accounting equation

Assets – Liabilities = Equity **or** Assets = Liabilities + Equity

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

Format of a statement of financial position

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

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

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

Example: statement of financial position

Lahore Shipping Limited: Statement of financial position as at [date]		
Assets	**Rs.(000s)**	**Rs. (000s)**
Non-current assets:		
Property, plant and equipment		400,000
Intangibles		100,000
Deferred tax		80,000
		580,000
Current assets:		
Inventory	20,000	
Receivables	30,000	
Cash and bank	5,000	
		55,000
Total assets		635,000
Equity and liabilities		
Equity:		
Owner's capital		440,000
Non-current liabilities:		
Bank loan		170,000
Current liabilities:		
Trade payables	10,000	
Accrued liabilities	15,000	
		25,000
Total equity and liabilities		635,000

The statement of financial position is not a statement of value. The value of a business is determined by the profits that the business is expected to generate using the assets that it owns. There is no way of telling what a business is worth by looking at the financial statements. (Further analysis would be required to arrive at a valuation).

1.7 The statement of comprehensive income

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

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

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

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

Income

Income consists of:

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

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

Expenses

Expenses consist of:

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

Format of a simple statement of comprehensive income

The order of presentation is usually as follows:

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

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

Example: Statement of comprehensive income

Lahore Shipping Limited: Statement of comprehensive income for the year ended [date]

	Rs. (000s)
Revenue	800,000
Cost of sales	500,000
Gross profit	300,000
Other income	10,000
	310,000
	270,000
Net profit before tax	40,000

Gross profit and net profit

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

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

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

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

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

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

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

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

2. ACCOUNTING CONCEPTS

Section overview

- Introduction
- Accruals basis (matching concept)
- Consistency
- Completeness
- Relevance
- Faithful representation
- Materiality
- Prudence
- Going concern basis
- Substance over form

2.1 Introduction

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

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

Example:

Question: What is the objective of financial reporting?

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

Knowledge of the following concepts is required by your syllabus.

- Accounting concepts
  - Accruals basis
  - Completeness
  - Relevance
  - Faithful representation
  - Materiality
  - Prudence
  - Going concern basis
  - Substance over form
- The elements of financial statements

2.2 Accruals basis (matching concept)

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

- Revenue from sales and other income should be reported in the period when the income arises (which might not be the same as the period when the cash is received from the customer / client).

- ☐ The cost of sales in the statement of comprehensive income must be matched with the sales. Income and 'matching' expenses must be reported in the same financial period. In other words, when the revenue is recognised from sale then the cost must also be recognised in the similar accounting period.
- ☐ Other expenses should be charged in the period to which they relate, not the period in which they are paid for.

Illustration: Statement of comprehensive income

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

Example 1: Accruals basis

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

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

Accruals basis:

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

Example 2: Accruals basis

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

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

Accruals basis:

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

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

Definitions

Prepayment.

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

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

Accrued expense or accrual.

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

Example: Accrual

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

The first payment is due on 30 June Year 2.

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

Accruals basis:

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

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

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

Accounting for accruals and prepayments is described in detail in the chapter 7 of this study text.

2.3 Consistency

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

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

Example: Consistency

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

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

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

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

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

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

2.4 Completeness

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

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

Materiality is explained below.

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

Example: Completeness

The accruals example can be used to illustrate this.

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

The first payment is due on 30 June Year 2.

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

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

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

2.5 Relevance

Information must be relevant (i-e. capable of making a difference in the decisions made by users). Information is relevant if it can be used for predictive and/or confirmatory purposes.

- It has **predictive value** if it helps users to predict what might happen in the future.
- It has **confirmatory value** if it helps users to confirm the assessments and predictions they have made in the past.

Predictability relates to the future outcome whereas confirmatory value relates to the past. Both of them are interrelated. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that was made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

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

Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity’s financial report. Therefore, it is not possible for the IASB to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

2.6 Faithful representation

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

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

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

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

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

2.7 Materiality

The relevance of information is affected by its materiality.

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

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

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

Magnitude

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

Example: Materiality

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

Each business discovers a Rs. 20,000 error.

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

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

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

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

Nature

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

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

2.8 Prudence

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

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

Example: Prudence

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

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

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

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

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

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

2.9 Going concern basis

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

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

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

2.10 Substance over form

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

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

IFRSs contain many rules that are based on this concept.

Example: Substance over form (leases)

Alpha rents (leases) an asset from Beta.

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

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

Analysis:

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

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

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

Example: Substance over form (sale and repurchase agreements)

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

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

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

Analysis:

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

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

Example: ABC Enterprises

Following principles are used by ABC Enterprises for preparation of its financial statements:

i. Fixed assets are stated at cost less accumulated depreciation.

ii. Items of capital nature, costing less than Rs. 1,000 are charged to cost.

iii. Stock-in-trade is valued on the same basis as is being followed for last many years.

iv. Appropriate provision is made for bad and doubtful debts.

v. Sales revenue is recorded on dispatch of goods to customers irrespective of the date of receipt of payment.

vi. Cost of sales is recorded in the same period in which the revenue earned from the sale is recorded.

The accounting concepts/principles being followed by ABC Enterprises for preparation of its financial statements are as follows:

i. Historical Cost: This is the actual amount of cash paid or received. For example, the historical cost of an item of fixed assets is the amount that was paid to buy it in the past.

ii. Materiality: Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial statements of an entity.

iii. Consistency: The financial statements must be presented consistently from one period to another. The presentation may be changed only if necessary to improve the quality of information presented in terms of its usefulness to the users or if a new rule requires a change.

iv. Prudence: Prudence involves allowing for some caution in preparing financial statements, by making reasonable and sensible allowance in order to avoid overstating assets or income and to avoid understating liabilities and expenses.

v. Accrual basis accounting: Revenue from sales and other income should be reported in the period when income arises (which might not be the same as the period when the cash is received)

vi. Matching concept: The cost of sales in the statement of comprehensive income must be matched with the sales.

Example: Aladdin Traders

On reviewing the draft financial statements of Aladdin Traders (AT) for the year ended 30 June 2018, following matters have been identified:

i. Freight-in incurred on merchandise was classified into administration expenses. Last year such cost was charged to cost of sales.

ii. Depreciation on land and building has not been charged due to rising market values.

iii. Cost of improvements and repairing equipment was capitalized to the cost of the equipment.

iv. A part of the business premises is used by owner for residential purposes. However, total rent and utilities of the premises are charged to expenses.

v. A leased vehicle has been recorded in the books as non-current asset although the vehicle is registered in the bank's name.

vi. Sales has been recorded for goods not yet dispatched.

the accounting concept(s) that has been applied or needs to be considered in each of the above situations are as follows:

(i) **Consistency:** The contents of financial statements must be presented consistently from one period to another. Therefore, cost of freight-in should be consistently charged to cost of sales rather than operating expenses.

(ii) **Matching:** Depreciation is the systematic allocation of the cost of property, plant and equipment over its estimated useful life and is not a valuation method.

Building needs to be depreciated over useful life irrespective of its market value. However, land should not be depreciated because of indefinite useful life.

(iii) **Capital or Revenue Expenditure:** Expenditure made to improve equipment are capitalized while costs of repairs are expensed out.

(iv) **Business entity/separate entry:** This concept implies that affairs of a business are to be treated as being quite separate from the non-business activities of its owner(s). Therefore, rent related to residential premises should be treated as drawings instead of business expenses.

(v) **Substance over form:** It is an accounting principle that transactions and other events must be accounted for and presented according to their substance and financial / economic reality instead of according to their legal form. In a financial lease, the lessor obtains title to the assets only at the end of the lease. However, the substance of the transaction is that the lessee obtains substantial rights on the asset from the outset of the lease. Thus, we treat the asset as if it was purchased outright at the start.

(vi) **Accrual concept / Revenue recognition:** Revenue from sales and other income should be reported in the period in which the income is earned i.e., when the goods are dispatched.

3 ENHANCED QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Section overview

- Introduction
- Enhancing qualitative characteristics
- Cost constraint on useful information

3.1 Introduction

Qualitative characteristics of useful financial information are covered in chapter 3 of ***The IASB Conceptual Framework***.

Information must have certain characteristics in order for it to be useful for decision making. The *IASB Conceptual Framework* describes:

- ☐ fundamental qualitative characteristics; and
- ☐ enhancing qualitative characteristics

Fundamental qualitative characteristics

The fundamental qualitative characteristics are;

- ☐ relevance; and
- ☐ faithful representation

These are covered in previous section of this chapter.

The qualitative characteristics that enhance the usefulness of information that is relevant and a faithful representation are:

- ☐ comparability;
- ☐ verifiability
- ☐ timeliness; and
- ☐ understandability

> "If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable".

3.2 Enhancing qualitative characteristics

Comparability

Comparability enables users to identify and understand similarities in, and differences among, items

Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency is related to comparability but is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Consistency helps to achieve the goal of comparability.

Verifiability

This quality helps to assure users that information faithfully represents the economic phenomena it purports to represent.

- Verifiability means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.
- Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

Verification can be direct or indirect.

- Direct verification means verification through direct observation, e.g. by counting cash or inventory.
- Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. For example, the carrying amount of inventory might be verified by checking the inputs (e.g. costs) and recalculating the closing inventory using the same assumption (e.g. FIFO).

Timeliness

This means having information available to decision-makers in time to be capable of influencing their decisions.

Understandability

Information is made understandable by classifying, characterising and presenting it in a clear and concise manner.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.

3.3 Cost constraint on useful information

Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

The benefits obtained from financial information should exceed the cost of obtaining and providing it. Information should not be provided if the cost is not worth the benefit.

Since it is difficult to measure the benefits of financial information, the setters of accounting standards must use their judgement in deciding whether certain items of information should be provided in the financial statements (and if so, in how much detail).

4 THE ELEMENTS OF FINANCIAL STATEMENTS

Section overview

- Introduction
- Assets
- Liabilities
- Equity
- Income
- Expenses
- Measurement of elements of financial statements
- Recognition of elements of financial statements

4.1 Introduction

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

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

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

4.2 Assets

An asset is defined as:

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

Resource controlled by the entity

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

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

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

The result of past events

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

Expected future economic benefits

An economic resource is a right that has the potential to produce economic benefits. An asset should be expected to provide future economic benefits to the entity.

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

4.3 Liabilities

A liability is defined as:

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

Present obligation

A liability is an obligation that already exists. An obligation is a duty or responsibility that the entity has no practical ability to avoid. An obligation may be legally enforceable as a result of a binding contract or a statutory requirement, such as a legal obligation to pay a supplier for goods purchased.

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

Past transactions or events

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

Future outflow of economic resources

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

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

4.4 Equity

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

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

4.5 Income

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

- ☐ **Revenue** is income arising in the course of the ordinary activities of the entity. It includes sales revenue, fee income, royalties' income, rental income and income from investments (interest and dividends).

- ☐ **Gains** include gains on the disposal of non-current assets. Realised gains are often reported in the financial statements net of related expenses. They might arise in the normal course of business activities. Gains might also be unrealised. Unrealised gains occur whenever an asset is revalued upwards, but is not disposed of. For example, an unrealised gain occurs when marketable securities owned by the entity are revalued upwards.

4.6 Expenses

Expenses include:

- ☐ **Expenses** arising in the normal course of activities, such as the cost of sales and other operating costs, including depreciation of non-current assets. Expenses result in the outflow of assets (such as cash or finished goods inventory) or the depletion of assets (for example, the depreciation of non-current assets).

- **Losses** include for example, the loss on disposal of a non-current asset, and losses arising from damage due to fire or flooding. Losses are usually reported as net of related income. Losses might also be unrealised. Unrealised losses occur when an asset is revalued downwards, but is not disposed of. For example, and unrealised loss occurs when marketable securities owned by the entity are revalued downwards.

4.7 Measurement of elements of financial statements

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

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

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

4.8 Recognition of elements of financial statements

Accounts

The word account is used in a number of ways:

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

Statement of comprehensive income

This is a statement of performance with two sections:

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

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

Recognition

- It is probable that economic benefits will flow towards/from the entity; and
- Cost can be measured reliably.

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

Cost

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

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

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

Net

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

Practice question **1**

What are the components of a set of financial statements?

Practice question: Concepts and Terms **2**

Explain the meaning of following accounting concepts/terms with reference to financial statements:

(i) Consistency

(ii) True and fair view

(iii) Completeness

(iv) Materiality

(v) Substance over form

(vi) Prudence

Practice question **3**

Name the accounting concepts on which the following rules are based.

(i) Inventories are valued on the same basis in each accounting period.

(ii) Assets are valued assuming there will be no sudden stoppage in business.

(iii) Assets and liabilities are valued with due caution in times of uncertainty.

(iv) Personal transactions should be distinguished from business transactions.

(v) Cost of small calculators may be charged to expenses instead of being capitalized.

(vi) The financial statements must disclose all the relevant information.

(vii) Transactions are recorded in various periods assuming money has a constant value.

(viii) Income is not recognized when a fee is received but when a service is rendered.

(ix) Leased vehicles might be recorded as assets although these are not owned by the organisation.

(x) Income and all costs relating to earning such income are accounted for in the same accounting period.

Practice question **4**

Differentiate between cash and accrual basis of accounting. Which method would you prefer and why?

Practice question **5**

Explain the following accounting terms:

i. Asset

ii. Liability

iii. Accrual basis of accounting

iv. Going concern basis

Practice question: Statements and Concepts **6**

Identify accounting concepts/principles on which the following statements are based and give one example of each:

i. Expenses are recognized on the basis of a direct association between the costs incurred and the earning of specific items of income.

ii. Accounting policies in use are applied from one period to the next.

iii. Overstating assets/income and understating liabilities/expenses are avoided.

iv. Revenue and other income are recognised when these are earned, irrespective of the date of receipt.

v. Any information, omitting or misstating of which could influence a decision of a user of the financial statements, is disclosed.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

A complete set of financial statements comprises of:

(i) a statement of financial position as at the end of the period;

(ii) a statement of comprehensive income for the period;

(iii) a statement of changes in equity for the period;

(iv) a statement of cash flows for the period;

(v) notes, comprising a summary of significant accounting policies and other explanatory information.

Solutions **2**

(i) **Consistency**:

The presentation and classification of items in the financial statements should be similar from one period to the next unless:

- It is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies or
- A Standard or an Interpretation requires a change in presentation.

(ii) **True and Fair view:**

The application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that show a true and fair view.

(iii) **Completeness:**

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

(iv) **Materiality:**

Information is material if its omission or misstatement could influence the economic decisions taken by the users on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement and the circumstances related thereto.

(v) **Substance over form**

It means that the transactions are accounted for and presented in the financial statements in accordance with their substance and economic reality and not merely their legal form.

(vi) **Prudence**

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because in that case, the financial statements would not give a true and fair view.

Solutions **3**

(i)	Consistency	(ii)	Going concern
(iii)	Prudence	(iv)	Entity / Separate entity
(v)	Materiality	(vi)	Full disclosure / completeness
(vii)	Stable currency unit	(viii)	Accrual / realization basis
(ix)	Substance over form	(x)	Matching concepts

Solutions **4**

Cash basis:

Under the cash basis, revenue is recognized when cash is received and expenses are recognized when cash payments are made.

Accrual basis

Under the accrual accounting, revenue is recognized when it is earned and expenses are recognized in the period in which they contribute to the generation of revenue, irrespective of the date of payment/receipt.

The accrual basis gives a better measurement of profitability than does the cash basis, because the accrual basis associates the determination of income to the Matching Principle.

Solutions **5**

(i) **Asset**

- It is a resource controlled by the entity;
- It is a result of past events; and
- It is expected that future economic benefits would flow from it to the entity.

(ii) **Liability:**

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

(iii) **Accrual basis of accounting:**

- It recognises a revenue when it is earned, irrespective of the date of receipt.
- It recognises an expense in the period in which it is incurred irrespective of the date of payment.

(iv) **Going concern basis:**

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

Solutions **6**

Accounting concept/principle with examples

S. No.	Accounting Concept/principle	Example(s) - [Only one example is required for each concept)
(i)	Matching	▪ Cost of sales is recorded in the period in which sales is recorded. ▪ Costs are charged in the period in which benefits are received.
(ii)	Consistency	▪ Use of same cost formula for stock valuation which was used in the previous period.
(iii)	Prudence	▪ Provision for doubtful debts ▪ Inventory valuation at lower of cost and net realisable value.
(iv)	Accruals	▪ Purchases are recorded although suppliers are yet to be paid. ▪ Sales are recorded although cash their against is yet to be received from the customers.
(v)	Materiality	▪ Fixed assets below a certain limit, are charged to profit and loss account

5 OBJECTIVE BASED QUESTIONS

01. Identify whether the following statements are true or false and give brief reasons to support your conclusion:

(i) The concept of separate entity is not applicable to a partnership.

(ii) Closing inventory does not appear in the pre-closing trial balance but appears in the post-closing trial balance.

(iii) The concept of going concern supposes that the life of business entity will be more than 15 years.

(iv) When the allowance for bad debts is based on age analysis, the opening balance of allowance for doubtful debts is not taken into consideration.

(v) Net realizable value of inventories is equal to selling price.

(vi) The 'prudence' concept allows a business to build substantially higher reserves/ allowances than are actually required.

02. Fill in the blanks with appropriate word(s) to complete the following sentences. Do not write the whole sentence.

(i) A bank overdraft is indicated by a ________ balance in the bank statement.

(ii) Cheques issued but not presented, cause the bank statement balance to be ________than the cash book balance.

(iii) The withdrawal of inventory by the owner for his own use should appear in the trading account as a deduction from ________.

(iv) The balance of purchase ledger control account represents ________.

(v) If closing inventory is undervalued, then net profit would be ________.

(vi) The basic accounting equation is given by the formula:

Equity + Long term liabilities = _________+ Current assets – Current liabilities.

(vii) Economic resources owned by a business are called its ________.

(viii) According to the ________ concept, the business is regarded as separate from the personal affairs of its owners.

03. Under the Conceptual Framework for Financial Reporting, which of the following is the 'threshold quality' of useful information?

(a) Relevance

(b) Reliability

(c) Materiality

(d) Understandability

04. According to The Conceptual Framework for Financial Reporting, which of the following is the underlying assumption of a set of financial statements?

(a) Going Concern

(b) Prudence

(c) Accruals

(d) Comparability

05. The Board's Framework identifies qualitative characteristics.

- (i) Relevance
- (ii) Comparability
- (iii) Verifiability
- (iv) Understand ability
- (v) Faithful representation.

Which of the above are not listed as enhancing characteristics?

- **(a)** (i), (iv) and (v)
- **(b)** (ii), (iii) and (iv)
- **(c)** (ii) and (iii)
- **(d)** (i) and (v)

06. Which of the following gives the best description of the objectives of financial statements as set out by the IASB's Conceptual Framework for Financial Reporting?

- **(a)** To fairly present the financial position and performance of an entity.
- **(b)** To fairly present the financial position, performance and changes in financial position of an entity.
- **(c)** To provide information about the financial position and performance of an entity that is useful to a wide range of users in making economic decisions.
- **(d)** To provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

07. The IASB's Conceptual Framework for Financial Reporting defines a liability as:

- **(a)** an amount owed to another entity
- **(b)** a present obligation arising as a result of past events, the settlement of which is expected to result in an outflow of economic benefits
- **(c)** expenditure that has been incurred but not yet charged to the statement of profit or loss
- **(d)** an obligation that may arise in the future

08. The IASB's Conceptual Framework for Financial Reporting identifies qualitative characteristics of financial statements.

Which TWO of the following characteristics are NOT fundamental qualitative characteristics according to the IASB's The Conceptual Framework for Financial Reporting?

- **(a)** Relevance
- **(b)** Reliability
- **(c)** Faithful representation
- **(d)** Comparability

09. The IASB's Conceptual Framework for Financial Reporting defines an asset as:

(a) A resource controlled by an entity which is capable of generating independent cash flows.

(b) A resource controlled by an entity as a result of past events, from which future economic benefits are expected.

(c) A resource owned by an entity as a result of past events, from which future economic benefits are expected.

(d) A resource capable of generating income for the entity.

10. Which of the following criteria need to be satisfied in order for an element to be recognised within the financial statements?

(i) It meets the definition of an element of the financial statements.
(ii) It is probable that future economic benefits will flow to or from the entity.
(iii) It is certain that future economic benefits will flow to or from the entity.
(iv) The item has a cost or value.
(v) The item has a cost or value that can be reliably measured.

(a) (i), (ii) and (v)

(b) (i), (iii) and (v)

(c) (i), (ii) and (iv)

(d) (i), (iii) and (iv)

11. Which description defines information that is relevant to users of financial information?

(a) Information that is free from error, bias and is a faithful representation of events

(b) Information that has been prudently prepared

(c) Information that is comparable from one period to the next

(d) Information that influences the decisions of users

12. Identify the accounting principle / concept undedicated by the following statement: “Fixed assets are stated at cost less accumulated depreciation”

(a) Prudence
(b) Consistency
(c) Materiality
(d) Historical cost

13. Identify the accounting principle / concept undedicated by the following statement: “Items of capital nature, costing less than Rs. 1,000 are charged to cost.

(a) Prudence

(b) Consistency

(c) Materiality

(d) Historical cost

14. Identify the accounting principle / concept undedicated by the following statement: “Stock-in-trade is valued on the same basis as is being followed for last many years.”

- **(a)** Prudence
- **(b)** Consistency
- **(c)** Materiality
- **(d)** Historical cost

15. Identify the accounting principle / concept undedicated by the following statement: “Appropriate provision is made for bad and doubtful debts.”

- **(a)** Prudence
- **(b)** Consistency
- **(c)** Materiality
- **(d)** Historical cost

16. Identify the accounting principle / concept undedicated by the following statement: “Sales revenue is recorded on dispatch of goods to customers irrespective of the date of receipt of payment.”

- **(a)** Accrual basis
- **(b)** Consistency
- **(c)** Materiality
- **(d)** Historical cost

17. Identify the accounting principle / concept undedicated by the following statement: “Cost of sales is recorded in the same period in which the revenue earned from the sale is recorded.”

- **(a)** Prudence
- **(b)** Materiality
- **(c)** Matching
- **(d)** Historical cost

18. The basic accounting equation is given by the formula:

Equity + Long term liabilities =

_________+ Current assets – Current liabilities.

19. Economic resources owned by a business are called its ________**.**

20. According to the ________ concept, the business is regarded as separate from the personal affairs of its owners.

21. Name the accounting concept on which the following rule is based: "The financial statements must disclose all the relevant information."

____

22. Name the accounting concept on which the following rule is based: "Leased vehicles might be recorded as assets although these are not legally owned by the entity."

____

23. The main source(s) of Generally Accepted Accounting Principles (GAAP) is/are:

(a) Company Law

(b) International Finance Reporting Standards (IFRSs)

(c) Tax law

(d) Sales Tax Act

24. Which of the following is not the main objective of accounting?

(a) Systematic recording of transactions

(b) Ascertaining profit or loss

(c) Ascertainment of financial position

(d) Solving tax disputes with tax authorities

25. The concept that the entity will continue in a foreseeable future is known as

(a) Consistency

(b) True and fair view

(c) Going Concern

(d) Substance over form

26. Accounting procedures and practices should remain same from year to year under which of the following accounting principles:

(a) Duality

(b) Materiality

(c) Timeliness

(d) Consistency

27. The concept that recognises the distinction between the receipt of cash and the right to receive the cash is called

(a) Accrual concept

(b) Cash concept

(c) Materiality concept

(d) None of the above

28. When a machinery is purchased for cash, the cash balance is reduced and to that extent, the amount of machinery as an asset is recorded. This is done to follow which of the following accounting principles:

(a) Dual-aspect

(b) Materiality

(c) Timeliness

(d) Consistency

29. Using "lower of cost and net realisable value" for the purpose of inventory valuation is the implementation of which of the following concepts?

(a) Going concern

(b) Separate entity

(c) Matching

(d) Prudence

30. The revenue recognition principle dictates that all types of income should be recorded or recognized when

(a) Cash is received

(b) At the end of accounting period

(c) They are earned

(d) Interest is paid

31. The matching concept matches which of the following;

(a) Assets with liabilities

(b) Income with expenses

(c) Capital with reserves

(d) Expenses with capital

32. Human resources will not appear in the statement of financial position according to which concept?

- **(a)** Accrual
- **(b)** Going concern
- **(c)** Reliable money measurement
- **(d)** Matching

33. In which of the following cases, accounting estimates are needed?

- **(a)** Doubtful debts
- **(b)** Impairment loss
- **(c)** Inventory obsolescence
- **(d)** All of the above

34. Which of the following factor is not considered while selecting accounting policies?

- **(a)** Prudence
- **(b)** Accounting errors
- **(c)** Substance over form
- **(d)** Materiality

35. Historical cost concept requires the valuation of an asset at

- **(a)** Original cost
- **(b)** Replacement value
- **(c)** Net realizable value
- **(d)** Market value

36. For every debit there will be an equal credit according to which concept?

- **(a)** Matching
- **(b)** Consistency
- **(c)** Money measurement
- **(d)** Dual-aspect

37. Matching concept means

- **(a)** Assets = capital + liabilities
- **(b)** Transactions recorded at accrual concept
- **(c)** Anticipate no profit but recognize all losses
- **(d)** Expenses should be matched with the revenue of the period

5 OBJECTIVE BASED ANSWERS

01.	(i) **False:** In accounting, business is considered to be a separate entity from the proprietor and the concept is applicable to all forms of business organizations. (ii) **True:** closing inventory appears outside the trial balance in pre-closing trial balance but after passing the closing entries when opening inventory and other revenue accounts are closed, only statement of financial position items including closing inventories form part of the post closing trial balance. (iii) **False:** No specific period has been specified. The concept of going concern supposes that the business is going to continue for the foreseeable future. (iv) **False:** the allowance is required to arrive at net receivables (as would appear in the statement of financial position) is calculated by age analysis. However, opening balance has to be considered for making the adjusting entry. (v) **False:** net realizable value is equal to selling price less the estimated cost of completion and the costs necessary to make the sale. (vi) **False:** The prudence concept does not allow a business to build excessive reserves/allowances. However, prudence means the exercise of a degree of caution such that assets or income are not overstated and liabilities and expenses are not understated.	
02.	(i) Debit (ii) more/higher/greater (iii) purchases (iv) Total payables/creditors (v) understated/reduced (vi) Non-current assets (vii) Assets (viii) Entity	
03.	**(c)**	
04.	**(a)**	
05.	**(d)**	
06.	**(d)**	The objectives of financial statements are set out in the IASB Framework. Note that providing information about changes in the financial position, as well as information about financial position and financial performance, is included within these objectives.

07.	**(b)**	(1) a liability is a present obligation that has arisen out of a past event, and (2) it is certain or probable that settlement of this obligation will result in an outflow of economic benefits, such as a payment of money. It is also necessary for the amount of the liability to be measured reliably.
08.	**(b) & (d)**	It is important to learn that the two fundamental characteristics are relevance and faithful representation.
09.	**(b)**	All other definitions include some part of the correct answer but are incomplete.
10.	**(a)**	There only has to be probable flow of economic benefits, rather than a certain flow. Also, the cost or value must be capable of reliable measurement, or no amount can be put into the financial statements.
11.	**(d)**	Information is relevant if it influences the economic decisions of the users. The other definitions describe good treatment but are not explaining the concept of relevance.
12.	**(d)**	This is the actual amount of cash paid or received. For example, the historical cost of an item of fixed assets is the amount that was paid to buy it in the past.
13.	**(c)**	Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial statements of an entity.
14.	**(b)**	The financial statements must be presented consistently from one period to another. The presentation may be changed only if necessary to improve the quality of information presented in terms of its usefulness to the users or if a new rule requires a change.
15.	**(a)**	Prudence involves allowing for some caution in preparing financial statements, by making reasonable and sensible allowance in order to avoid overstating assets or income and to avoid understating liabilities and expenses.
16.	**(a)**	Revenue from sales and other income should be reported in the period when income arises (which might not be the same as the period when the cash is received)
17.	**(c)**	The cost of sales in the statement of comprehensive income must be matched with the sales.
18.	**Non-current assets**	
19.	**Assets**	
20.	**Business Entity**	
21.	**Completeness**	
22.	**Substance over form**	
23.	**(a) & (b)**	
24.	**(d)**	
25.	**(c)**	

26.	**(d)**	
27.	**(a)**	
28.	**(a)**	
29.	**(d)**	
30.	**(c)**	
31.	**(b)**	
32.	**(c)**	
33.	**(d)**	
34.	**(b)**	
35.	**(a)**	
36.	**(d)**	
37.	**(d)**	

Certificate in Accounting and Finance
Introduction to accounting

CHAPTER

3

The accounting equation

Contents

1 THE ACCOUNTING EQUATION

Section overview

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

1.1 A simple representation of the statement of financial position

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

Formula: Accounting equation

Assets = Equity + Liabilities

A = E + L

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

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

The accounting equation and the business entity concept

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

Illustration:

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

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

1.2 The effect of financial transactions on the accounting equation

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

Example: Abbas – Transaction 1

Setting up a business by introducing capital

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

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

This transaction is recorded in the accounting equation as follows:

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

Capital has been introduced into the new business. This is recorded as the owner's capital.
The new business also has cash in the bank, which is an asset.
Assets and equity have both increased by Rs. 30,000.

Example : Abbas – Transaction 2

Borrowing money

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

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

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

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

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

Example : Abbas – Transaction 3

Buying an asset for cash

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

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

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

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

Example : Abbas – Transaction 4

Buying assets (inventory) on credit

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

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

Both assets and liabilities have increased by the same amount.

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

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

Example : Abbas – Transaction 5

Making a cash payment to settle a liability

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

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

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

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

Example : Abbas – Transaction 6

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

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

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

Profit is added to the owner's capital.

After the sale, the accounting equation changes to:

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

Example : Abbas – Transaction 7

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

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

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

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

After the sale, the accounting equation changes to:

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

Practice question 1

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

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

1.3 Drawings

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

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

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

Example : Abbas – Transaction 12

Suppose that the accounting equation of Abbas is as follows:

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

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

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

The accounting equation now changes as follows:

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

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

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

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

However, there are links between the two financial statements.

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

1.5 Using the accounting equation

The accounting equation is:

Formula: Accounting equation

Assets = Liabilities + Equity or Assets – Liabilities = Equity

A = L + E A – L = E

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

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

Movements in equity are caused by:

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

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

Illustration:

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

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

Example:

Sohaib operates a business as a sole trader.

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

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

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

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

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

Example:

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

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

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

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

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

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

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

ONA – L + CI – D = CNA.

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

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

Practice question: Bob **2**

a) Bob inherited Rs. 10,000,000 and decided to set himself up as a construction machinery distributor, starting to trade on 1 July.

During July he entered into the following transactions.

(1) Paid the Rs.10,000,000 into a business bank account

(2) Bought Machine 1 for Rs.1,000,000 cash

(3) Bought Machine 2 for Rs.2,500,000 cash

(4) Sold Machine 1 for Rs.1,500,000 cash

(5) Paid rent for his premises of Rs.300,000 cash.

(6) Bought office equipment for Rs.200,000 cash

(7) Bought Machine 3 for Rs.4,000,000 cash

(8) Sold Machine 2 for Rs.3,250,000 cash

(9) Drew Rs.400,000 in cash from the business

(Note: The word “cash” above is used to distinguish the transaction from credit transactions. All cash payments were made from the bank account.).

Required: Show the accounting equation which results from EACH of these transactions.

(Note: Each transaction follows on from the one before.)

b) The following transactions were entered into during August:

(1) Bought Machine 4 for cash (Rs.3,000,000) and Machine 5 (Rs.2,500,000)

(2) Sold Machine 4 for Rs.4,500,000 cash

(3) Received a telephone bill for Rs.100,000 which he paid

(4) Sold Machine 5 for Rs.1,800,000 cash

(5) Drew Rs.600,000 in cash from the business

(6) Bought an Machine 6 for Rs.5,600,000 cash

Required:

Show the accounting equation at 31 August after ALL the above transactions.

Practice question: Paracha Enterprises 3

Following information pertains to Paracha Enterprises, a sole proprietorship:

i. A machine costing Rs. 450,000 and having book value of Rs. 120,000 was sold for Rs. 150,000.

ii. A purchase order for supply of goods amounting to Rs. 1,500,000 was issued to ABC & Co. Payment would be made on delivery of the goods. ABC & Co accepted the purchase order immediately.

iii. Goods costing Rs. 200,000 were sold at 40% above cost. 20% of the sales amount had been received in advance and the remaining amount is to be received within 60 days.

iv. Rent amounting to Rs. 600,000 was paid for offices premises. 40% of the rent paid had already been accrued in the books.

v. A loan instalment of Rs. 545,000 including interest expense amounting to Rs. 45,000 was paid.

Required:

Show the effects of the above information in the form of accounting equation.

Practice question: Arish Enterprises (AE) 4

Following information pertains to Arish Enterprises (AE) for the month of August 2016:

i. Goods purchased on credit for Rs. 842,000 were returned to the supplier.

ii. A customer bought goods amounting to Rs. 96,000. 40% payment was made in cash and the balance amount was set off against amount payable by AE to the customer.

iii. A customer owes Rs. 348,000 to AE. It is expected that AE would be able to recover 60% and a provision for doubtful debts is to be made for the remaining amount.

iv. The owner withdrew cash of Rs. 35,000 and goods costing Rs. 65,000 for his own use.

Required:

Show the effect of the above in the form of accounting equations.

Practice question: Ben Ten Trader

5

The following table depicts the effects of certain transactions of Ben Ten Trader in accounting equation form:

	Assets				**=**	**Liabilities**	**+**	**Owner's equity**
	Cash	**Debtors**	**Inventory**	**Equipment**				
(i)	+50,000	+50,000	−75,000					+25,000
(ii)	+20,000	−50,000						−30,000
(iii)			−23,000			−23,000		
(iv)	−15,000			+65,000		+50,000		
(v)			−15,000					−15,000
(vi)	+60,000			−55,000				+5,000
(vii)	−2,500	−17,500				−20,000		
(viii)						−17,000		+17,000
(ix)		−35,000	+28,000					−7,000
(x)	−39,200					−40,000		+800

Required:

Give brief narrative/description of each of the above transactions.

Practice question: Transactions Descriptions

6

The following table depicts the effects of certain transactions in accounting equation form:

	Transaction date							
	3-Jan	**5-Jan**	**8-Jan**	**12-Jan**	**16-Jan**	**20-Jan**	**25-Jan**	**28-Jan**
	——————— Rs. in million ———————							
ASSETS:								
Fixed assets - cost					−5.00			
Accumulated depreciation					+2.40			
Account receivables – Gross			– 6.00					
Provision for doubtful debts			+1.20					
Prepayments & other receivables						−4.80		
Inventory	+17.00	– 20.00		−2.00		+8.00	−8.00	
Cash & bank	– 4.25	+22.5	+3.00	−1.50	+3.00	−3.20	+9.50	−3.80
	+12.75	+2.50	−1.80	−3.50	+0.40	-	+1.50	−3.80

	Transaction date							
	3-Jan	5-Jan	8-Jan	12-Jan	16-Jan	20-Jan	25-Jan	28-Jan
	——— Rs. in million ———							
EQUITY:								
Capital				–3.50				
Profit & loss account		+5.00	–1.80		+0.40		+1.50	–0.80
LIABILITIES:								
Long-term loans								–3.00
Account payables	+12.75							
Accruals & other payables		–2.50						
	+12.75	+2.50	–1.80	–3.50	+0.40	-	+1.50	–3.80

Required:

Give brief narration/description of each of the above transactions.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

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

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

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

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

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

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

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

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

Solutions **2**

(a) July transactions

(1) Introduction of capital

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Cash	10,000		Capital	10,000		
	10,000	=		**10,000**	+	

(2) Purchase of Machine 1

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Cash	9,000		Capital	10,000		
Inventory	1,000					
	10,000	=		**10,000**	+	

(3) Purchase of Machine 2

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Cash	6,500		Capital	10,000		
Inventory	3,500					
	10,000	=		**10,000**	+	

(4) Sale of Machine 1

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Cash	8,000		Capital:			
Inventory	2,500		Original	10,000		
			Profit	500		
				10,500		
	10,500	=		**10,500**	+	

(5) Rent payment

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Cash	7,700		Capital:			
Inventory	2,500		Original	10,000		
			Profit	200		
				10,200		
	10,200	=		**10,200**	+	

(6) Purchase of desk

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Office equipment	200		<u>Capital:</u>			
Cash	7,500		Original	10,000		
Inventory	2,500		Profit	200		
				10,200		
	10,200	=		**10,200**	+	

(7) Purchase of Machine 3

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Office equipment	200		<u>Capital:</u>			
Cash	3,500		Original	10,000		
Inventory	6,500		Profit	200		
				10,200		
	10,200	=		**10,200**	+	

(8) Sale of Machine 2

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Office equipment	200		<u>Capital:</u>			
Cash	6,750		Original	10,000		
Inventory	4,000		Profit	950		
				10,950		
	10,950	=		**10,950**	+	

(9) Drawings

	Assets	=		Equity	+	Liabilities
	Rs. 000			Rs. 000		Rs. 000
Office equipment	200		<u>Capital:</u>			
Cash	6,350		Original	10,000		
Inventory	4,000		Profit	950		
			Drawings	(400)		
				10,550		
	10,550	=		**10,550**	+	

(b) Accounting equation at 31 August

There are no liabilities so the accounting equation becomes assets = equity.

	Assets		**Equity**
	Rs.(000)		Rs.(000)
Non-current assets	**200**	Capital	10,000
Inventory	*4,000*	Profit (July)	950
(1)	*5,500*		——
(2)	*(3,000)*		10,950
(4)	*(2,500)*	Less Drawings (July)	(400)
(6)	*5,600*		——
	——	Capital (end of July)	**10,550**
	9,600		
Cash	*6,350*	Profit (August)	
(1)	*(5,500)*	*(3)*	*(100)*
(2)	*4,500*	*(2)*	*1,500*
(3)	*(100)*	*(4)*	*(700)*
(4)	*1,800*		——
(5)	*(600)*		**700**
(6)	*(5,600)*	Drawings:	
		(5)	**(600)**
	——		
	850		
	——		——
	10,650		10,650
	══		══

Solutions **3**

Paracha Enterprises

S.No.	*** Head of account**	**Assets =**	**Equity +**	**liabilities**
		Rupees [Increase/(Decrease)]		
(i)	Cash/Bank	150,000		
	Fixed assets - cost	(450,000)		
	Accumulated depreciation	330,000		
	Fixed assets – net of Accumulated dep.	**(120,000)**		
	Gain on disposal		30,000	
(ii)	No business transaction takes place by issuing and accepting a purchase order. Therefore, there is no effect on accounting equation.			
(iii)	Stock in trade	(200,000)		
	Cost of sales		(200,000)	
	Sales **(200,000×140÷100)**		280,000	
	Advance from customers (280,000×20%)			(56,000)
	Account receivable (280,000×80%)	224,000		
(iv)	Cash/Bank	(600,000)		
	Accrued rent (600,000×40%)			(240,000)
	Rent expense		(360,000)	
(v)	Cash/Bank	(545,000)		
	Loan			(500,000)
	Interest expense		(45,000)	

Solutions **4**

Arish Enterprises

S.No.	**Head of account**	**Assets =**	**Equity +**	**Liabilities**
		——— Rupees [Increase/(Decrease)] ———		
(i)	Account payable	-		(842,000)
	Purchase return	-	842,000	-
(ii)	Sales	-	96,000	-
	Cash	38,400	-	-
	Account payable	-	-	(57,600)
(iii)	Bad debt expense	-	(139,200)	-
	Provision for doubtful debts	(139,200)	-	-
(iv)	Drawings	-	(100,000)	-
	Purchases	-	65,000	-
	Cashs	(35,000)	-	-

Solutions	**5**
(i)	Goods costing Rs. 75,000 were sold for Rs. 100,000 and part payment of Rs. 50,000 received in cash.
(ii)	An amount of Rs. 20,000 was received from a debtor and remaining Rs. 30,000 were written off.
(iii)	Goods purchased on credit for Rs. 23,000 were returned.
(iv)	Equipment was purchased for Rs. 65,000 against part payment of Rs. 15,000.
(v)	Inventory costing Rs. 15,000 was destroyed/lost/used in office/distributed as sample/withdrawn by owner.
(vi)	Equipment having a net book value of Rs. 55,000 were sold for cash of Rs. 60,000.
(vii)	A liability of Rs. 20,000 was settled by adjusting receivable from same party of Rs. 17,500 and cash payment of Rs. 2,500.
(viii)	Owner paid to supplier Rs. 17,000 from personal cash. / A liability of Rs. 17,000 was written back as it was no more payable.
(ix)	Goods costing Rs. 28,000 and sold on credit for Rs. 35,000 were returned by a customer.
(x)	Payment of Rs. 39,200 was made to a supplier in settlement of Rs. 40,000.

Solutions	**6**
Date	**Narration/description of the transactions**
3-Jan	Goods costing Rs. 17 million purchased against 25% cash payment and balance on credit.
5-Jan	Goods costing Rs. 20 million sold for Rs. 25 million. 10% amount was received in advance and the balance has been collected on delivery.
8-Jan	Against the account receivable balance of Rs. 6 million, Rs. 3 million were recovered. Out of non-recoverable amount of Rs. 3 million, Rs. 1.2 million were charged to provision for doubtful debts and the balance amount was charged to profit and loss account.
12-Jan	Goods costing Rs. 2 million and cash of Rs. 1.5 million were withdrawn by the owner for his personal use.
16-Jan	Fixed assets having WDV of Rs. 2.6 million were sold for Rs. 3 million.
20-Jan	Goods costing Rs. 8 million were purchased. Amount of Rs. 4.8 million had been paid in advance previously whereas the balance of Rs. 3.2 million was paid on delivery.
25-Jan	Goods costing Rs. 8 million sold on cash for Rs. 9.5 million.
28-Jan	Repayment of long-term loan instalment comprising of principal and interest amounting to Rs. 3 million and Rs. 0.8 million respectively.

2 OBJECTIVE BASED QUESTIONS

01. A business has capital of Rs.10,000.

Which of the following asset and liability figures could appear in this business's statement of financial position?

	Assets (Rs.)	Liabilities (Rs.)
(a)	6,000	16,000
(b)	6,000	4,000
(c)	10,000	10,000
(d)	14,000	4,000

02. Which of the following is incorrect?

	Assets (Rs.)	Liabilities (Rs.)	Capital (Rs.)
(a)	7,850	1,250	6,600
(b)	8,200	2,800	5,400
(c)	9,550	1,150	8,200
(d)	6,540	1,120	5,420

03. Stock worth Rs. 5,000 is sold for Rs. 8,000. The complete effect of this transaction on the accounting equation will be?

(a) Profit will be increased by Rs. 3,000

(b) Stock will decrease by Rs. 5,000, cash will increase by Rs. 8,000 & profit will increase by Rs. 3,000

(c) Stock will decrease by Rs. 5,000, & profit will increase by Rs. 8,000

(d) Cash will increase by Rs. 8,000 & profit will increase by Rs. 3,000

04. Goods which originally cost Rs. 400 were sold for Rs. 550. In the accounting equation Net Assets will?

(a) Rise by Rs. 550

(b) Rise by Rs. 150

(c) Fall by Rs. 550

(d) Fall by Rs. 150

05. At beginning of the month; Aslam has opening capital of Rs. 16,500, closing capital Rs. 11,350, and drawings were Rs. 3,300.

What is the amount of profit or loss for the month?

(a) Loss for the year was Rs. 1,850

(b) Profit for the year was Rs. 1,850

(c) Loss for the year was Rs. 8,450

(d) Profit for the year was Rs. 8,450

06. A business receives an accountant's bill of Rs. 150,000.

Which of the following statements correctly shows the effect upon the accounting equation of the business, assuming the bill is unpaid?

(a) Assets decrease, Liabilities increase

(b) Capital decrease, Liabilities increase

(c) Capital increase, Liabilities decrease

(d) Assets decrease, Capital decrease

07. The owner of a business withdrew Rs. 10,000 from cash for his personal use.

What would be the effect of this transaction on the accounting equation?

(a) Assets increase, capital decreases

(b) Assets decrease, Liabilities increase

(c) Assets decrease, Capital decrease

(d) Assets decrease, Capital increases

08. John introduces his car into his business.

Which parts of the business accounting equation will change?

(a) Capital and profit

(b) Assets and capital

(c) Capital and liabilities

(d) Liabilities and assets

09. Asif provided following balances at end of July 2018:

	Rs.
Cash	45,000
Account payable	30,000
Office equipment	21,000
Capital	77,000.

What is the amount of trade receivables at that date?

(a) Rs. 62,000

(b) Rs. 11,000

(c) Rs. 41,000

(d) Rs. 86,000

10. Sattar has following assets and liabilities at 31st July 2018:

	Rs.
Building	15,000
Trade receivables	7,500
Cash	3,500
Trade payables	5,000

During the month he has earned profit of Rs. 7,200 and made drawings of Rs. 2,750.

What is the opening balance of his capital account as at 1st July 2018?

(a) Rs. 25,450

(b) Rs. 21,000

(c) Rs. 26,000

(d) Rs. 16,550

11. What is the value of liabilities in an accounting equation with the help of given data?

	Rs.
Furniture	90,000
Cash	100,000
Debtors	11,000
Owner's equity	90,000

(a) Rs. 201,000

(b) Rs. 111,000

(c) Rs. 290,000

(d) Rs. 291,000

12. During a reporting period, a company's assets increase by Rs. 80,000,000. Liabilities decrease by Rs. 20,000,000.

What should be the change in capital of the company?

(a) Increase by Rs. 60,000,000

(b) Increase by Rs. 100,000,000

(c) Decrease by Rs. 60,000,000

(d) Decrease by Rs. 100,000,000

13. The liabilities of a business are Rs. 30,000; the capital of the proprietor is Rs. 70,000.

The total assets are?

(a) Rs. 100,000

(b) Rs. 40,000

(c) Rs. 70,000

(d) Rs. 30,000

14. Which of the following will be affected in an accounting equation, if the goods are sold on credit to a customer?

(a) Cash and capital

(b) Accounts receivable and capital

(c) Cash and accounts receivable

(d) Accounts payable and capital

15. The favorable balance of profit and loss should be?

(a) Added in liabilities

(b) Subtracted from current assets

(c) Subtracted from liabilities

(d) Added in capital

16. At 1 January 2018 Aisha's business assets were valued at Rs. 360,000 and her liabilities amounted to Rs. 240,000. At 31 December 2018, her assets amounted to Rs. 570,000 and include her private car which she had brought into the business on 1st November when it was valued at Rs. 190,000. Her trade payables at 31 December totaled Rs. 170,000 and her drawings during the year were Rs. 27,000.

Aisha's profit for the year to 31 December was:

Rs. ___________

17. Farhan had net assets of Rs. 190,000 at 30 April 2017. During the year to 30 April 2018, he introduced Rs. 98,000 additional capital into the business. Profits were Rs. 80,000, of which he withdrew Rs. 40,200.

What was the capital of Farhan at 30 April 2018?

Rs. ___________

18. The following transactions relate to Mujahid's business:

		Rs. 000
1 May	Purchase of goods for resale on credit	1,300
2 May	Mujahid injects long term capital into the business	1,400
3 May	Payment of rent made	750
5 May	Mujahid withdraws cash from the business	400
7 May	Sales made on credit	1,200

The goods sold on 7th May originally cost Rs. 600,000. At the start of the week, the assets of the business were Rs. 15,700,000 and liabilities amounted to Rs. 11,200,000.

At the end of the week, what is the amount of Mujahid's capital?

Rs. ___________

19. A business had opening capital of Rs. 116,500, closing capital Rs. 111,350, and drawings were Rs. 13,300.

What is the amount of profit for the year?

Rs. __________

20. Aiman has closing capital of Rs. 25,500 at 31st January 2019. She introduced additional capital of Rs. 12,000 during the month. Profit for the month was Rs. 6,500 and drawings for the month were Rs. 3,000.

What is the amount of opening capital as at 1st January 2019?

Rs. __________

21. The correct form of accounting equation is

(a) Assets + Liabilities = Equity

(b) Assets – Liabilities = Equity

(c) Assets – Trade payables= Equity

(d) Assets + Receivable = Equity

22. An entity (with 31 December year-end) has bought the machine for Rs.1,000,000 with the down payment of Rs.200,000and remaining payment Rs.800,000 would be made after a month. The transaction happened in 15 December 2011.

What would be the effect on the of transaction?

(a) Machine increased by Rs.800,000 and liabilities decreased by Rs.800,000

(b) Machine decreased by Rs.800,000 and liabilities increased by Rs.800,000

(c) Machine increased by Rs.1,000,000 and liabilities increased by Rs.800,000 while cash is decreased by Rs.200,000

(d) Machine increased by Rs.800,000 and liabilities increased by Rs.800,000 while cash is decreased by Rs.200,000

23. As per accrual concept, which of the followings is not true

(a) Revenue – expenditure = profit

(b) Revenue – profit = expenditure

(c) Sales + gross profit = revenue

(d) Revenue = profit + expenditure

24. Purchase of machinery for cash

(a) Increases total assets

(b) Decreases total assets

(c) Increases assets and liabilities

(d) Keeps total assets unchanged

25. Expenses paid by a business decrease:

- **(a)** Cash
- **(b)** Capital
- **(c)** Cash and capital
- **(d)** Capital and Accounts payable

26. Current assets – current liability =?

- **(a)** Capital
- **(b)** Total assets
- **(c)** Net assets
- **(d)** Net working capital

27. The investment of cash into the business results in a/an

- **(a)** Increase in cash and a decrease in capital
- **(b)** Increase in cash and an increase in capital
- **(c)** Decrease in cash and an increase in capital
- **(d)** Increase in fees earned and an increase in capital

28. Services rendered for cash will result in a/an

- **(a)** Increase in cash and a decrease in capital
- **(b)** Increase in cash and an increase in fees earned
- **(c)** Decrease in cash and an increase in fees earned
- **(d)** Increase in fees earned and an decrease in capital

29. If during the accounting period the assets increased by Rs.7 million, and the owner's equity decreased by Rs.3 million, then the liabilities must have;

- **(a)** Increased by Rs.10 million
- **(b)** Increased by Rs.4 million
- **(c)** Decreased by Rs.4 million
- **(d)** Decreases by Rs.10 million

30. One of the local fast-food outlets hired a first-year accounting student to oversee the cash-collection procedures.

When the firm pays the student his weekly wage, the transaction will

- **(a)** Increase an asset, increase a liability
- **(b)** Decrease an asset, decrease a liability
- **(c)** Increase an asset, increase owner's equity
- **(d)** Decrease an asset, decrease owner's equity

31 QK Company records the transaction as a debit to Consultant Expense for Rs.500,000 and an equivalent credit to Accounts Payable.

What would be impact on accounting equation?

- **(a)** Increase a liability, increase owner’s equity
- **(b)** Decrease an asset, decrease a liability
- **(c)** Increase a liability, decrease owner's equity
- **(d)** Decrease an asset, decrease owner's equity

32. Which of the following will cause owner's equity to increase?

- **(a)** Revenue
- **(b)** Expense
- **(c)** Drawings
- **(d)** Asset’s depreciation

33. The owner contributes his personal car to the business

- **(a)** Increase an asset, increase a liability
- **(b)** Decrease an asset, decrease a liability
- **(c)** Increase an asset, increase owner's equity
- **(d)** Decrease an asset, decrease owner's equity

34. The company purchases a significant amount of office supplies on credit

- **(a)** Decrease an asset, decrease a liability
- **(b)** Increase an asset, increase owner's equity
- **(c)** Decrease an asset, decrease owner's equity
- **(d)** Increase an asset, increase a liability

2 OBJECTIVE BASED ANSWERS

01.	**(d)**	Capital = Assets – liabilities
02.	**(c)**	Rs. 9,550 – 1,120 = 8,400
03.	**(b)**	
04.	**(b)**	
05.	**(a)**	Closing capital = Opening capital + profit – drawings Rs. 11,350 = Rs. 16,500+ profit – 3,300 Loss = Rs. 1,850
06.	**(b)**	Expense payable is recorded
07.	**(c)**	
08.	**(b)**	
09.	**(c)**	Total assets = Capital + Liabilities = Rs. 77,000+Rs. 30,000= Rs. 107,000 Trade receivables = Rs. 107,000-Rs. 21,000-Rs. 45,000 = Rs. 41,000
10.	**(d)**	Closing capital = Rs. 15,000+7,500+3,500 – 5,000 = Rs. 21,000 Opening capital = Closing capital + Drawings – Profit = Rs. 21,000+2,750-7,200 = Rs. 16,550
11.	**(b)**	Liabilities = Rs. 90,000 + 100,000 + 11,000 - 90,000= Rs. 111,000
12.	**(b)**	
13.	**(a)**	Assets = Capital + Liabilities
14.	**(b)**	
15.	**(d)**	
16.	**Rs. 117,000**	Opening capital =Rs. 360,000-240,000 = 120,000 Closing capital = Rs. 570,000 - 170,000 = 400,000 Closing capital = Opening capital + profit + capital introduced – drawings 400,000 = 120,000 + 190,000 + profit – 27,000 Profit = 117,000
17.	**Rs. 327,800**	Capital = 190,000 + 98,000 + 80,000- 40,200 = Rs. 327,800
18.	**Rs. 5,350,000**	Opening capital = Rs. 15,700,000 - 11,200,000= Rs. 4,500,000 Closing capital = Opening capital + capital injected +profit – drawings Closing capital = Rs. 4,500,000 +1,400,000 + [1,200,000 – 600,000 – 750,000] – 400,000 Closing capital = Rs. 5,350,000

19.	**Rs. 8,150**	Profit = Closing capital + drawings – opening capital = 111,350 + 13,300 – 116,500 = Rs. 8,150
20.	**Rs. 10,000**	Opening capital = closing capital + drawings – profit – capital introduced = 25,500 + 3,000 – 6,500 – 12,000 = Rs. 10,000
21.	**(b)**	
22.	**(c)**	
23.	**(c)**	
24.	**(d)**	
25.	**(c)**	
26.	**(d)**	
27.	**(b)**	
28.	**(b)**	
29.	**(a)**	
30.	**(d)**	
31.	**(c)**	
32.	**(a)**	
33.	**(c)**	
34.	**(d)**	

CHAPTER

4

Double entry bookkeeping

Contents

1 INTRODUCTION TO ACCOUNTING SYSTEMS

Section overview

- The dual nature of transactions
- Overview of accounting

1.1 The dual nature of transactions

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

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

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

Book-keeping

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

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

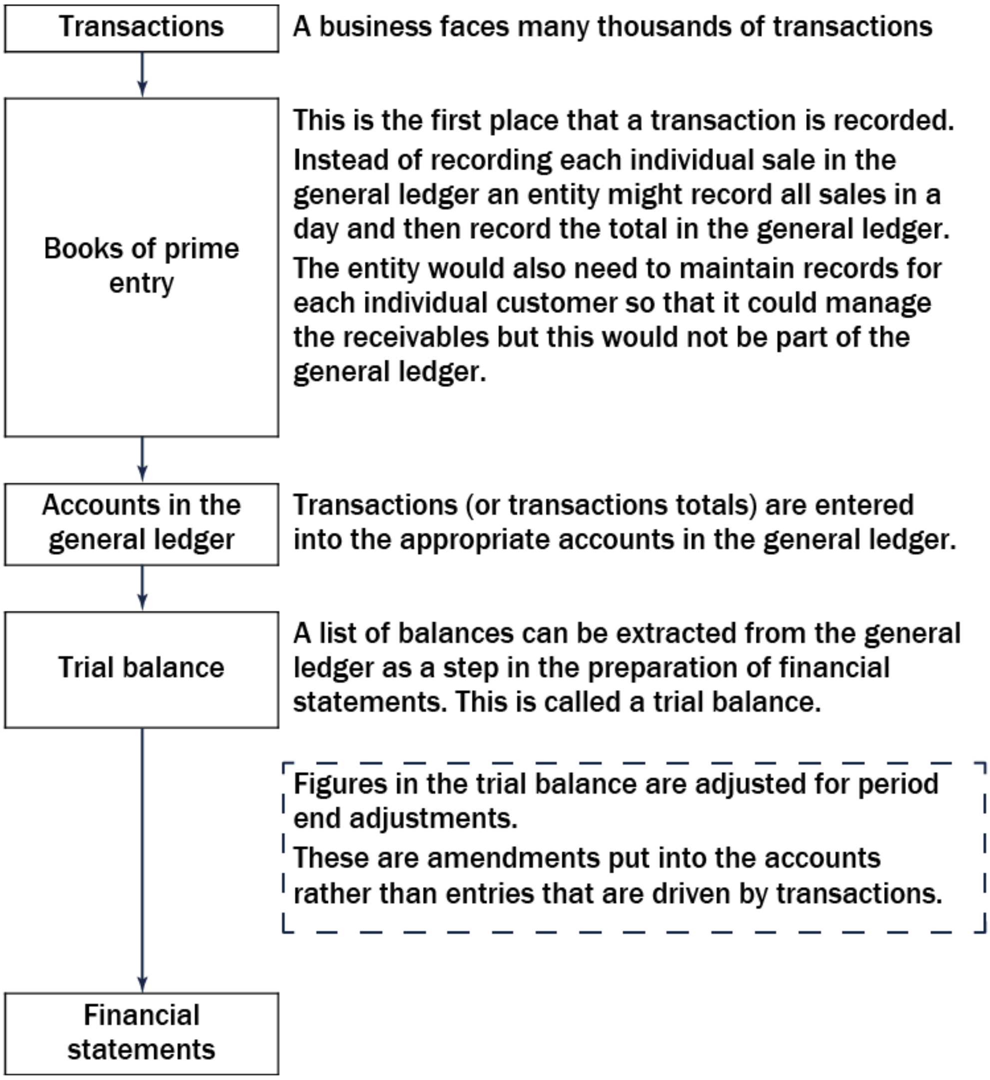
Accounts are kept together in a ***ledger***. A ledger is a term meaning a collection of related accounts.

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

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

1.2 Overview of accounting

Illustration:



A business faces many thousands of transactions

This is the first place that a transaction is recorded.

Instead of recording each individual sale in the general ledger an entity might record all sales in a day and then record the total in the general ledger.

The entity would also need to maintain records for each individual customer so that it could manage the receivables but this would not be part of the general ledger.

Transactions (or transactions totals) are entered into the appropriate accounts in the general ledger.

A list of balances can be extracted from the general ledger as a step in the preparation of financial statements. This is called a trial balance.

Figures in the trial balance are adjusted for period end adjustments.

These are amendments put into the accounts rather than entries that are driven by transactions.

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

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

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

2 BASIC RULES OF DOUBLE ENTRY BOOKKEEPING

Section overview

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

2.1 Debit and credit entries, and T accounts

The following rules apply to the accounts in the main ledger (nominal ledger or general ledger).

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

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

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

Illustration:

Account name

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

By convention, the terms 'debit' and 'credit' are shortened to 'Dr' and 'Cr' respectively. Alternative presentation

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

2.2 The rules of debits and credits

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

Illustration:

Account name

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

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

Example

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

The double entry is:

Debit: Electricity charges (= increase in expense)

Credit: Total trade payables (= increase in liability)

Electricity expense

	Rs.		Rs.
Trade payables	2,300		

Expenses payables

	Rs.		Rs.
		Electricity expense	2,300

This can be written as:

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

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

2.3 Double entry book-keeping and the cash account

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

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

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

Illustration:

Cash at bank

Debit side (Dr)	Credit side (Cr)
Record as a debit entry:	**Record as a credit entry**:
Transactions that provide an INCREASE in cash	Transactions that result in a REDUCTION in cash
The matching credit entry might be to	The matching debit entry might be to
(1) a sales account for cash sales (2) the total trade receivables account for payments received from credit customers1 (3) the capital account for new capital introduced by the owner in the form of cash	(1) an expense account, for payments of cash expenses (2) the total trade payables account, for payments to suppliers for purchases on credit/amounts owing (3) a payment in cash for a new asset, (4) a drawings account, for withdrawals of profit by the business owner

Example: Abbas revisited

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

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

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

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

5 Abbas pays his supplier Rs. 10,000.

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

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

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

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

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

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

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

Post all transactions to ledger accounts.

Example: Abbas – Transaction 1

Abbas sets up a business by putting Rs. 30,000 into a bank account.
This increases the cash of the business, and its capital.
The double entry is:

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

Capital

	Rs.		Rs.
		(1) Bank	30,000

Bank

	Rs.		Rs.
(1) Capital	30,000		

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

Example: Abbas – Transaction 2

Abbas borrows Rs. 40,000 to purchase a van.
There are two separate transactions, the loan of cash and the purchase of the van.
The double entries are:

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

Bank

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

Loan

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

Van

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

Example: Abbas – Transaction 3

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

The double entry is:

Dr Stall	**5,000**	
Cr Bank		**5,000**

Bank

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

Stall

		Rs.			Rs.
(3)	Bank	5,000			

The next transaction is a purchase of inventory. This is reflected in an account called purchases rather than inventory.

Example: Abbas – Transaction 4

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

The double entry is:

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

Purchases

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

Trade payables

		Rs.			Rs.
			(4)	Purchases	18,000

Note on purchases of inventory

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

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

Inventory is ignored until such time as when the business wishes to calculate profit (usually the end of an accounting period) when it is counted and valued. This value is then used in a calculation of a cost of sale figure. (This will be demonstrated a little later in this chapter and the full inventory double entry explained in chapter 11).

Example: Abbas – Transaction 5

Abbas pays Rs. 10,000 to the supplier.

The double entry is:

Dr Trade payables	10,000	
Cr Bank		10,000

Bank

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

Trade payables

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

Example: Abbas – Transaction 6

Abbas sells inventory for Rs. 12,000 cash.

The double entry is:

Dr Bank	12,000	
Cr Sales		12,000

Bank

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

Sales

		Rs.			Rs.
			(6)	Bank	12,000

Example: Abbas – Transaction 7

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

The double entry is:

Dr Trade receivables	9,000	
Cr Sales		9,000

Trade receivables

		Rs.			Rs.
(7)	Sales	9,000			

Sales

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

Example: Abbas – Transaction 8

Abbas repays Rs. 10,000 of the loan

The double entry is:

Dr Loan 10,000

Cr Bank 10,000

Bank

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

Loan

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

Example: Abbas – Transaction 9

Abbas pays Rs. 6,000 to the supplier.

The double entry is:

Dr Trade payables 6,000

Cr Bank 6,000

Bank

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

Trade payables

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

Example: Abbas – Transaction 10

Abbas receives Rs. 8,000 from a customer.

The double entry is:

Dr Bank	8,000	
Cr Trade receivables		8,000

Bank

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

Trade receivables

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

Example: Abbas – Transaction 11

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

The double entry is:

Dr Purchases	2,500	
Cr Bank		2,500

Purchases

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

Trade payables

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

Example: Abbas – Transaction 12

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

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

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

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

Bank

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

Purchases

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

Drawings

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

3 ACCOUNT BALANCES AND THE TRIAL BALANCE

Section overview

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

3.1 Closing off an account and bringing down the balance

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

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

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

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

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

Step 1: Add up both sides of the account

Bank

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

Example: Closing off and bringing down a balance

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

Bank

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

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

Bank

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

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

Bank

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

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

The full working in that case would look like this:

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

Bank

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

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

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

Note

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

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

Returning to Abbas.......

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

Capital

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

Loan

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

Van

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

Stall

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

Example: Abbas – All accounts closed off

Purchases

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

Trade payables

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

Trade receivables

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

Example: Abbas – All accounts closed off

Sales

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

Drawings

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

3.2 Trial balance

The purpose of a trial balance

A trial balance is a list of all the debit balances and all the credit balances on the accounts in the general ledger. A trial balance can be ‘extracted’ from the general ledger simply by listing the balances on every account. The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.

- Accounts with debit balances will be asset accounts and expense accounts
- Accounts with credit balances will be liability accounts, capital account (or share capital and reserve accounts in the case of a company) and income accounts.

Since the accounting system uses double entry principles, the total of debit balances and the total of credit balances should be equal, because for every debit entry in the general ledger there should be a matching credit entry.

A trial balance has two main purposes.

It is a **starting point for producing a statement of comprehensive income and a statement of financial position** at the end of an accounting period. A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts (which are recorded as journal entries before being entered in the general ledger). Year-end adjustments include adjustments for opening and closing inventory, depreciation charges, accruals and prepayments, writing off bad debts and adjusting the allowance for irrecoverable debts.

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

A second purpose of a trial balance is **to check for errors in the accounting system**. Errors must have occurred if the total of debit balances and total of credit balances on the general ledger accounts are not equal. Having identified that an error (or more than one error) must exist, the task of the bookkeeper is to find the cause of the error and correct it.

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

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

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

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

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

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

Limitations of trial balance

Trial balance is taken as test of arithmetical accuracy. If both the debit and credit columns of trial balance are equal to each other, we assume that there is no mistake in the posting of journal and subsidiary books to ledger accounts, in carrying forward balances of ledger accounts to trial balance and even in the balancing of ledger accounts. This assumption is correct but should never be taken as conclusive proof of accuracy. It means that there are certain errors which remain undetected by trial balance. Both the debit and credit columns of the trial balance may be equal in spite of certain mistakes of omissions and principles. These errors may be mentioned as under:

1. Errors of omission in the books of original record
2. Errors of principle
3. Compensating errors ·
4. Incorrect account in the original books
5. Posting to wrong account.

1. Errors of omission in the books of original record

The entire transaction is not recorded in the books of accounts; we omit to record the transaction. If the omission is made in posting only one part of journal entry or omission is made in posting the total of the subsidiary books to ledger accounts or the total of ledger accounts to trial balance itself, the mistake will be detected. The trial balance will fail to discover the error, if the entire transaction has not been passed through journal or subsidiary book or a particular journal entry has not been posted in the ledger accounts completely.

2. Errors of principle

Errors of principles may be committed, if we debit or credit a wrong account due to our ignorance. For example, purchases of building is capital expenditure and building account should be debited but if the accountant debits purchases account instead of building account, errors of principle will be there in the accounts. The trial balance will tally. Accountants and auditors should never take it as granted that there are no mistake after the agreement of trial balance, i.e. trial balance should not be taken as final proof of accuracy.

3. Incorrect account in the original book

If the name of wrong account is used in the journal or subsidiary books, trial balance will not be able to detect it. For example, goods sold to Faheem for Rs.30,000 was wrongly debited to Nadeem with Rs.30,000. The mistake will not affect trial balance, because posting at the debit side of the trial balance has been made against Nadeem's account though instead of Faheem's account. In the same way, debiting or crediting wrong personal accounts cannot be detected by trial balance.

4. Posting to wrong account

If the posting from the debit side or credit side of cash book or from purchases book or sales book is made to wrong account but at the correct side and also with the correct amount, both the debit and credit side of trial balance will be equal despite of these errors.

3.3 Preparing accounts from a trial balance

Year-end adjustments

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

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

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

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

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

Example: Abbas – Trial balance as at 31 December 2013

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

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

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

Opening and closing inventory and the cost of sales

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

When there are differences between the quantity of materials purchased or made, and the quantity of materials used or sold, there is an increase or decrease in inventory during the period. To calculate the cost of sales for a statement of comprehensive income, it is necessary to make an adjustment for changes in the amount of inventory.

Illustration: Cost of sales

	Rs.
Opening inventory	X
Purchases	X
	X
Less: Closing inventory	(X)
Cost of sales	X

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

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

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

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

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

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

4 THE GENERAL JOURNAL

Section overview

- Journal entries to record transactions
- Illustration using Abbas

4.1 Journal entries to record transactions

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

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

- postings from books of prime entry;
- year-end adjustments;
- correction of errors or
- any other adjustment.

The format of a journal entry is as follows:

Illustration:

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

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

4.2 Illustration using Abbas

Example: Abbas revisited

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

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

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

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

5 Abbas pays his supplier Rs. 10,000.

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

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

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

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

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

Prepare journals for each of the above transactions.

Example: Abbas – Journalising transactions

Transaction 1	**Debit**	**Credit**
Cash	30,000	
Capital		30,000
Being: The introduction of capital at the start of a new business		
Transaction 2		
Cash	40,000	
Loan payable		40,000
Asset – Van	40,000	
Cash		40,000
Being: The borrowing of cash and the purchase of a van.		
Transaction 3		
Asset – Market stall	5,000	
Cash		5,000
Being: The purchase of a market stall		
Transaction 4		
Purchases	18,000	
Payables		18,000
Being: The purchase of inventory on credit		
Transaction 5		
Payables	10,000	
Cash		10,000
Being: A payment to a supplier.		
Transaction 6		
Cash	12,000	
Sales		12,000
Being: The cash sale of inventory.		
Transaction 7		
Receivables	9,000	
Sales		9,000
Being: The sale of inventory on credit.		
Transaction 8		
Loan payable	10,000	
Cash		10,000
Being: A part repayment on the loan.		
Transaction 9		
Payables	6,000	
Cash		6,000
Being: Payment to suppliers.		
Transaction10		
Cash	8,000	
Receivables		8,000
Being: Cash received from credit customer		

5 GENERAL LEDGER

Section overview

- Introduction
- Year-end exercise

5.1 Introduction

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

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

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

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

5.2 Year-end exercise

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

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

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

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

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

Process:

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

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

Step 3: Close off this account

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

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

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

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

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

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

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

Bank

Balance b/d	15,000		

Loan

		Balance b/d	30,000

Van

Balance b/d	40,000		

Stall

Balance b/d	5,000		

Trade payables

		Balance b/d	4,500

Trade receivables

Balance b/d	1,000		

Capital

		Balance b/d	30,000

Drawings

Balance b/d	6,000		

Sales

		Balance b/d	21,000

Purchases

Balance b/d	18,500		

Inventory (statement of comprehensive income)

		Balance b/d	4,500

Inventory (asset)

Balance b/d	4,500		

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

Bank

Balance b/d	15,000		

Loan

		Balance b/d	30,000

Van

Balance b/d	40,000		

Stall

Balance b/d	5,000		

Trade payables

		Balance b/d	4,500

Trade receivables

Balance b/d	1,000		

Capital

		Balance b/d	30,000

Drawings

Balance b/d	6,000		

Profit or loss (NEW ACCOUNT)

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

Sales

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

Purchases

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

Inventory (statement of comprehensive income)

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

Inventory (asset)

Balance b/d	4,500		

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

Capital

		Balance b/d	30,000

Drawings

Balance b/d	6,000		

Profit or loss (NEW ACCOUNT)

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

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

Capital

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

Drawings

Balance b/d	6,000		

Profit or loss (NEW ACCOUNT)

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

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

Capital

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

Drawings

Balance b/d	6,000	Capital	6,000

Final balances in the general ledger

Bank

Balance b/d	15,000		

Loan

		Balance b/d	30,000

Van

Balance b/d	40,000		

Stall

Balance b/d	5,000		

Trade payables

		Balance b/d	4,500

Trade receivables

Balance b/d	1,000		

Capital

		Balance b/d	31,000

Inventory (asset)

Balance b/d	4,500		

The Abbas year end exercise would require the following journals.

Example: Abbas – end of year general ledger exercise

	Debit	Credit
Step 1		
Inventory asset	4,500	
Inventory (statement of comprehensive income)		4,500
Being: The recognition of closing inventory		
Step 2		
Sales	21,000	
Profit or loss		21,000
Profit or loss	18,500	
Purchases		18,500
Inventory (statement of comprehensive income)	4,500	
Profit or loss		4,500
Being: Transfer of income and expense amounts to profit or loss		
Step 4 (there was no double entry in step 3)		
Profit or loss	7,000	
Capital		7,000
Being: Transfer of profit for the period into capital		
Step 5		
Capital	6,000	
Drawings		6,000
Being: Transfer of drawings for the period into capital		

Example: Ravi Traders

Ravi Traders (RT) commenced its business on 1 January 2018. The books of prime entry as maintained by RT for the month of January 2018 are reproduced below:

CASH BOOK - RECEIPTS

Date	Description	Discount	Cash	Bank
		——— Rupees ———		
1-Jan	Capital	-	1,000	8,000
10-Jan	Return outward	-	50	-
11-Jan	Trade debtors - Quality Traders	150	-	6,100
14-Jan	Sales	-	-	1,250
20-Jan	Trade debtors - Himalaya Super Store	90	300	1,410
26-Jan	Bank	-	500	-
		240	1,850	16,760

CASH BOOK - PAYMENTS				
Date	Description	Discount	Cash	Bank
		——— Rupees ———		
4-Jan	Office rent	-	200	300
5-Jan	Fixed assets (Office equipment)	-	-	1,500
7-Jan	Purchases	-	-	650
14-Jan	Trade debtors - Quality Traders	-	-	6,100
15-Jan	Trade creditors - Zee Traders	100	500	3,400
20-Jan	Return inward	-	60	-
21-Jan	Fixed assets (Computers)	-	250	-
24-Jan	Drawings	-	100	180
25-Jan	Utility bills	-	120	140
26-Jan	Cash	-	-	500
		100	1,230	12,770

PURCHASES DAY BOOK		
Date	Suppliers' name	Rupees
2-Jan	ABC & Co.	4,500
10-Jan	Zee Traders	6,000
28-Jan	Unity Enterprises	7,500
		18,000

PURCHASES RETURNS DAY BOOK		
Date	Suppliers' name	Rupees
12-Jan	Zee Traders	900

SALES DAY BOOK		
Date	Customers' name	Rupees
8-Jan	Quality Traders	6,250
19-Jan	Himalaya Super Store	2,350
24-Jan	ABC & Co.	8,000
		16,600

GENERAL JOURNAL			
Date	Particulars	Debit	Credit
		—— Rupees ——	
1-Jan	Fixed assets (Furniture)	300	
	Capital		300
14-Jan	Drawings	100	
	Purchases		100
14-Jan	Trade debtors - Quality Traders	150	
	Discount allowed		150
31-Jan	Drawings	50	
	Fixed assets (Computers)		50
31-Jan	Trade creditors - ABC & Co.	4,500	
	Trade debtors - ABC & Co.		4,500

The trial balance for the month ended 31 January 2018 shall be prepared as follows.

Ravi Traders

Trial balance for the month of January 2018

Description		Debit	Credit
		Rupees	
Capital	1,000+8,000+300		9,300
Purchase return /Return outward	900+50		950
Discount allowed	150+90-150	90	
Sales	16,600+1,250		17,850
Office rent	200+300	500	
Fixed assets	1,500+250+300-50	2,000	
Purchases	18,000+650-100	18,550	
Sales return /Return inward		60	
Drawings	100+180+100+50	430	
Utility bills	120+140	260	
Trade debtors	W-1	10,300	
Trade creditors	W-2		8,600
Discount received			100
Cash in hand	1,850-1,230	620	
Cash at bank	16,760-12,770	3,990	
		36,800	**36,800**

W-1: Trade debtors			**Rupees**
Quality Traders	6,250	-150-6,100+6,100+150	6,250
Himalaya Super Store	2,350	-90-300-1,410	550
ABC & Co.	8,000	-4,500	3,500
	16,600		**10,300**

W-2: Trade creditors			**Rupees**
ABC & Co.	4,500	-4,500	-
Zee Traders	6,000	-900-100-500-3,400	1,100
Unity Enterprises	7,500		7,500
	18,000		**8,600**

Practice question **1**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Required:

a) Post all transactions to ledger accounts.

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

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

Practice question: May Transactions **2**

The following transactions in May 2013 are those of a new business entity, Home Oak Garden Traders.

May 2013	
Date	
1	Set up the entity with capital in cash: Rs.2,500,000.
2	Bought goods on credit from the following suppliers: The Bushes Company Rs.540,000, Flower City Rs.870,000, D Gibson Rs.250,000, Weedkill Rs.760,000, T Greenery Rs.640,000.
4	Sold goods on credit to: The Office Company Rs.430,000, V Cork Rs.640,000, Texas Chain Stores Rs.1,760,000.
6	Paid rent Rs.120,000.
9	The Office Company paid the Rs.430,000 that it owed.
10	Texas Chain Stores paid Rs.1,500,000.
12	The following payments were made: to D Gibson Rs.250,000 and to The Bushes Company Rs.540,000.
15	Advertising costs of Rs.230,000 were paid to the local newspaper publisher.
18	Bought goods on credit from the following suppliers: The Bushes Company Rs.430,000, Landscape Rs.1,100,000.
21	Sold goods on credit to Public Parks Rs.670,000
31	Paid rent Rs.180,000.

Required

(a) Use T accounts to show how these transactions should be recorded in the main ledger accounts of the entity. The accounting system maintains separate accounts for each individual payable and receivable in the main ledger.

(b) Prepare a trial balance as at 31 May 2013.

Practice question: Lee

3

Enter the following transactions in the main ledger accounts of Lee, and extract a trial balance as at 31 March 2013.

Assume that all receipts and payments are by cheque unless told otherwise.

March 2013	
Date	
1	Started business with Rs.80,000 in the bank
2	Bought goods on credit from: KH Supplies Rs.7,600; Hatts Rs.2,700; Toby Traders Rs.5,600
5	Cash sales Rs.8,700. The cash was kept in a safe in Lee's office.
6	Paid wages Rs.1,400 by cheque.
7	Sold goods on credit to: Elliotts Rs.3,500; L. Lane Rs.4,200; Carton Leisure Rs.7,200
9	Bought goods for cash Rs.4,600 using cash from Lee's safe.
10	Bought goods on credit from: KH Supplies Rs.5,700; Toby Traders Rs.9,800
12	Paid wages Rs.1,400 by cheque.
13	Sold goods on credit to: L. Lane Rs.3,200; Carton Leisure Rs.2,300
15	Bought shop fixtures on credit from Beta Fittings Rs.5,000
17	Paid K H Supplies Rs.8,400
18	Goods returned to Toby Traders Rs.2,000
21	Paid Beta Fittings Rs.5,000
24	Payment received from Carton Leisure Rs.9,500
27	Goods returned to KH Supplies Rs.2,400
30	King Bank provides a loan of Rs.6,000
31	Bought a motor van, paying by cheque Rs.40,000

Practice question: Quality Services

4

Quality Services (QS) was established on 1 April 2017 to provide various maintenance services to textile industry. A summarized bank book of QS for the quarter ended 30 June 2017 is as follows:

	Receipts	Payments
	— Rs. in '000 —	
Opening of a bank account in the name of QS by its owner	5,000	
Purchase of a vehicle on commencement of the business		1,200
Supplies		650
Maintenance services	4,500	
Cash given for petty office expenses		300
Utility bills (electricity, gas, telephone, etc.)		250
Wages and salaries		1,450
Owner's personal expenses		390
Office rent for the nine months ending 31 December 2017		900
Bank charges		10
Total	9,500	5,150

Additional information:

i. On 1 April 2017, a machine costing Rs. 240,000 was purchased for business use. The owner paid the amount from his personal bank account in May 2017.

ii. Supplies costing Rs. 850,000 were purchased during the quarter.

iii. Unused supplies as at 30 June 2017 amounted to Rs. 350,000.

iv. Payment of utility bills includes refundable deposits of Rs. 20,000.

v. Electricity bill of Rs. 45,000 for June 2017 was received in July 2017.

vi. Vouchers of Rs. 250,000 for petty office expenses were submitted during the quarter.

vii. Wages and salaries include payment of supervisor's salary for July 2017 amounting to Rs. 150,000.

viii. A bank advice of Rs. 5,000 dated 30 June 2017 for bank charges was received on 4 July 2017.

ix. Maintenance services for Rs. 700,000 have been rendered during the quarter but the amount due has not yet been received.

x. Maintenance services against collections of Rs. 1,250,000 will be rendered in the next quarter.

xi. QS has adopted the policy of charging depreciation on fixed assets @ 20% per annum on a straight line basis. Depreciation is to be charged from the month the assets are available for use.

Required:

Prepare a Trial Balance for the quarter ended 30 June 2017 incorporating all the adjustments necessary for accrual basis of accounting. (Ledger accounts are not required)

Practice question: Traders and Enterprises **5**

Consider the following situations:

i. Due to heavy losses during the current year, Quality Traders (QT) decided to discontinue its operations with effect from 1 August 2016. However, QT's financial statements for the year ended 30 June 2016 were prepared using the same basis as last year.

ii. Results of Shan Enterprises (SE) fluctuate widely from year to year. Therefore, SE's management has decided to create certain provisions in the periods of higher profits and adjust those provisions in the period of lesser profits to maintain profits at a consistent level from year to year.

Required:

Suggest adjustments, if any, to correct the financial statements for the year ended 30 June 2016.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1a**

Bank

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

Capital

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

Motor van

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

Purchases

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

Sales

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

Solution **1a**

Trade payables

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

Trade receivables

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

Drawings

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

Motor expenses

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

Insurance

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

Bank loan

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

Solution **1b**

Naseer: Trial balance as at 31 July 2013

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

Solution **1c**

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

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

Solution **1c**

Naseer: Statement of financial position as at 31 July 2013

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

Solution **2**

(a) Accounts in the main ledger

Capital

31	Balance c/f	2,500,000	1	Bank	2,500,000
		2,500,000			2,500,000
			1 June	Balance b/f	2,500,000

Cash at bank

1	Capital	2,500,000	6	Rent	120,000
9	The Office Company	430,000	12	D Gibson	250,000
10	Texas Chain Stores	1,500,000	12	The Bushes Company	540,000
			15	Advertising	230,000
			31	Rent	180,000
			31	Balance c/f	3,110,000
		4,430,000			4,430,000
1 June	Balance b/f	3,110,000			

Purchases

2	The Bushes Company	540,000			
	Flower City	870,000			
	D Gibson	250,000			
	Weedkill	760,000			
	Greenery	640,000			
18	The Bushes Company	430,000			
	Landscape	1,100,000	31	Balance c/f	4,590,000
		4,590,000			4,590,000
1 June	Balance b/f	4,590,000			

Sales

			4	The Office Company	430,000
				V Cork	640,000
				Texas Chain Stores	1,760,000
31	Balance c/f	3,500,000	21	Public Parks	670,000
		3,500,000			3,500,000
			1 June	Balance b/f	3,500,000

Payables – The Bushes Company

12	Cash at bank	540,000	2	Purchases	540,000
31	Balance c/f	430,000	18	Purchases	430,000
		970,000			970,000
			1 June	Balance b/f	430,000

Payables – Flower City

31	Balance c/f	870,000	2	Purchases	870,000
		870,000			870,000
			1 June	Balance b/f	870,000

Payables – D Gibson

12	Cash at bank	250,000	2	Purchases	250,000
		250,000			250,000

Payables – Weedkill

31	Balance c/f	760,000	2	Purchases	760,000
		760,000			760,000
			1 June	Balance b/f	760,000

Payables – T Greenery

31	Balance c/f	640,000	2	Purchases	640,000
		640,000			640,000
			1 June	Balance b/f	640,000

Payables – Landscape

31	Balance c/f	1,100,000	18	Purchases	1,100,000
		1,100,000			1,100,000
			1 June	Balance b/f	1,100,000

Receivables – The Office Company

4	Sales	430,000	9	Cash at bank	430,000
		430,000			430,000

Receivables – V Cork

4	Sales	640,000		Balance c/f	640,000
		640,000			640,000
1 June	Balance b/f	640,000			

Receivables – Texas Chain Stores

4	Sales	1,760,000	10	Cash at bank	1,500,000
				Balance c/f	260,000
		1,760,000			1,760,000
1 June	Balance b/f	260,000			

Receivables – Public Parks

21	Sales	670,000		Balance c/f	670,000
		670,000			670,000
1 June	Balance b/f	670,000			

Rent (expense)

6	Bank	120,000			
31	Bank	180,000	31	Balance c/f	300,000
		300,000			300,000
1 June	Balance b/f	300,000			

Advertising expenses

15	Bank	230,000	31	Balance c/f	230,000
		230,000			230,000
1 June	Balance b/f	230,000			

(b) Trial Balance as at 31 May 2013

Home Oak Garden Traders: Trial balance as at 31 May

	Debit Rs.	Credit Rs.
Capital		2,500,000
Bank	3,110,000	
Purchases	4,590,000	
Sales		3,500,000
Payables:		
The Bushes Company		430,000
Flower City		870,000
Weedkill		760,000
T Greenery		640,000
Landscape		1,100,000
Receivables:		
V Cork	640,000	
Texas Chain Store	260,000	
Public Parks	670,000	
Rent	300,000	
Advertising	230,000	
	9,800,000	9,800,000

Solution

3

Capital

Date		Rs.	Date		Rs.
	Balance c/d	80,000	1	Bank	80,000
		80,000			80,000
				Balance b/d	80,000

Bank

Date		Rs.	Date		Rs.
1	Capital	80,000	6	Wages	1,400
24	Carton Leisure	9,500	12	Wages	1,400
30	Loan	6,000	17	KH Supplies	8,400
			21	Beta Fittings	5,000
			31	Motor van	40,000
				Balance c/d	39,300
		95,500			95,500
	Balance b/d	39,300			

Cash in hand

Date		Rs.	Date		Rs.
5	Sales	8,700	9	Purchases	4,600
				Balance c/d	4,100
		8,700			8,700
	Balance b/d	4,100			

Purchases

Date		Rs.	Date		Rs.
2	KH Supplies	7,600			
	Hatts	2,700			
	Toby Traders	5,600			
9	Cash in hand	4,600			
10	KH Supplies	5,700			
	Toby Traders	9,800	31	Balance c/d	36,000
		36,000			36,000
	Balance b/d	36,000			

Payables – KH Supplies

Date		Rs.	Date		Rs.
17	Bank	8,400	2	Purchases	7,600
27	Purchase returns	2,400	10	Purchases	5,700
31	Balance c/d	2,500			
		13,300			13,300
				Balance b/d	2,500

Payables - Hatts

Date		Rs.	Date		Rs.
31	Balance c/d	2,700	2	Purchases	2,700
		2,700			2,700
				Balance b/d	2,700

Payables – Toby Traders

Date		Rs.	Date		Rs.
18	Purchase returns	2,000	2	Purchases	5,600
31	Balance c/d	13,400	10	Credit Purchases	9,800
		15,400			15,400
				Balance b/d	13,400

Payables – Beta Fittings

Date		Rs.	Date		Rs.
21	Bank	5,000	15	Fixtures	5,000
		5,000			5,000

Sales

		Rs.	Date		Rs.
			5	Cash in hand	8,700
			7	Elliots	3,500
				L. Lane	4,200
				Carton Leisure	7,200
			13	L. Lane	3,200
31	Balance c/d	29,100		Carton Leisure	2,300
		29,100			29,100
				Balance b/d	29,100

Receivables – Elliots

Date		Rs.	Date		Rs.
7	Sales	3,500	31	Balance c/d	3,500
		3,500			3,500
	Balance b/d	3,500			

Receivables – L Lane

Date		Rs.	Date		Rs.
7	Sales	4,200			
13	Sales	3,200	31	Balance c/d	7,400
		7,400			7,400
	Balance b/d	7,400			

Receivables – Carton Leisure

Date		Rs.	Date		Rs.
7	Sales	7,200	24	Bank	9,500
13	Sales	2,300			
		9,500			9,500

Wages

Date		Rs.	Date		Rs.
6	Bank	1,400			
12	Bank	1,400		Balance c/d	2,800
		2,800			2,800
	Balance b/d	2,800			

Motor van

Date		Rs.		Rs.
31	Bank	40,000	Balance c/d	40,000
		40,000		40,000
	Balance b/d	40,000		

Fixtures and fittings

		Rs.		Rs.
15	Other payables	5,000	Balance c/d	5,000
		5,000		5,000
	Balance b/d	5,000		

Purchase returns

	Rs.	Date		Rs.
		18	Toby Trader	2,000
Balance c/d	4,400	27	KH Supplies	2,400
	4,400			4,400
			Balance b/d	4,400

Loan

	Rs.	Date		Rs.
Balance c/d	6,000	30	Bank	6,000
	6,000			6,000
			Balance b/d	6,000

Lee: Trial balance at 31 March 2013

	Debit	Credit
	Rs.	Rs.
Capital		80,000
Bank	39,300	
Cash	4,100	
Purchases	36,000	
Payables:		
KH Supplies		2,500
Hatts		2,700
Toby Traders		13,400
Sales		29,100
Receivables:		
Elliots	3,500	
L. Lane	7,400	
Wages	2,800	
Motor van	40,000	
Fixtures and fittings	5,000	
Purchase returns		4,400
Loan		6,000
	138,100	138,100

Solution **4**

Quality Services

Trial Balance for the quarter ended 30 June 2017

S.No.	Description		Debit	Credit
			— Rs. in '000 —	
1	Cash at bank	(9,500−5,150) −5	4,345	
2	Capital	5,000+240		5,240
3	Fixed assets - Vehicle		1,200	
4	Supplies expense	650+200−350	500	
5	Maintenance service revenue	4,500+700−1,250		3,950
6	Petty cash balance	300-250	50	
7	Utility expenses	250−20+45	275	
8	Wages and salaries	1,450−150	1,300	
9	Drawings		390	
10	Office rent expense	900−600	300	
11	Bank charges	10+5	15	
12	Fixed Assets - Machine		240	
13	Supplies payables	850−650		200
14	Unused supplies as at 30 June 2017		350	
15	Security deposits		20	
16	Electricity bill payable			45
17	Petty cash expenses		250	
18	Prepaid salaries		150	
10	Revenue receivables		700	
20	Unearned maintenance revenue			1,250
21	Depreciation expense	60+12	72	
22	Allowance for depreciation	(1,200+240)×20%÷12×3		72
23	Prepaid office rent	900×6÷9	600	
			10,757	**10,757**

Solution **5**

Traders and Enterprises

(i) After QT's decision to discontinue its operations, QT is no more a going concern. Therefore, as at 30 June 2016, its assets and liabilities should be valued at their estimated disposal value.

(ii) Making provisions just to even out the profits is against the true and fair view/faithful representation and should be avoided. Therefore, any provisions made on this basis should be reversed immediately.

6 OBJECTIVE BASED QUESTIONS

01. The process of transferring transaction from journal to ledgers is called?

- **(a)** Journalizing
- **(b)** Summarizing
- **(c)** Posting
- **(d)** Analyzing

02. Any transaction which cannot be recorded in any book of prime entry is recorded in?

- **(a)** Cash book
- **(b)** Petty cash book
- **(c)** General journal
- **(d)** Day books

03. What ledger entries would be made to record the purchase of an item of machinery on credit?

- **(a)** Debit machinery, credit cash
- **(b)** Debit machinery, credit accounts payables
- **(c)** Debit purchases, credit trade payables
- **(d)** Debit trade payables, credit machinery

04. What transaction is presented by the entries: debit bank, credit Receivables?

- **(a)** Sale of goods for cash
- **(b)** Purchase of goods for cash
- **(c)** Receipt of cheque from receivables
- **(d)** Payment of cheque to payables

05. A debit entry usually represents

- **(a)** Assets and Income
- **(b)** Liabilities and Income
- **(c)** Assets and Expenses
- **(d)** Liabilities and Expenses

06. The double entry to record the withdrawal of cash from a business bank account by the owner is?

(a)	Debit: drawings	Credit: bank
(b)	Debit: drawings	Credit: capital
(c)	Debit: liability	Credit cash
(d)	Debit: capital	Credit: drawings

07. Which of the following would normally be a credit balance in the trial balance?

(i) Loan
(ii) Owner's capital
(iii) Drawings
(iv) Purchases

(a) (i) and (ii)

(b) (i) and (iii)

(c) (ii) and (iii)

(d) (ii) and (iv)

08. A debit balance would be expected to arise when the accounts are balanced at the period end on which of the following accounts?

(a) Capital

(b) Sales

(c) Electricity

(d) Loan

09. A business sells Rs. 100,000 worth of goods to a customer, the customer pays Rs. 50,000 in cash immediately and will pay the remaining Rs. 50,000 in 30 days time.

What is the double entry to record the purchase in the customer's accounting records?

(a) Dr. cash Rs. 50,000; Cr. payables Rs. 50,000; Cr. purchases Rs. 50,000

(b) Dr. payables Rs. 50,000; Dr. cash Rs. 50,000 ;Cr. purchases Rs. 100,000

(c) Dr. purchases Rs. 100,000 ;Cr. payables Rs. 50,000; Cr. cash Rs. 50,000

(d) Debit purchases Rs. 100,000; credit cash Rs. 100,000

10. A trial balance is made up of a list of debit balances and credit balances.

Which of the following statements is correct?

(a) Every debit balance represents an expense

(b) Assets are represented by debit balances

(c) Liabilities are represented by debit balances

(d) Income is included in the list of debit balances

11. Basheer has extracted the following list of balances from his general ledger at 31 October 2015:

	Rs.
Sales	258,542
Opening inventory	9,649
Purchases	142,958
Expenses	34,835
Non-current assets (carrying amount)	63,960
Receivables	31,746
Payables	13,864
Cash at bank	1,783
Capital	12,525

What is the total of the debit balances in Basheer's trial balance at 31 October 2015?

(a) Rs. 267,049

(b) Rs. 275,282

(c) Rs. 283,148

(d) Rs. 284,931

12. At 31 October 2016 Zahid's trial balance included the following balances:

	Rs.
Machinery	12,890
Inventory	5,754
Trade receivables	11,745
Trade payables	7,830
Bank overdraft	1,675
Cash at bank	150

What is the value of Zahid's current assets at 31 October 2016?

(a) Rs. 17,649

(b) Rs. 17,499

(c) Rs. 15,974

(d) Rs. 13,734

13. Mariam has the following transactions:

(i) Receipt of cash from Nauman in respect of an invoice for goods sold three weeks ago

(ii) Receipt of cash from Amjad for cash sales

What are the ledger entries required to record the above transactions?

(a) Dr Cash; Cr Sales

(b) Dr Cash; Cr Sales; Cr Trade Receivables

(c) Dr Sales; Cr Cash

(d) Dr Trade Receivables; Dr Sales; Cr Cash

14. A business has purchased machinery on credit. Which of the accounts mentioned below are affected by the transactions?

(a) Trade payables

(b) Purchases

(c) Machinery

(d) Capital

15. A business has provided following information in the trial balance;

	Rs.
Machinery	150,000
Equipment	120,220
Trade receivables	35,150
Trade payables	40,220
Bank overdraft	18,997
Cash at bank	32,112

What is the amount of non – current assets to be shown in the financial position?

(a) Rs. 337,482

(b) Rs. 270,220

(c) Rs. 356,479

(d) Rs. 318,485

16. A business buys machinery costing Rs. 120,000 and sells machinery costing Rs. 18,000 in the year. The opening balance of the machinery account is Rs. 80,000.

What will be the balance brought down in the next period?

Rs. ___________

17. A company had a cash balance of Rs. 18,000 at the start of the month. During the month, the following transactions occurred.

- **(i)** Sales on credit Rs. 72,000
- **(ii)** Cash from trade receivables Rs. 49,000
- **(iii)** Purchases on credit Rs. 33,000
- **(iv)** Payments to trade payables Rs. 35,000

What was the cash balance at the end of the month?

Rs. ___________

18. An accountant has inserted all the relevant figures into the trade payables account, but has not yet balanced off the account.

Accounts payable a/c

Particulars	**Rs.**	**Particulars**	**Rs.**
Bank a/c	100,750	b/d	250,225
		Purchases	325,010
	________		________
	________		________

Assuming there are no other entries to be made, other than to balance off the account, what is the closing balance on the trade payables account?

Rs. ___________

19. You are given the following information:

	Rs.
Receivables at 1 January 2018	10,000
Receivables at 31 December 2018	9,000
Total receipts during 2018 (including cash sales of Rs.5,000)	85,000

What are sales on credit during 2018?

Rs. ___________

20. The following totals appear in the day books for March 2018.

	Rs.
Sales day book	40,000
Purchases day book	20,000
Returns inwards day book	2,000
Returns outward day book	4,000

Opening and closing inventories are both Rs. 3,000.

What is the gross profit for March 2018?

Rs. ___________

21. The terms accounting and book keeping are classified as

- **(a)** Same
- **(b)** Different
- **(c)** Opposite
- **(d)** None of these

22. Which one is the principle of Double Entry System?

- **(a)** Purchase increases Debit, income decreases Credit
- **(b)** Expense increases Debit, Income decreases Credit
- **(c)** Receiver is Debit and Giver is Credit
- **(d)** Receiver is Credit and Giver is Debit

23. Payment of insurance through the bank involves entries in which of the two accounts

- **(a)** Insurance account (Debit) and petty cash account (Credit)
- **(b)** Insurance account (Debit) and bank account (Credit)
- **(c)** Insurance account (Debit) and rent account (Credit)
- **(d)** Insurance account (Debit) and capital account (Credit)

24. X Ltd. purchases a vehicle for Rs. 1.5 million for business use, paying by cheque, what is the double entry:

- **(a)** Purchases account (debit) and bank account (credit)
- **(b)** Vehicle account (debit) and bank account (credit)
- **(c)** Vehicle account (credit) and bank account (debit)
- **(d)** Debit vehicle account (debit) and petty cash account (credit)

25. The journal entry for return of goods purchased from Khan Limited on account is:

- **(a)** Cash (debit) and purchases (credit)
- **(b)** Accounts payable (debit) and purchases (credit)
- **(c)** Accounts payable (debit) and purchases return (credit)
- **(d)** None of the above

26. Accounting entry for payment of a telephone bill is;

- **(a)** Telephone expense (debit) and cash (credit)
- **(b)** Office equipment (debit) and cash (credit)
- **(c)** Office supplies (debit) and cash (credit)
- **(d)** Cash (debit) and utilities (credit)

27. Khalid is a dealer in electronic goods (refrigerator, washing machine, air conditioners, televisions, etc.). He purchased two air conditioners and installed in his showroom. In the books of Khalid, the cost two air conditioners will be debited to

(a) Drawing account

(b) Capital Account

(c) Fixed assets

(d) Purchases account

28. An asset was purchased for Rs.1,000,000 with the down payment of Rs.200,000 and bills accepted for Rs.800,000/-.

What would be the effect on the total asset and total liabilities in the statement of financial position?

(a) Assets increased by Rs.800,000 and liabilities decreased by Rs.800,000

(b) Assets decreased by Rs.800,000 and liabilities increased by Rs.800,000

(c) Assets increased by Rs.1,000,000 and liabilities increased by Rs.800,000

(d) Assets increased by Rs.800,000 and liabilities increased by Rs.800,000

29. BS Corporation provides laptop repair services. It offers services on the advance part-payment policy. A customer walked into their shop for services, paid Rs.2,000 in the beginning, and once the laptop got repaired, he paid Rs.2,000 upon delivery. What would be the accounting entry?

(a) Laptop = 2,000 (debit) and Cash = 2,000 (credit)

(b) Labour = 2,000(debit) and Accounting receivable = 2,000 (credit)

(c) Cash= 2,000 (debit), Accounts receivable = 2,000(debit) and Service revenue = 4,000 (credit)

(d) Purchases = 2,000 (debit), Accounts receivable = 2,000 (debit) and Service revenue = 4,000 (credit)

30. BS Corporation provides laptop repair services. It offers services on the advance part-payment policy. A customer walked into their shop for services, paid Rs.2,000 in the beginning, and once the laptop got repaired, he paid Rs.2,000 upon delivery

Post the accounting entry for the above when the laptop is repaired and handed over to the customer.

(a) Cash = 2,000 (Debit) and Accounts receivable = 2,000 (credit)

(b) Cash = 2,000 (Debit) and Service revenue = 2,000 (credit)

(c) Cash = 2,000 (Debit) and Accounts payable = 2,000 (credit)

(d) Cash = 2,000 (Debit) and Other income = 2,000 (credit)

6 OBJECTIVE BASED ANSWERS

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<tr><td>Purchases</td><td>120,000</td><td>c/d</td><td>282,000</td></tr>
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<tr><td>b/d</td><td>18,000</td><td>Payables</td><td>35,000</td></tr>
<tr><td>Receivables</td><td>49,000</td><td>c/d</td><td>32,000</td></tr>
<tr><td></td><td>67,000</td><td></td><td>67,000</td></tr>
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<tr><td>18.</td><td>Rs. 474,485</td><td>Accounts payable a/c
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<tr><td>Bank a/c</td><td>100,750</td><td>b/d</td><td>250,225</td></tr>
<tr><td>c/d</td><td>474,485</td><td>Purchases</td><td>325,010</td></tr>
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Accounts receivables a/c
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<tr><td>Sales</td><td></td><td>40,000</td></tr>
<tr><td>Returns inwards</td><td></td><td>(2,000)</td></tr>
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<tr><td>Opening inventory</td><td>3,000</td><td></td></tr>
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CHAPTER

5

Books of Prime Entry

Contents

1 INTRODUCTION TO BOOKS OF PRIME ENTRY

Section overview

- The role of books of prime entry
- Posting transactions

1.1 The role of books of prime entry

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

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

Books of prime entry include the following:

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

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

1.2 Posting transactions

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

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

Definition: Control account

An account which summarises a large number of transactions.

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

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

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

The balance on the receivables control account should always equal the total of the list of balances in the receivables ledger. If this is not the case an error has been made and must be investigated. This is covered in chapter 9.

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

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

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

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

2 ACCOUNTING FOR SALES

Section overview

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

2.1 Documents in the sales cycle

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

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

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

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

Illustration: Credit note

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

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

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

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

2.2 Recording sales

Sales day book

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

Double entry and updating the receivables ledger

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

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

Illustration:

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

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

Responsibilities

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

Example: Recording sales

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

Sales day book:

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

General ledger

Receivables control account

	Rs.		Rs.
Sales	75,000		

Sales

	Rs.		Rs.
		Receivables	75,000

Receivables ledger

Danish

	Rs.		Rs.
Sales	25,000		

Fahad

	Rs.		Rs.
Sales	10,000		

Hasan

	Rs.		Rs.
Sales	40,000		

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

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

Being: Posting of sales from the sales day book.

2.3 Recording sales returns

Sales returns day book

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

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

Double entry and updating the receivables ledger

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

Illustration:

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

Example

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

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

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

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

Example: General ledger

Receivables control account

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

Sales

	Rs.		Rs.
		Receivables (1)	140,000

Sales returns

	Rs.		Rs.
Receivables (2)	5,000		

Bank

	Rs.		Rs.
Receivables (3)	60,000		

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

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

Example: Receivables ledger

Customer A

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

Customer B

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

Customer C

	Rs.		Rs.
(1c) Sales	50,000	(3b) Bank	20,000
		Balance c/d	10,000
	50,000		30,000
Balance c/d	10,000		

Customer D

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

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

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

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

2.4 Discounts allowed

Introduction

Businesses sometimes give discounts to customers.

There are two main types of discount:

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

Trade discount

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

Example: Trade discounts

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

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

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

Arif buys 20 bags off the building merchant.

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

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

Settlement discounts

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

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

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

Example: Settlement discounts

A building merchant offers credit terms to large customers.

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

The reduction of 3% is a settlement discount.

Bashir Builders buys goods worth Rs. 80,000.

- **If Bashir Builders pays within 30 days it need only pay Rs.77,600.**
- **If Bashir Builders does not pay within 30 days it must pay Rs.80,000.**

Discounts allowed

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

Accounting for discounts allowed

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

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

Illustration: Discount allowed double entry

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

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

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

Example: Discount allowed

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

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

Bashir pays in 19 days.

Asad would record the transaction as follows:

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

Discounts allowed and the receivables ledgers

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

2.5 Receivables control account

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

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

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

Illustration: Double entries into receivables control account

Receivables control account

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

Dishonoured cheques

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

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

Entries not recorded in the receivables control account

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

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

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

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

2.6 Terminology

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

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

3 ACCOUNTING FOR PURCHASES

Section overview

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

3.1 Documents in the purchases cycle

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

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

Document	Purpose	Impacts double entry?
Purchase requisition	An item should be requisitioned first if not lying in the stock	No
Quotation and approval	Where value of goods exceeds certain limit, quotations will be obtained from at least three suppliers. After all quotations have been received and examined for completeness, a dated summary sheet will be prepared enlisting all the necessary details. Contract should ideally be awarded to the lowest bidder after an evaluation of the quotations submitted by them. However, besides financial concerns, weight age should also be given to non-financial and other qualitative factors before a final decision.	No
Purchase order	After selection and finalization of quotation and approval of purchase requisitions, a Purchase Order (PO) will be issued in the name of selected supplier.	No
Goods received note	A document produced when goods are received. It is produced after the goods have been checked against the delivery note and what has actually been received. The GRN is sent to accounts staff who will check that what has been received is what was ordered and that the invoice agrees with what was received.	No
Purchase invoice	A request for payment from the supplier for goods delivered.	**Yes**
Statement	A document from the supplier to show the amount still owed at a point in time.	No

3.2 Recording purchases

Purchases day book

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

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

Double entry and updating the payables ledger

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

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

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

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

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

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

Illustration:

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

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

Illustration: Recording purchase

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

Illustration: Recording purchase

A journal can easily be constructed to affect the double entry

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

3.3 Recording purchase returns

Purchases returns day book

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

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

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

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

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

Illustration:

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

Example

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

Purchases day book	Rs.	
Supplier: A	30,000	
Supplier: B	60,000	
Supplier: C	20,000	
Supplier: D	70,000	
	180,000	(1)

Purchase returns day book	Rs.	
Supplier: B	20,000	(2)

Cash paid to:	Rs.	
Supplier: A	29,000	
Supplier: D	25,000	
	54,000	(3)

Discount received	Rs.	
Supplier: A	1,000	(4)

Example: General ledger

Payables control account

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

Purchases

	Rs.		Rs.
Payables (1)	180,000		

Purchase returns

	Rs.		Rs.
		Payables (2)	20,000

Bank

	Rs.		Rs.
		Payables (3)	54,000

Discount received

	Rs.		Rs.
		Payables (4)	1,000

Example: General ledger

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

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

Example: Payables ledger

Supplier A

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

Supplier B

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

Supplier C

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

Supplier D

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

Example: (continued)

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

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

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

3.4 Discounts received

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

Accounting for discounts received

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

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

Illustration: Discount received double entry

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

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

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

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

Example: Discount received

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

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

Bashir pays in 19 days.

Bashir would record the transaction as follows:

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

Discounts received and the payables ledgers

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

3.5 Payables control account

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

Opening payables balance

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

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

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

Illustration: Double entries into payables control account

Payables control account

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

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

3.6 Contra entries

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

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

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

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

Illustration: Contra entry

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

Example: Contra entry

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

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

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

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

Books of A:

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

3.7 Terminology

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

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

Example: Lotus Pharma

Lotus Pharma (LP) was established on 1 January 2016. Following transactions pertain to the first month of business:

<table>
<tr><th>Transaction date</th><th>Description</th></tr>
<tr><td>1-Jan-2016</td><td>Bought medicines on credit from the following suppliers:
<table>
<tr><th></th><th>Rs. in million</th></tr>
<tr><td>Shan Traders</td><td>8.50</td></tr>
<tr><td>Rahat Stores</td><td>12.50</td></tr>
<tr><td>Quality Medicos</td><td>15.00</td></tr>
</table></td></tr>
<tr><td>12-Jan-2016</td><td>Bought medicines on cash for Rs. 3.8 million.</td></tr>
<tr><td>20-Jan-2016</td><td>Medicines worth Rs. 2.5 million were returned to Rahat Stores.</td></tr>
<tr><td>24-Jan-2016</td><td>A part payment of Rs. 5.8 million was made to Shan Traders.</td></tr>
<tr><td>28-Jan-2016</td><td>Amount payable to Quality Medicos was fully settled to avail an early payment discount of 2%.</td></tr>
<tr><td>31-Jan-2016</td><td>Rahat Stores was paid in full after adjusting Rs. 1.2 million against its account receivable balance.</td></tr>
</table>

a) The extracts of purchase day book for the above transactions shall be as follows.

Lotus Pharma

Purchase day book		
Date	**Suppliers**	**Rs. in million**
1-Jan-2016	Shan Trader	8.50
	Rahat Store	12.50
	Quality Medicos	15.00
		36.00

b) Subsidiary and control accounts for trade payables shall be as follows.

Subsidiary purchase ledger accounts

Shan Trader					
Date	**Particulars**	**Rs. in million**	**Date**	**Particulars**	**Rs. in million**
24-Jan	Bank	5.80	1-Jan	Purchases	8.50
31-Jan	Balance c/f	2.70			
		8.50			**8.50**

Rahat Store					
Date	**Particulars**	**Rs. in million**	**Date**	**Particulars**	**Rs. in million**
20-Jan	Purchase return	2.50	1-Jan	Purchases	12.50
31-Jan	Account receivable	1.20			
31-Jan	Bank	8.80			
		12.50			**12.50**

Quality Medicos					
Date	**Particulars**	**Rs. in million**	**Date**	**Particulars**	**Rs. in million**
28-Jan	Bank *(15×98%)*	14.70	1-Jan	Purchases	15.00
28-Jan	Discount received *(15×2%)*	0.30			
		15.00			**15.00**

Trade payables control account					
Date	**Particulars**	**Rs. in million**	**Date**	**Particulars**	**Rs. in million**
20-Jan	Purchase return-Rahat	2.50	1-Jan	Purchases 8.5+12.5+15	36.00
24-Jan	Bank-Shan Traders	5.80			
28-Jan	Bank-Quality Medicos	14.70			
28-Jan	Discount received	0.30			
31-Jan	Trade account rec. - Rahat	1.20			
31-Jan	Bank-Rahat 12.5-2.5-1.2	8.80			
31-Jan	Balance c/f	2.70			
		36.00			**36.00**

Example: Rana Brothers

Following transactions pertain to Rana Brothers for the month of August 2016:

Date	Name of suppliers	Description	Rupees
05-Aug	Bravo Traders	Credit purchase	950,000
05-Aug	Alpha & Sons	Credit purchase	438,000
08-Aug	Bravo Traders	Return of goods purchased on credit	60,000
09-Aug	Charlie Brothers	Goods received against advance payment made on 3 July 2016	540,000
10-Aug	Alpha & Sons	Credit purchase	800,000
10-Aug	Bravo Traders	Credit purchase	635,000
11-Aug		Goods destroyed in fire to be recovered from Rahat Insurance Co.	79,000

i. The above transactions shall be entered in the related books of prime entry as follows.

Entries in the books of prime entry

Purchase day book

Date	Suppliers	Rs.
5-Aug-2016	Bravo Traders	950,000
	Alpha & Sons	438,000
		1,388,000
10-Aug-2016	Alpha & Sons	800,000
	Bravo Traders	635,000
		1,435,000
	Total	**2,823,000**

Purchase return day book

Date	Suppliers	Rs.
8-Aug-2016	Bravo Traders	**60,000**

General journal

Date	Particulars	Debit (Rs.)	Credit (Rs.)
9-Aug-2016	Purchases	540,000	
	Advance to supplier		540,000
	(To record purchases against advance payment)		
11-Aug-2016	Insurance claim	79,000	
	Purchases/inventory		79,000
	(Goods lost in fire and recoverable from the insurance company)		

General journal

Date	Particulars	Debit (Rs.)	Credit (Rs.)
31-Aug-2016	Purchases	2,823,000	
	Trade payable control account		2,823,000
	(To record credit purchases)		
31-Aug-2016	Trade payable control account	60,000	
	Purchases return		60,000
	(To record return of goods purchased on credit)		

ii. Relevant general ledger accounts and subsidiary ledger accounts shall be as follows.

Main ledger accounts

Purchases

9-Aug-2016	Adv. to suppliers	540,000	11-Aug-2016	Insurance claim	79,000
31-Aug-2016	Trade payable control account	2,823,000			

Purchase Return

			31-Aug-2016	Trade payable control account	60,000

Advance to suppliers

			9-Aug-2016	Purchases	540,000

Trade payable control account

Date	Particulars	Rupees	Date	Particulars	Rupees
31-Aug-2016	Purchase return	60,000	31-Aug-2016	Purchases	2,823,000

Insurance Claim

11-Aug-2016	Purchases	79,000			

Subsidiary purchase ledger accounts

Alpha & Sons

			5-Aug-2016	Purchases day book	438,000
			10-Aug-2016	Purchases day book	800,000

Bravo Traders

8-Aug-2016	Purchase return day book	60,000	5-Aug-2016	Purchase day book	950,000
			10-Aug-2016	Purchase day book	635,000

Example: Gul Brothers

Following transactions pertain to Gul Brothers (GB) for the month of February 2017:

3-Feb	Bought goods on credit from QT Stores for Rs. 295,000.
3-Feb	Purchased goods in bulk on 15 days credit from Bana & Co. at a price of Rs. 190,000 (net of 5% trade discount).
8-Feb	Sold goods on cash for Rs. 300,000.
15-Feb	Issued a cheque of Rs. 90,000 to XYZ in full and final settlement of an old outstanding balance of Rs. 100,000.
18-Feb	Sold goods on 15 days credit to Qavi for Rs. 275,000. Qavi would be entitled to 2% discount if payment is made on the due date.
18-Feb	Sold goods on credit to Child Care Centre at a concessional price of cost plus 10%. The cost of goods was Rs. 158,000.
23-Feb	Johar & Sons, a debtor owing a balance of Rs. 65,000 was declared bankrupt. The balance due was written-off. GB maintains adequate provision against its debtors.
25-Feb	Received cheques from debtors – Chenab Rs. 68,000 and Ameen Stores Rs. 32,000.

(a) The above transactions shall be entered in the related books of prime entry as follows.

Gul Brothers

Books of prime entry

Purchase Day Book

Date	Supplier	Rupees
3-Feb	QT Stores	295,000
3-Feb	Bana & Co.	190,000
	Total	**485,000**

Sales Day Book

Date	Customer	Rupees
18-Feb	Qavi	275,000
18-Feb	Child Care Centre (158,000×1.10)	173,800
	Total	**448,800**

Cash book							
Date	**Description**	**Cash (Rs.)**	**Bank (Rs.)**	**Date**	**Description**	**Cash (Rs.)**	**Bank (Rs.)**
8-Feb	Cash sales	300,000	-	15-Feb	XYZ	-	90,000
25-Feb	Chenab	-	68,000				
25-Feb	Ameen Stores	-	32,000				

General Journal			
Date	**Description**	**Debit**	**Credit**
		—— Rupees ——	
15-Feb	Payables control account - XYZ	10,000	
	Discount income		10,000
23-Feb	Provision for doubtful debts	65,000	
	Receivables control account - Johar & Sons		65,000

(b) The entries shall be posted to Receivables Control Account and Payables Control Account as follows.

Control accounts

Payables control account					
Date	**Description**	**Rupees**	**Date**	**Description**	**Rupees**
15-Feb	Bank - XYZ	90,000	3-Feb	Purchases (295,000+190,000)	485,000
15-Feb	Discount income - XYZ	10,000			

Receivables control account					
Date	**Description**	**Rupees**	**Date**	**Description**	**Rupees**
18-Feb	Sales [275,000+(158,000×1.1)]	448,800	23-Feb	Prov. for doubtful debts (Johar & Sons)	65,000
			25-Feb	Bank (68,000+32,000)	100,000

4 ACCOUNTING FOR CASH

Section overview

- The cash book
- Types of cash book

4.1 The cash book

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

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

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

4.2 Types of cash book

The cashbook records all the transactions that involve receipts and payments of cash and deposits in and withdrawals from the bank in a chronological order. The debit side represents the receipts side and the credit side represents the payments side.

There are four basic types of a cash book.

☐ Single column cash book
☐ Two column cash book
☐ Triple column cash book
☐ Petty cash book

Single column cash book

A simple cash book or a single column cash book is just like an ordinary account that carries one amount column on each side. The left hand side is for recording receipts of cash and the right hand side is for recording payments of cash. It is balanced just like any other ledger account.

Example: Single column cash book

Following data has been extracted from Sara Shah's records for the month of June 2016.

June2016		
1	**Opening balance of cash**	**12,000**
2	**Received cash from Akhtar**	**3,800**
5	**Paid rent by cash**	**4,000**
9	**Made sales on cash**	**3,000**
14	**Paid to Bilal**	**1,760**
18	**Purchased Furniture on cash**	**3,000**
23	**Paid salaries**	**3,600**
26	**Rent due, yet not paid for June**	**2,700**

Enter the above transactions in the single column cash book of Sara.

Sara Shah
Cash Book

Date	Details	Cash (Rs.)	Date	Details	Cash (Rs.)
2016			2016		
June 1	Balance b/d	12,000	June 5	Rent	4,000
2	Akhtar	3,800	14	Bilal	1,760
9	Sales	3,000	18	Furniture	3,000
			23	Salaries	3,600
			30	Balance c/d	6,440
		18,800			18,800
Aug 1	Balance b/d	6,440			

Two column cash book

The double column cash book has two columns i.e. the cash column and the bank column on both the sides of the cash book. All the cash receipts and cash payments are recorded in the cash columns and all the deposits in and withdrawals from the bank are entered in the bank columns accordingly.

Example: Two column cash book

July 2016

1 Naeem Traders started business with a capital of Rs.40,000. The amount was paid into the business's bank account.

2 Paid rent of Office premises Rs.1,700 by cheque.

5 Purchased goods worth Rs.12,000 on credit from Shahzaib Traders.

9 Withdrew Rs.1,000 from the bank account for office use.

14 Paid advertising expenses, Rs.700 in cash.

18 Sold goods, Rs.8120 to Niazi Trading and received cheque.

23 Paid Shahzaib Traders by cheque.

26 Purchased Motor Vehicle Rs.30,000 and paid by cheque.

28 Naeem took Rs.2,000 from the business through cheque for personal use.

Enter the above transactions in the cash book of Naeem Traders. The cash and bank accounts should be shown in a two columnar cash book.

Naeem Traders
Cash Book

Date	Details	Cash Rs.	Bank Rs.	Date	Details	Cash Rs.	Bank Rs.
2016				2016			
July 1	Capital		40,000	July 2	Rent		1,700
9	Bank	1,000		9	Cash		1,000
18	Sales		8,120	14	Advertising	700	
				23	Shahzaib Traders		12,000
				26	Motor Vehicles		30,000
				28	Drawings		2,000
				31	Balance c/d	300	1,420
		1,000	48,120			1,000	48,120
Aug 1	Balance b/d	300	1,420				

Three column cash book

Many businesses maintain a Three-column cash book instead of the Two-column cash book. The only difference is the extra column that is meant to record **cash discount**.

Cash receipts

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

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

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

The additional column on the cash receipts side of the cash book is for recording discounts allowed. This is nothing to do with cash as such but the discounts might be recorded here so that the business is able to keep track of it. Such a record is described as being a memorandum (reminder).

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

Illustration: Cash receipts

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

A journal can easily be constructed to affect the double entry

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

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

Cash payments

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

The additional column on this side is for recording discounts received and it is a memorandum column in the cash book.

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

Illustration: Cash payments

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

A journal can easily be constructed to affect the double entry

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

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

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

Petty cash Book

Definition of petty cash

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

Recording petty cash transactions

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

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

Illustration: x

	Debit	Credit
Office expenses	X	
Petty cash		X

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

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

Imprest system

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

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

Example-1:

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

The imprest is set at Rs. 10,000.

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

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

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

Example-2:

Shanzay Industries keeps an analysed petty cash book using the imprest system. The imprest amount is Rs.2,000. The following information is available for the month of June 2016.

2016 June		Rs.	Voucher Number
1	Balance	2,000	
6	Paid window cleaner	200	1
8	Bought pens and pencils	100	2
11	Paid for bus fare	60	3
16	Paid for printer cartridge	400	4
18	Purchased envelops	270	5
20	Paid for coffee and milk for office staff	70	6
22	Bought printing papers	80	7
23	Paid taxi fare	200	8
24	Paid office cleaner	170	9
26	Paid for biscuits and tea	100	10
28	Purchased paper pins	40	11
29	Paid for petrol	70	12

Required

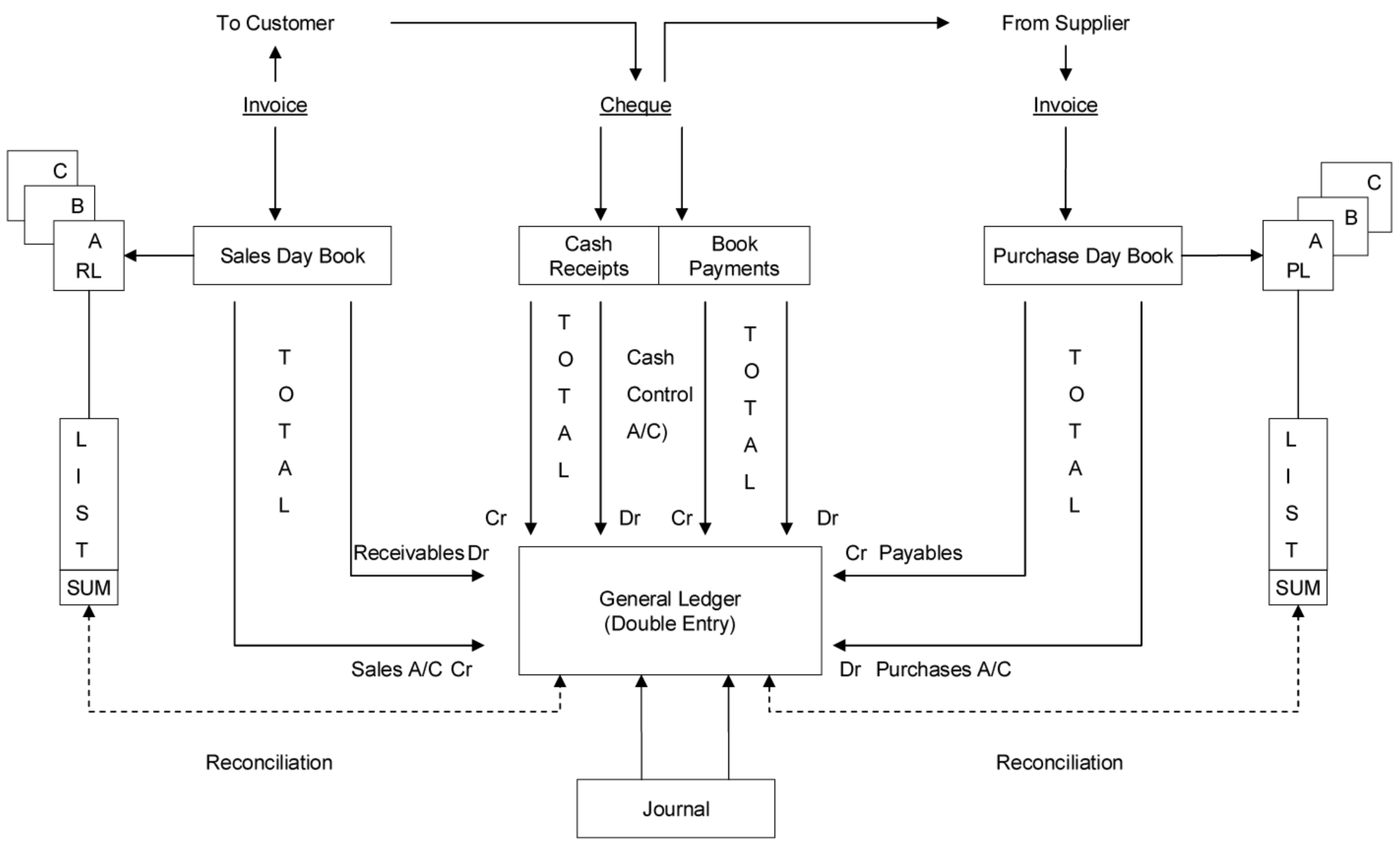
Write up the petty cash book for the month of June 2016 for Shanzay Industries. Balance the petty cash book and carry down the balance. Show the restoration of imprest as on July 1 2016.

Shanzay Industries
Petty Cash Book

Date	Details	Total received	Date	Details	Vo	Total paid	Cleaning	Stationery	Travel expenses	Postage	Food
		Rs.				Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
2016			2016								
June 1	Balance b/d	2,000	June 6	Window cleaner	1	200	200				
			8	Pens and pencils	2	100		100			
			11	Bus fare	3	60			60		
			16	Printer cartridge	4	400		400			
			18	Envelops	5	270				270	
			20	Coffee and milk	6	70					70
			22	Printing paper	7	80		80			
			23	Taxi fare	8	200			200		
			24	Office cleaner	9	170	170				
			26	Biscuits and tea	10	100					100
			28	Paper pins	11	40		40			
			29	Petrol	12	70			70		
						1,760	370	620	330	270	170
			30	Balance c/d		240					
						2,000					
2016											
July 1	Balance b/d	240									
	Cash	1,760									

Illustration: Overview

Books of Prime Entry – The System



Practice question

1

List the documents used in a system designed to control and account for purchases and briefly describe the purpose for issuance of these documents.

Practice question: Henry Brothers

2

Henry Brothers (HB) is engaged in trading of textile products. As at 1 July 2018, HB had cash and bank balances of Rs. 76,000 and Rs. 286,000 respectively. Following transactions pertain to the month of July 2018:

4 July	Purchased goods on credit amounting to Rs. 250,000 and Rs. 180,000 from Alpha Enterprises (AE) and Bravo Traders respectively. AE offered 3% discount if payment was made within 15 days.
6 July	Purchased office furniture costing Rs. 90,000 from Lavish Designs and paid Rs. 50,000 through cheque. Rs. 40,000 had already been paid in June 2018 and debited to Advances.
8 July	Sold goods to HRS Garments and received a cheque of Rs. 300,000. Also sold goods on cash to Shan Garments having list price of Rs. 250,000 and offered discount of 2%.
14 July	20% goods sold to Shan Garments on 8 July were returned and the amount was refunded in cash. These goods were sold on mark up of 25% of cost.
16 July	Sold old office furniture on cash for Rs. 12,000. The cost of furniture was Rs. 75,000 and its book value was nil.
17 July	Goods costing Rs. 35,000 were returned to AE and the remaining amount was paid through cheque.
23 July	Sold goods on cash to Salim Sons for Rs. 236,500.
26 July	Saleh & Co. offered discount of 5% on list price of Rs. 500 per unit if at least 250 units are purchased. HB purchased 300 units to avail the discount and paid through cheque.
28 July	Paid loan instalment of Rs. 150,000 including interest of Rs. 35,000 in cash.
30 July	Deposited cash into bank Rs. 200,000.

Required:

Record the above transactions in the relevant books of prime entry in a proper format. (Narrations are not required)

Practice question: Alpha Traders **3**

Following information pertains to Alpha Traders (AT):

Balances as at 1 August 2017:

	Rupees
Cash in hand	178,000
Bank overdraft	769,000

Transactions for the month of August 2017:

Date	Transactions
02-Aug	Office furniture purchased from RABBIT for cash and on credit for Rs. 38,000 and Rs. 129,000 respectively.
03-Aug	Goods purchased for cash from Bena & Co. for Rs. 85,000.
05-Aug	Goods purchased on credit in bulk (net of 5% trade discount) from Moon & Co. and Shan Traders for Rs. 475,000 and Rs. 513,000 respectively.
08-Aug	Goods sold on credit for Rs. 236,000 and Rs. 198,000 to A-Z Super Store and Apollo Center respectively.
10-Aug	Goods costing Rs. 68,000 were returned to Moon & Co.
12-Aug	Cash sales to Danish & Sons for Rs. 40,000.
16-Aug	Cheques (net of 5% discount) amounting to Rs. 194,750 and Rs. 243,200 were received from A-Z Super Store and Bright & Co. respectively.
20-Aug	It was agreed with Columbus Traders to adjust Rs. 200,000 payable to AT against receivables from AT.
25-Aug	Payment of Rs. 225,000 (net of 10% discount) to Al-Shams.

Required:

Record the above transactions in relevant books of prime entry in a proper format.

Practice question: Kwark **4**

The following are transactions of Kwark, a new business, during May 2013.

May 2013	
Transaction	
1	Started the business with capital of Rs.2,500,000, paid into a business bank account.
2	Bought goods on credit from the following entities: Ellis Rs.810,000; Mendez Trading Rs.1,305,000; Gibson Rs.375,000; Dynasty Rs.1,140,000; Liners Rs.960,000. (Total Rs.4,590,000).
3	Sold goods on credit to: Bailey Stores Rs.753,000; Fastshop Rs.1,120,000; Spencers Rs.3,080,000. (Total Rs.4,953,000).
4	Bailey Stores paid by cheque Rs.723,000. A discount of Rs.30,000 was allowed for early payment.
5	Spencers paid Rs.1,500,000 by cheque
6	The following payment was made: Ellis Rs.700,000
7	The following payment was made Gibson: Rs.350,000. A discount of Rs.25,000 was received for early payment.
8	Paid carriage outwards: Rs.345,000
9	Purchase returns to Dynasty Rs.400,000
10	Sales returns from Spencers: Rs.270,000
11	Purchases on credit from Mendez Trading Rs.753,000; Dynasty Rs.1,650,000. (Total Rs.2,403,000).
12	Sold goods on credit to Fastshop Rs.1,005,000.

Kwark maintains control accounts for receivables and payables in the main ledger, and accounts for individual customers and suppliers in a receivables ledger and a payables ledger respectively.

Required

(a) Use T accounts to show how the relevant transactions will be recorded in the receivables control account and the payables control account in the main ledger of Kwark in May. (You are not required to prepare T accounts for any of the other main ledger accounts.)

(b) Show the list of balances in the receivables ledger after recording the above transactions.

(c) Show the list of balances in the payables ledger after recording the above transactions.

Practice question: June Transactions **5**

The following transactions in June 2013 are those of a new business entity, Parakeet.

June 2013	
Date	
1	Set up the entity with capital in cash of Rs.6,500,000 paid into a bank account.
2	Bought goods on credit from C Jones Rs.1,800,000
3	Credit sales: J Bird Rs.660,000, D Swann Rs.250,000, Swallow Company Rs.430,000. (Total Rs.1,340,000).
4	Purchased goods for cash (by cheque) Rs.230,000.
5	Bought second-hand motor van for Rs.2,560,000, paying by cheque.
7	Paid motor expenses Rs.120,000.
9	Credit sales: M Parrott Rs.240,000, Canary Company Rs.260,000, G Finch Rs.680,000. (Total Rs.1,180,000).
11	Purchased goods on credit: C Jones Rs.2,400,000, E Davies Rs.620,000, A Evans Rs.460,000. (Total Rs.3,480,000).
13	Purchases returned to C Jones Rs.250,000.
19	Sales returns from D Swann Rs.110,000.
20	Cash drawings taken by owner: Rs.440,000 by cheque.
21	Payments made to E Davies Rs.620,000, A Evans Rs.460,000. (Total Rs.1,080,000). All payments were made by cheque.
23	Received payment from J Bird: Rs.660,000 by cheque.
25	Received payment from Swallow Company: Rs.430,000 in cash which was kept in the office.
28	Purchases returned to C Jones: Rs.420,000.
29	Purchased stationery Rs.40,000 (record as a sundry expense) using cash.
30	Credit sales: D Swann Rs.420,000, Canary Company Rs.540,000. (Total Rs.960,000).

Required

(a) Prepare journal entries to show how the following transactions in June 2013 should be recorded in the main ledger accounts of Parakeet, a newly-established business entity.

The accounting system contains a receivables ledger and a payables ledger for individual accounts, and there are control accounts (total accounts) for receivables and payables in the main ledger.

You are not required to include any narrative in the journal entries.

(b) List the transactions that will be entered in the receivables ledger accounts for the month.

(c) List the transactions that will be entered in the payables ledger accounts for the month.

Practice question: May Transactions Revised **6**

The following transactions in May 2013 are those of a new business entity, Home Oak Garden Traders.

May 2013	
Date	
1	Set up the entity with capital in cash: Rs.2,500,000.
2	Bought goods on credit from the following suppliers: The Bushes Company Rs.540,000, Flower City Rs.870,000, D Gibson Rs.250,000, Weedkill Rs.760,000, T Greenery Rs.640,000. (Total Rs.3,060,000).
4	Sold goods on credit to: The Office Company Rs.430,000, V Cork Rs.640,000, Texas Chain Stores Rs.1,760,000. (Total Rs.2,830,000).
6	Paid rent Rs.120,000.
9	The Office Company paid the Rs.430,000 that it owed.
10	Texas Chain Stores paid Rs.1,500,000.
12	The following payments were made: to D Gibson Rs.250,000 and to The Bushes Company Rs.540,000. (Total Rs.790,000).
15	Advertising costs of Rs.230,000 were paid to the local newspaper publisher.
18	Bought goods on credit from the following suppliers: The Bushes Company Rs.430,000, Landscape Rs.1,100,000. (Total Rs.1,530,000).
21	Sold goods on credit to Public Parks Rs.670,000
31	Paid rent Rs.180,000.

Required

(a) Prepare extracts of the sales day book and purchase day book for the relevant transactions above.

(b) Use T accounts to show how these transactions should be recorded in the main ledger accounts of the entity. The accounting system contains a receivables ledger and a payables ledger for individual accounts, and there are control accounts (total accounts) for receivables and payables in the main ledger.

(c) Post the transactions to individuals' accounts in the receivables ledger and the payables ledger and extract a list of balances from these. (The total of each list should agree with the balance on the receivables control account and payables control account respectively).

(d) Prepare a trial balance as at 31 May 2013.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Documents used in a system designed to control and account for purchases.

Document		Purpose for issuance of document
(i)	Purchase order	Sent by a buyer to place an order
(ii)	Goods receiving note	Prepared to record goods received and for verification of invoice prior to its payment.
(iii)	Purchase invoice	A request for payment from the supplier for goods delivered.
(iv)	Credit note/debit note	Issued by a supplier/customer on return of goods or allowing any discount.
(v)	Statement of account	A document from a supplier listing the outstanding invoices at a point in time.

Solutions **2**

Henry Brothers

Books of prime entry

Purchase day book

Date	Supplier	Rupees
4-Jul-18	Alpha Enterprises	250,000
4-Jul-18	Bravo Traders	180,000
		430,000

Purchase return day book

Date	Supplier	Rupees
17-Jul-18	Alpha Enterprises	35,000
		35,000

Cash Book/Bank Book

Receipts				Payments			
Date	**Description**	**Cash**	**Bank**	**Date**	**Description**	**Cash**	**Bank**
		— Rupees —				**— Rupees —**	
1-Jul-18	Balance b/d	76,000	286,000	6-Jul-18	Office furniture		50,000
8-Jul-18	Sales		300,000	14-Jul-18	Return inwards {(245,000)×0.2}	49,000	
8-Jul-18	Sales (250,000×0.98)	245,000		17-Jul-18	Alpha Enterprises - Account payable {(250,000-35,000)×0.97}		208,550
16-Jul-18	Disposal/gain on disposal	12,000					
23-Jul-18	Sales	236,500					
30-Jul-18	Cash		200,000	26-Jul-18	Purchases {(300×500×0.95)}		142,500
				28-Jul-18	Loan	115,000	
					Interest account	35,000	
				30-Jul-18	Bank	200,000	
				31-Jul-18	Balance c/d	170,500	384,950
		569,500	**786,000**			**569,500**	**786,000**

General Journal			
Date	Description	Debit	Credit
		—— Rupees ——	
6-Jul-18	Office furniture – cost	40,000	
	Advances		40,000
16-Jul-18	Office furniture - Accumulated depreciation	75,000	
	Office furniture - cost		75,000
17-Jul-18	Payable control account (250,000–35,000)×3%	6,450	
	Discount received		6,450

Solutions **3**

Alpha Traders

Recording of transactions in relevant books of prime entry

Purchases day book		
Date	Supplier	Rupees
05-Aug-17	Moon & Co.	475,000
05-Aug-17	Shan Traders	513,000
		988,000

Purchases returns day book		
Date	Supplier	Rupees
10-Aug-17	Moon & Co.	68,000

Sales day book		
Date	Customer	Rupees
08-Aug-17	A-Z Super Store	236,000
08-Aug-17	Apollo Center	198,000
		434,000

Cash book									
Receipts					Payments				
Date	Description	Discount allowed memo	Cash	Bank	Date	Description	Discount received memo	Cash	Bank
		—— Rupees ——					—— Rupees ——		
01-08-17	Opening balance	-	178,000	-	01-08-17	Opening balance	-	-	769,000
12-08-17	Sales	-	40,000	-	02-08-17	Office furniture	-	38,000	-
16-08-17	A-Z Super Store	10,250	-	194,750	03-08-17	Purchases	-	85,000	-
16-08-17	Bright & Co.	12,800	-	243,200	25-08-17	Al-Shams	25,000	-	225,000
31-08-17	Closing balance	-	-	556,050	31-08-17	Closing balance	-	95,000	-
		23,050	**218,000**	**994,000**			**25,000**	**218,000**	**994,000**

General Journal			
Date	**Description**	**Debit**	**Credit**
		Rupees	
02-Aug-17	Office furniture	129,000	
	Payables control account		129,000
	(Purchased office furniture on credit)		
16-Aug-17	Discount expense [(194,750+243,200)÷95%×5%]	23,050	
	Receivables control account		23,050
	(Allowed 5% discount to A-Z Super Store and Bright Est.)		
20-Aug-17	Payables control account	200,000	
	Receivables control account		200,000
	(Adjustments of inter-company balances with Columbus Traders)		
25-Aug-17	Payables control account [225,000÷90%×10%]	25,000	
	Discount income		25,000
	(Availed 10% discount on payment to Al-Shams)		

Solutions **4**

(a)

Payables control account

		Rs.(000)			**Rs.(000)**
6	Bank	700	2	Purchases	4,590
7	Bank	350	9	Purchases	2,403
7	Discount received	25			
9	Purchase returns	400			
	Balance c/d	5,518			
		6,993			6,993
				Balance b/d	5,518

Receivables control account

		Rs.(000)			**Rs.(000)**
3	Sales	4,953	4	Bank	723
12	Sales	1,005	4	Discounts allowed	30
			5	Bank	1,500
			10	Sales returns	270
				Balance c/d	3,435
		5,958			5,958
	Balance b/d	3,435			

(b)

Receivables ledger balances at 31 May	Rs.(000)
Bailey Stores (753 – 723 – 30)	0
Fastshop (1,120 + 1,005)	2,125
Spencers (3,080 – 1,500 – 270)	1,310
Total balances	3,435

= Receivables control account balance: main ledger

(c)

Payables ledger balances at 31 May	Rs.(000)
Ellis (810 – 700)	110
Mendez Trading (1,305 + 753)	2,058
Gibson (375 – 350 – 25)	0
Dynasty (1,140 + 1,650 – 400)	2,390
Liners	960
Total balances	5,518

= Trade payables control account balance: main ledger

Solutions **5**

(a) Main ledger transactions

Date		**Debit**	**Credit**
June		**Rs.(000)**	**Rs.(000)**
1	Bank	6,500	
	Capital		6,500
2	Purchases	1,800	
	Payables control account		1,800
3	Receivables control account	1,340	
	Sales		1,340
4	Purchases	230	
	Bank		230
5	Motor van (asset account)	2,560	
	Bank		2,560
7	Motor expenses	120	
	Bank		120
9	Receivables control account	1,180	
	Sales		1,180

Date		Debit	Credit
June		Rs.(000)	Rs.(000)
11	Purchases	3,480	
	Payables control account		3,480
13	Payables control account	250	
	Purchase returns		250
19	Sales returns	110	
	Receivables control account		110
20	Drawings	440	
	Bank		440
21	Payables control account	1,080	
	Bank		1,080
23	Bank	660	
	Receivables control account		660
25	Cash in hand	430	
	Receivables control account		430
28	Payables control account	420	
	Purchase returns		420
29	Sundry expenses	40	
	Cash in hand		40
30	Receivables control account	960	
	Sales		960

(b) Receivables ledger entries

Date		Debit	Credit
June		Rs.(000)	Rs.(000)
3	J Bird	660	
3	D Swann	250	
3	Swallow Company	430	
9	M Parrott	240	
9	Canary Company	260	
9	G Finch	680	
19	D Swann		110

Date		**Debit**	**Credit**
June		**Rs.(000)**	**Rs.(000)**
23	J Bird		660
25	Swallow Company		430
30	D Swann	420	
	Canary Company	540	

(c) Payables ledger entries

Date		**Debit**	**Credit**
June		**Rs.(000)**	**Rs.(000)**
2	C Jones		1,800
11	C Jones		2,400
	E Davies		620
	A Evans		460
13	C Jones	250	
21	E Davies	620	
	A Evans	460	
28	C Jones	420	

Solutions **6**

(a) **Day books**

Purchases day book

Date	**Supplier**	**Rs.**
2 May	The Bushes Company	540,000
	Flower City	870,000
	D Gibson	250,000
	Weedkill	760,000
	T Greenery	640,000
		3,060,000
18 May	The Bushes Company	430,000
	Landscape	1,100,000
		1,530,000

Sales day book

Date	Customer	Rs.
4 May	The Office Company	430,000
	V Cork	640,000
	Texas Chain Stores	1,760,000
		2,830,000
21 May	Public Parks	670,000
		670,000

(b) Accounts in the main ledger

Capital

31	Balance c/f	2,500,000	1	Bank	2,500,000
		2,500,000			2,500,000
			1 June	Balance b/f	2,500,000

Cash at bank

1	Capital	2,500,000	6	Rent	120,000
9	The Office Company	430,000	12	D Gibson	250,000
10	Texas Chain Stores	1,500,000	12	The Bushes Company	540,000
			15	Advertising	230,000
			31	Rent	180,000
			31	Balance c/f	3,110,000
		4,430,000			4,430,000
1 June	Balance b/f	3,110,000			

Purchases

2	Payables	3,060,000			
18	Payables	1,530,000	31	Balance c/f	4,590,000
		4,590,000			4,590,000
1 June	Balance b/f	4,590,000			

Sales

			4	Receivables	2,830,000
31	Balance c/f	3,500,000	21	Receivables	670,000
		3,500,000			3,500,000
			1 June	Balance b/f	3,500,000

Payables control account

12	Cash at bank	790,000	2	Purchases	3,060,000
31	Balance c/f	3,800,000	18	Purchases	1,530,000
		4,590,000			4,590,000
			1 June	Balance b/f	3,800,000

Receivables control account

4	Sales	2,830,000	9	Cash at bank	430,000
21	Sales	670,000	10	Cash at bank	1,500,000
			31	Balance c/f	1,570,000
		3,500,000			3,500,000
1 June	Balance b/f	1,570,000			

Rent (expense)

6	Bank	120,000			
31	Bank	180,000	31	Balance c/f	300,000
		300,000			300,000
1 June	Balance b/f	300,000			

Advertising expenses

15	Bank	230,000	31	Balance c/f	230,000
		230,000			230,000
1 June	Balance b/f	230,000			

(c) **Accounts in receivables and payables ledgers**

Payables ledger

Payables – The Bushes Company

12	Cash at bank	540,000	2	Purchases	540,000
31	Balance c/f	430,000	18	Purchases	430,000
		970,000			970,000
			1 June	Balance b/f	430,000

Payables – Flower City

31	Balance c/f	870,000	2	Purchases	870,000
		870,000			870,000
			1 June	Balance b/f	870,000

Payables – D Gibson

12	Cash at bank	250,000	2	Purchases	250,000
		250,000			250,000

Payables – Weedkill

31	Balance c/f	760,000	2	Purchases	760,000
		760,000			760,000
			1 June	Balance b/f	760,000

Payables – T Greenery

31	Balance c/f	640,000	2	Purchases	640,000
		640,000			640,000
			1 June	Balance b/f	640,000

Payables – Landscape

31	Balance c/f	1,100,000	18	Purchases	1,100,000
		1,100,000			1,100,000
			1 June	Balance b/f	1,100,000

List of balances in the payables ledger

	Rs.
The Bushes Company	430,000
Flower City	870,000
D Gibson	nil
Weedkill	760,000
T Greenery	640,000
Landscape	1,100,000
	3,800,000

Receivables ledger

Receivables – The Office Company

4	Sales	430,000	9	Cash at bank	430,000
		430,000			430,000

Receivables – V Cork

4	Sales	640,000		Balance c/f	640,000
		640,000			640,000
1 June	Balance b/f	640,000			

Receivables – Texas Chain Stores

4	Sales	1,760,000	10	Cash at bank	1,500,000
				Balance c/f	260,000
		1,760,000			1,760,000
1 June	Balance b/f	260,000			

Receivables – Public Parks

21	Sales	670,000	Balance c/f	670,000
		670,000		670,000
1 June	Balance b/f	670,000		

List of balances in the receivables ledger:

	Rs.
The Office Company	nil
V Cork	640,000
Texas Chain Stores	260,000
Public Parks	670,000
	1,570,000

(d) **Trial Balance as at 31 May 2013**

Home Oak Garden Traders: Trial balance as at 31 May

	Debit Rs.	Credit Rs.
Capital		2,500,000
Bank	3,110,000	
Purchases	4,590,000	
Sales		3,500,000
Payables conrol account		3,800,000
Receivables control account	1,570,000	
Rent	300,000	
Advertising	230,000	
	9,800,000	9,800,000

5 OBJECTIVE BASED QUESTIONS

01. Samreen has made following transactions during current week:

Sales Rs. 15,000 out of which Rs. 4,000 are on cash

A customer paid 800 after availing discount of 2%

Rent paid Rs. 100

What is the total of receipt column of cash book?

(a) Rs. 15,800

(b) Rs. 4,800

(c) Rs. 4,700

(d) Rs. 15,700

02. A business has made following sales:

Credit sales Rs. 1,500

Cash sales Rs. 1,200

Which statement is correct for recording of sales transactions?

(a) Sales day book Rs. 1,500, Cash receipt book Rs. 1,200

(b) Cash receipt book Rs. 2,700

(c) Sales day book Rs. 1,500, Petty cash book Rs. 1,200

(d) Sales day book Rs. 2,700

03. Sufyan has purchased certain goods on credit from Aliyan. List price of the goods was Rs. 10,000. Trade discount of 2% was allowed. Aliyan also offered a discount of 1% if the amount due is paid within 10 days. Sufyan availed the discount.

For recording the above transactions by Sufyan; which books of prime entry are involved and at what amount?

(a) Purchase day book Rs. 10,000, Cash book discount column Rs. 298 and Cash book payment column Rs. 9,702

(b) Purchase day book Rs. 9,702, Cash book Rs. 9,702

(c) Purchase day book Rs. 9,800, Cash book discount column Rs. 98 and payment column Rs. 9,702

(d) Sales day book Rs. 9,800, Cash book discount column Rs. 98 and receipt column Rs. 9,702

04. A businessman maintains petty cash book under imprest system. The imprest amount is Rs. 500. During a month, payments totaling Rs. 300 were made.

How much amount will be reimbursed at the end of the month to restore the petty cash to the imprest amount?

(a) Rs. 200

(b) Rs. 300

(c) Rs. 500

(d) Rs. 800

05. Following information is available about Saim:

	Rs.
Receivable as on January 1, 2018	70,000
Receivable as on December 31, 2018	25,000
Cash received from customers during the year	250,000
Discount allowed to customers	4,000

What is the amount of total sales on credit during the year?

(a) Rs. 291,000

(b) Rs. 151,000

(c) Rs. 209,000

(d) Rs. 250,000

06. Alia's Account payable control ledger has a balance of Rs. 95,000 credit as on January 1, 2018. During the year, following transactions were performed:

	Rs.
Credit purchases	221,000
Cash purchases	85,000
Cheques issued to credit suppliers (after receiving discount of Rs. 2,000)	148,000
Credit purchases return	8,000

What is the amount shown in Account payable control ledger as on January 31, 2018?

(a) Rs. 158,000

(b) Rs. 160,000

(c) Rs. 243,000

(d) Rs. 245,000

07. In the books of Faizan; Sarmad has a debit balance of Rs. 3,000 and credit balance of Rs. 1,500. Sarmad has requested to adjust debit balance with credit.

What is the contra entry to be passed to adjust the balance?

(a) Dr Accounts receivable control a/c Rs. 3,000 Cr Accounts payable control a/c Rs. 3,000

(b) Dr Accounts payable control a/c Rs. 3,000 Cr Accounts receivable control a/c Rs. 3,000

(c) Dr Accounts receivable control a/c Rs. 1,500 Cr Accounts payable control a/c Rs. 1,500

(d) Dr Accounts payable control a/c Rs. 1,500Cr Accounts receivable control a/c Rs. 1,500

08. Usuf made following transactions during a certain month**:**

Credit sales 15,000 out of which Rs. 3,000 were returned by the customers subsequently

Cash sales amounting Rs. 8,000

Cash received from customers Rs. 4,000

What is the total of sales day book for the month?

(a) Rs. 15,000

(b) Rs. 12,000

(c) Rs. 23,000

(d) Rs. 20,000

09. Which of the following document is prepared by the business's store keeper on receiving goods in store?

(a) Goods dispatched note

(b) Goods received note

(c) Remittance advice

(d) Debit note

10. In which of the following book returns inwards are recorded?

(a) Sales returns book

(b) Purchase returns books

(c) Cash receipts book

(d) Cash payment book

11. Gross amount of purchases must be equal to:

(a) Total of all invoices issued to customers

(b) Total of all credit notes issued to customers

(c) Total of all debit notes sent by customers

(d) Total of all invoices received from supplier

12. Which of the following statement describes the nature of weekly imprest system for petty cash?

(a) Maximum amount of weekly petty cash expense is defined

(b) For maintaining a fixed float; an amount equal to weekly expenses incurred is reimbursed

(c) Proper authorization is required for all expense

(d) Business transfers an equal amount to petty cash balance at regular intervals

13. Hussain runs a business of purchase and sales of furniture. During a particular period Hussain made following transactions:

Sales to A Rs. 12,000

Sales to B Rs. 10,000 list price and trade discount 2%

Sales returns from A Rs. 3,000

What is the total of sales day book for the period?

(a) Rs. 22,000

(b) Rs. 21,800

(c) Rs. 19,000

(d) Rs. 18,800

14. A business made following transactions during a certain period:

Credit purchases Rs. 12,000; out of which Rs. 2,000 were rejected and subsequently returned to the supplier. Supplier allowed a discount of 1% on settlement of amount.

What is the net amount of cash paid to the supplier?

(a) Rs. 10,000

(b) Rs. 12,000

(c) Rs. 9,900

(d) Rs. 11,880

15. Which of the following items will appear on the debit side of a payable control ledger?

(a) Payment to credit supplier

(b) Cash purchases

(c) Refunds from a credit supplier

(d) Balance b/d

16. An Account receivable control ledger account had a closing balance of Rs. 23,200. This control account receivable ledger contained a contra to the account payable ledger of Rs. 1,100; but it had been posted to wrong side of control account.

What is the correct closing balance in account receivable control ledger account after correction of the above?

Rs. ___________

17. Following information relates to Sales transaction of Sabir during March 2019

- Receivables as at 1 March Rs. 35,000
- Receivables as at 31 March Rs. 42,000
- Receipts during the period (after allowing discount of Rs. 4,000) Rs. 29,000

What is the amount of credit sales during March?

Rs. ___________

18. A payable control account contains the following relevant entries for the year ended 31 December 2018:

	Rs.
Payment through bank	160,000
Credit purchases during the year	185,000
Discount received	16,000
Contra with receivable control account	7,000
Balance c/d as on Dec 31, 2018	22,000

There are no other transactions related to account payable.

What is the amount of balance b/d of account payable control account as on 1 January 2018?

Rs. ___________

19. A receivable ledger control account at 1 June 2017 had balances of Rs. 32,850 debit.

During the year, sales (net) of Rs. 245,000 were made on credit.

Receipts from customers amounted to Rs. 210,200 and cash discounts of Rs. 700 were allowed. Refunds of Rs. 1,300 were made to customers.

What should be the closing balance at 31 May 2018 of account receivable control account?

Rs. ___________

20. Sadia maintains an imprest system of petty cash. Float is maintained at Rs. 1,000. During February 2019 Sadia has made payments of Rs. 650. At end of February it is decided to increase float by Rs. 100.

What amount is needed to achieve the required float?

Rs. ___________

21. Which of the following is not a book of prime entry?

(a) Sales day book

(b) Petty cash book

(c) Journal

(d) Trial balance

22. The sales day book is a book of primary entry:

(a) For recording all sales

(b) For recording credit sales

(c) In which cash sales are first recorded

(d) In which credit sales are first recorded

23. The purchases day book is a book of primary entry:

- **(a)** For recording all purchases
- **(b)** For recording credit purchases
- **(c)** In which cash purchases are first recorded
- **(d)** In which credit purchases are first recorded

24. A Credit Note is issued to a:

- **(a)** Customer for return of goods
- **(b)** Supplier for return of goods
- **(c)** Customer to accept the goods
- **(d)** Supplier to accept the goods

25. A debit note is issue to a:

- **(a)** Customer for return of goods
- **(b)** Supplier for return of goods
- **(c)** Customer to accept the goods
- **(d)** Supplier to accept the goods

26. In which book of prime entry does receipt from a debtor worth Rs.200,000 enter?

- **(a)** Petty cash book
- **(b)** Cash book
- **(c)** Receivable ledger
- **(d)** Debtor book

27. In which book of prime entry does payment to supplier worth Rs.300,000 enter?

- **(a)** Petty cash book
- **(b)** Accounts payable journal
- **(c)** Cash payment journal
- **(d)** None of the above

28. In which book of prime entry does payment of entertainment expense worth Rs.1,500 is recorded?

- **(a)** Petty cash book
- **(b)** Cash payment journal
- **(c)** Bank book
- **(d)** None of the above

29. In which book of prime entry does purchases on account of Rs. 500,000 would be recorded?

(a) Cash book

(b) Accounts payable book

(c) Purchase day book

(d) None of the above

30. In which book of prime entry does cash purchases worth Rs. 500,000 would be recorded?

(a) Petty cash book

(b) Cash book

(c) Purchase day book

(d) Accounts payable book

31. In which book of prime entry does debit note received worth Rs.100,000 would be recorded?

(a) Accounts payable book

(b) Purchase journal

(c) Return inwards journal

(d) Returns outward journal

32. In which book of prime entry does sales on account of Rs. 700,000 would be recorded?

(a) Sales journal

(b) Accounts receivable journal

(c) Cash book

(d) Return inwards journal

33. In which book of prime entry does cash sales worth Rs. 250,000 would be recorded?

(a) Petty cash book

(b) Cash book

(c) Sales day book

(d) Accounts receivable book

34. In which book of prime entry does credit note received worth Rs.150,000 would be recorded?

(a) Accounts receivable book

(b) Sales day book

(c) Return inwards journal

(d) Returns outward journal

35. The Return Inwards account would be found in

- **(a)** The Sales ledger
- **(b)** The Nominal ledger
- **(c)** The Purchases Returns ledger
- **(d)** The Purchases ledger

5 OBJECTIVE BASED ANSWERS

01.	**(b)**	Cash sales Rs. 4,000+800 = Rs. 4,800
02.	**(a)**	Credit sales are recorded in sales day book and cash sales are recorded in cash receipt book
03.	**(c)**	Purchase day book : Rs. 10,000 x 98% = 9,800 Discount received column in Cash book: Rs. 9,800x1%=Rs. 98 Cash payment column in cash book = Rs. 9,800-Rs. 98 = Rs. 9,702
04.	**(b)**	The amount spent is reimbursed so that impress amount becomes available again.
05.	**(c)**	Sales = Rs. 250,000 Credit +4,000 Credit +25,000 credit -70,000 debit =Rs. 209,000
06.	**(a)**	Closing balance = Rs. 95,000+221,000- [148,000 + 2,000] -8,000= Rs. 158,000 Cash purchases have no effect on payables.
07.	**(d)**	Payables (Liabilities) decreased, resulting in debit Receivables (assets) decreased, resulting in credit Only lower amount may be offset.
08.	**(a)**	Credit sales are entered in the sales day books; sales returns are entered in sales returns day book (not deducted from sales day book total); cash sales and cash received from customers are entered in cash receipt book
09.	**(a)**	
10.	**(a)**	
11.	**(d)**	
12.	**(b)**	
13.	**(b)**	Total sales = Rs. 12,000+ (Rs. 10,000x0.98) = Rs. 21,800
14.	**(c)**	Net amount payable = Rs. 12,000-Rs. 2,000 = Rs. 10,000 Cash paid = Rs. 10,000 x 99%= Rs. 9,900
15.	**(a)**	
16.	**Rs. 21,000**	=Rs. 23,200 – [Rs. 1,100 x 2] = Rs. 21,000 Due to posting on wrong side; for correction double amount is to be credited
17.	**Rs. 40,000**	=Rs. 42,000+4000+29,000-35,000= Rs. 40,000
18.	**Rs. 20,000**	=Rs. 160,000+16,000+7,000+22,000-185,000=Rs. 20,000
19.	**Rs. 65, 650**	=Rs. 32,850+245,000-210,200 – 700 - 1,300 = Rs. 65,650
20.	**Rs. 750**	New float = Rs. 1,000+100 = Rs. 1,100 Amount required to restore and increase = Rs. 100+Rs. 650 = Rs. 750
21.	**(d)**	

22.	**(b)**	
23.	**(b)**	
24.	**(a)**	
25.	**(b)**	
26.	**(b)**	
27.	**(c)**	
28.	**(a)**	
29.	**(c)**	
30.	**(b)**	
31.	**(d)**	
32.	**(a)**	
33.	**(b)**	
34.	**(c)**	
35.	**(b)**	

CHAPTER

6

Bad and doubtful debts

Contents

1 BAD DEBTS

Section overview

- Introduction
- Accounting for bad debts
- Bad debts recovered

1.1 Introduction

A business might make all its sales for cash but many businesses make some or even all their sales on credit. There is often no alternative to offering credit to customers. If competitors offer credit then a business will have little alternative but to offer credit as well so as not to lose customer. A major benefit of offering credit is that it usually increases revenue, compared to what revenue would be if all sales were for cash.

If sales are made on credit, there is always a chance that some customers will fall into financial difficulty and be unable to pay what they owe.

It would be misleading to the users of the financial statements if a business continued to show receivables where is no chance, or only a slight chance of collecting them.

The application of the concept of prudence would require that there should be an adjustment to reflect the fact that there are some receivables which the business thinks that it will not recover.

There are two categories of problem receivables for which adjustment might be required.

Bad debts (also known as irrecoverable debts or receivables)

A bad debt is an amount owed by a customer that the business believes it will never be able to collect.

Examples of circumstances that might lead to the conclusion that a receivable is irrecoverable include:

- ☐ The bankruptcy or insolvency of a customer.
- ☐ The death of a customer who has left insufficient assets to pay off his debts.
- ☐ A dispute with a customer.
- ☐ The dishonesty of a customer (where he has obtained goods on credit with no intention to pay).

Doubtful debts

A doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so. For example, the business might know that the customer is in difficulty but that he might be able to work his way out of it. This casts doubt on the collectability of the receivable but it still might be possible if the customer is able to recover from his difficulties.

Examples of circumstances that might lead to the conclusion that a receivable is doubtful include:

- ☐ A customer experiencing cash flow problems.
- ☐ A customer taking an unusually long time to settle a debt.
- ☐ A customer experiencing operational difficulties which might lead to financial problems (for example, strikes, natural disasters disrupting production etc.).

Bad debts and doubtful debts are accounted for differently, although there is often just a single ***bad and doubtful debts expense account*** in the general ledger.

Prudence

A business should not show an asset in its financial statements at an amount greater than the cash it will generate. When such a circumstance arises the asset is reduced in value down to the cash expected to result from the ownership of the asset.

1.2 Accounting for bad debts

Bad debts are receivables that an entity is owed, but that it does not expect to collect.

When a specific debt (receivable) is considered bad or irrecoverable, it is written off. This means that it is removed from the accounting system and supporting records.

Illustration: Write off of bad debt – double entry

Write off of bad debt	Debit	Credit
General ledger:		
Bad and doubtful debts expense	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

When a bad debt is written off, it is reduced to zero in the receivables ledger (and total receivables account):

- ☐ The total value of receivables is reduced (reducing assets).
- ☐ The bad debt is recorded as an expense (reducing profit and hence capital).

Example: Write off of bad debt

A business has trade receivables of Rs. 750,000 but decides to write off a bad debt of Rs. 15,000.

Receivables control account

	Rs.		Rs.
Balance b/f	750,000	Bad and doubtful debts	15,000
		Closing balance c/f	735,000
	750,000		750,000
Opening balance b/f	735,000		

Bad and doubtful debts account (expense)

	Rs.		Rs.
Receivables	15,000		

At the end of the financial period, the bad debt expense is transferred to the statement of comprehensive income as an expense for the period.

General ledger	Rs.	Rs.
Statement of comprehensive income	15,000	
Bad and doubtful debts		15,000

(This reduces the balance on both accounts)

The balance on the customer's account in the receivables ledger is reduced by Rs.15,000 (in all probability, from Rs. 15,000 to Rs. 0.)

1.3 Bad debts recovered

On rare occasions cash in respect of a debt that had been written off as bad in a previous year is subsequently received in a later period. The double entry for recording the recovery of a bad debt is:

Illustration: Subsequent recovery of bad debt – double entry

Write off of bad debt	**Debit**	**Credit**
General ledger:		
Cash	X	
Bad debt expense		X

The credit reduces the bad debt expense account. This recognises that the business had previously recognised an expense when it first wrote off the debt where, in hindsight, it need not have done so.

2 DOUBTFUL DEBTS

Section overview

- Basic double entry for doubtful debts
- Accounting for changes in the allowance account
- Bad and doubtful debts together
- Doubtful debts recovered
- Aged receivables analysis
- Summary of the rules on bad and doubtful debts

2.1 Basic double entry for doubtful debts

As stated above, a doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so.

The accounting treatment has to serve two objectives.

- ☐ The exercise of prudence requires that the value of the receivable should be adjusted downwards (perhaps to zero) and an expense recognised for the loss in value; but
- ☐ The receivable must stay in the accounting records so that the business continues to chase payment.

This is achieved in the following way. Instead of writing off the debt (which would remove it from the records) a business sets up an allowance account.

Illustration: Accounting for doubtful debts – basic double entry

	Debit	Credit
General ledger:		
Bad and doubtful debts expense	X	
Allowance for doubtful debts		X
Receivables ledger:		
No entry		X

Note that the ***allowance account*** might also be called the ***provision for doubtful debts account***.

The allowance is a credit balance which is then set against the carrying amount of the receivables in the statement of financial position.

Illustration: Presentation of receivables in statement of financial position

In the statement of financial position:	Rs.
Trade receivables (net of bad debts written off)	X
Allowance for doubtful debts	(X)
Figure shown for trade receivables on the face of the statement of financial position	X

Measurement of the allowance

An allowance is only recognised for a debtor (receivable) if the business knows that the debtor might not pay. Therefore, when a business has information about the financial difficulties of specific debtors it would set up an allowance account for these.

In addition, a business with many debtors would know from experience that at the end of each year, some of the debtors are in financial difficulty but it does not know that how much they ultimately pay for their debts. In such cases a business might recognise a further general amount in the allowance. Note that the business would have to justify this amount; it cannot recognise a general allowance from its judgment. This must be based on verifiable experience.

Example: Measuring allowance for doubtful debts

The Kasur Cotton Company has receivables at the year-end of Rs.1,500,000.

It has carried out a year-end review of its receivables and discovered that a customer owing Rs.75,000 has suffered a fire at their factory which will stop production for 3 months. The chief accountant believes that this casts doubt on their ability to pay their debt.

In addition, it is the Company to recognise an allowance for 5% of its receivables. This is based on experience and the treatment has been approved by the company's auditor.

The Kasur Cotton Company would recognise the following allowance:

	Rs.
Allowance for specific receivable	75,000
Total receivables	1,500,000
Less amount for which there is a specific allowance	(75,000)
	1,425,000
General allowance @ 5%	71,250
Total allowance required (75,000 + 71,250)	146,250
In the statement of financial position:	
Trade receivables	1,500,000
Allowance for doubtful debts	(146,250)
Figure shown for trade receivables on the face of the statement of financial position	1,353,750

In summary, when a bad debt is written off, receivables are reduced. When an allowance for irrecoverable debts is created, total receivables are not reduced. Instead, the allowance for irrecoverable debts is recorded in a separate account in the general ledger – an allowance for irrecoverable debts account. This always has a credit balance.

2.2 Accounting for changes in the allowance account

The double entry shown above is a little simplistic. In practice a business will recognise an allowance balance at each year end. When this is the case it is the movement on the allowance that is recognised as an expense.

Example: Accounting for change in the allowance

A business started on 1st January Year 1.

The balance on receivables and the required allowance for doubtful debts at the end of each of the first three years were as follows:

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	20,000	24,000	18,000

Example: Accounting for change in the allowance (continued)

Bad and doubtful debts expense account

YEAR 1	Rs.		Rs.
Allowance account (1)	20,000	Statement of comprehensive income	20,000
	20,000		20,000
YEAR 2			
Allowance account (2)	4,000	Statement of comprehensive income	4,000
	4,000		4,000
YEAR 3			
Statement of comprehensive income	6,000	Allowance account (3)	6,000
	6,000		6,000

Allowance for doubtful debts

			Rs.
YEAR 1	Rs.	Balance b/d	0
		Expense account (1)	20,000
Balance c/d	20,000		
	20,000		20,000
YEAR 2			
		Balance b/d	20,000
Balance c/d	24,000	Expense account (2)	4,000
	24,000		24,000
YEAR 3			
Expense account (3)	6,000	Balance b/d	24,000
Balance c/d	18,000		
	24,000		24,000
		Balance b/d	18,000

Note that in year 3 there is a credit to the bad debt expense. This would reduce the expense recognised in the year (or may even be an item of income).

The following figures would appear in the statement of financial position at each year-end:

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	(20,000)	(24,000)	(18,000)
	980,000	1,176,000	882,000

It is not obvious in the above example but the way to calculate the expense in respect of the allowance account is to identify the movement on the allowance.

Remember that any balance on the allowance account is a credit balance.

Illustration: Change in the allowance

	Debit	Credit
Increase in allowance		
Bad and doubtful debts expense	X	
Allowance for doubtful debts		X
Decrease in allowance		
Allowance for doubtful debts	X	
Bad and doubtful debts expense		X

Example: Accounting for change in the allowance (continued)

Year 2

	Year 2	
Allowance required at the start of the year	20,000	Cr
Allowance required at the end of the year	24,000	Cr
	4,000	Cr

In order to change a credit balance of 20,000 to a credit balance of 24,000 we must:

	Dr	Cr
Bad and doubtful debts expense	4,000	
Allowance for doubtful debts		4,000

Year 3

	Year 3	
Allowance required at the start of the year	24,000	Cr
Allowance required at the end of the year	18,000	Cr
	6,000	Dr

In order to change a credit balance of 24,000 to a credit balance of 18,000 we must:

	Dr	Cr
Allowance for doubtful debts	6,000	
Bad and doubtful debts expense		6,000

2.3 Bad and doubtful debts together

Any question on this area will involve both bad debts and doubtful debts.

This is best seen with an example.

Example:

A business has trade receivables of Rs. 75,000.

It identifies that Rs. 5,000 of these debts are irrecoverable and should be written off.

An allowance for irrecoverable debts of Rs. 2,000 should be created. It is the first time that the business has opened such an account.

These transactions will be accounted for as follows:

Receivables account

	Rs.		Rs.
Opening balance b/f	75,000	Bad debt expense (1)	5,000
		Closing balance c/f	70,000
	75,000		75,000
Opening balance b/f	70,000		

Note: The balance on the trade receivables account is reduced by the bad debts written off, but not by the allowance for doubtful debts.

Bad and doubtful debts(expense)

	Rs.		Rs.
Receivables (1)	5,000	Statement of comprehensive income	7,000
Allowance (2)	2,000		
	7,000		7,000

Allowance for doubtful debts

	Rs.		Rs.
		B and DD expense (2)	2,000

In the statement of financial position, trade receivables will be reported as:

	Rs.
Trade receivables	70,000
Less: Allowance for irrecoverable debts	2,000
	68,000

Example (continued into year 2)

In year 2, credit sales were Rs. 200,000, receipts from customers were Rs. 185,000 and bad debts written off were Rs. 8,000.

The allowance for irrecoverable debts is to be reduced from Rs. 2,000 to Rs. 1,500.

These transactions can be summarised as follows:

Receivables account

	Rs.		Rs.
Opening balance b/f	70,000	Bank	185,000
Sales	200,000	Bad debt expense (1)	8,000
		Closing balance c/f	77,000
	270,000		270,000
Opening balance b/f	77,000		

Bad and doubtful debts (expense)

	Rs.		Rs.
Receivables (1)	8,000	Allowance (2)	500
		Statement of comprehensive income	7,500
	8,000		8,000

Note: The amount charged in this account as an expense for the period is the bad debt written off minus the reduction in the allowance for irrecoverable debts.

Allowance for doubtful debts

	Rs.		Rs.
B and DD expense (2) (2,000 – 1,500)	500	Opening balance b/f	2,000
Closing balance c/f	1,500		
	2,000		2,000
		Opening balance b/f	1,500

In the statement of financial position, trade receivables will be:

	Rs.
Trade receivables	77,000
Less: Allowance for irrecoverable debts	1,500
	75,500

Example: (continued)

Continuing the same example above, the following year (Year 3) sales (all on credit) were Rs. 250,000, receipts from customers were Rs. 252,000 and bad debts written off were Rs. 7,000.

It is decided to reduce the allowance for doubtful debts from Rs. 1,500 to Rs. 900. The transactions shall be recorded in the ledger accounts as follows:

Receivables control account

	Rs.		Rs.
Opening balance b/f	77,000	Bad and doubtful debts	
Sales	250,000	(bad debts written off)	7,000
		Bank	252,000
		Closing balance c/f	
		(= balancing figure)	68,000
	327,000		327,000
Opening balance b/f	68,000		

Bad and doubtful debts expense

	Rs.		Rs.
Trade receivables (= bad debts written off)	7,000	Allowance for doubtful debts	
		(= reduction in allowance)	6,00
		Statement of comprehensive income	
		(= balancing figure)	6,400
	7,000		7,000

Allowance for doubtful debts

	Rs.		Rs.
Bad and doubtful debts		Opening balance b/f	1,500
(= reduction in allowance)	600		
Closing balance c/f	900		
	1,500		1,500
		Opening balance b/f	1,500

Example: Hubbard

The doubtful debts allowance brought forward on 1 January in the books of Hubbard was Rs.86,000. Trade receivables at 31 December amounted to Rs.2,840,000 and bad debts to be written off totalled Rs.115,000. Hubbard has estimated that the closing balance on the doubtful debts allowance account should be 5% of accounts receivable.

The bad debts expense account and the doubtful debts allowance account will show the following activity.

(a) **Bad debts expense a/c**

		Rs.(000)			Rs.(000)
31 Dec	Trade receivables a/c	115	31 Dec	P&L	165
31 Dec	Doubtful debts all.	50			
		165			165

(b) **Doubtful debts allowance a/c**

		Rs.(000)			Rs.(000)
31 Dec	Balance c/d 2,725 (W) × 5%	136	1 Jan	Balance b/d	86
			31 Dec	Bad debts expense a/c	50
		136			136

Working

Trade receivables a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance c/d	2,840	31 Dec	Bad debt expense	115
			31 Dec	Balance c/d	2,725
		2,840			2,840
1 Jan	Balance b/d	2,725			

Practice question: Apu **1**

The financial records of Apu include an allowance for doubtful debts of Rs.206,000 brought forward on 1 January. Trade receivables at 31 December amount to Rs.2,440,000 and bad debts to be written off total Rs.55,000. An allowance for doubtful debts of 5% of receivables is to be carried forward.

Required:

Write up the bad debts expense account and the doubtful debts allowance account.

Practice question: Barney **2**

The following information is available for Barney:

Year 1

(1) 1 January: Doubtful debts allowance of Rs.860,000 standing on the books.

(2) 31 December: Trade receivables amount to Rs.15,000,000.

(3) Bad debts written off during the year amounted to Rs.1,000,000.

(4) An allowance for 7.5% of trade receivables is required.

Year 2

(1) 31 December: Trade receivables, before adjustments are Rs.13,700,000.

(2) Bad debts to be written off are Rs.1,100,000.

(3) A allowance for 7.5% of debts due is still considered necessary.

Required:

Show the journal entries to record the above and the relevant bad and doubtful debt allowance ledger accounts.

2.4 Doubtful debts recovered

The accounting treatment to record a receipt of cash in respect of a doubtful debt is the same as for any other debt.

Illustration: Subsequent recovery of doubtful debt – double entry

	Debit	Credit
General ledger:		
Cash	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

There is no special accounting treatment to reflect the fact that the business has received cash for a debt against which it has already recognised an expense.

Common sense suggests that the business should now recognise a credit to the statement of comprehensive income but this happens automatically through the use of basic allowance accounting.

This is because the recovered amount will no longer be included as an allowance when this is re-estimated at the year-end. If all other things are equal this will cause the allowance account to fall. This fall results in a credit to the bad and doubtful debt expense account thus reducing the expense recognised in the statement of comprehensive income.

Example: Doubtful debts recovered

At the start of a period a business has an allowance for doubtful debts made up as follows:

	Allowance	
Allowance required for customer A receivable	6,000	Cr
Allowance required for customer B receivable	2,000	Cr
	8,000	Cr

Customer B pays in full during the period.

The only necessary double entry is:

	Dr	Cr
Cash	2,000	
Receivables control account		2,000

At the period end the allowance for customer B's receivable is no longer required.

	Allowance	
Allowance required at the start of the year	8,000	Cr
Allowance required at the end of the year	6,000	Cr
	2,000	Dr

In order to change a credit balance of 8,000 to a credit balance of 6,000 we must:

	Dr	Cr
Allowance for doubtful debts	2,000	
Bad and doubtful debts expense		2,000

Therefore, the credit to the statement of comprehensive income to reflect the fact that an expense was previously recognised when, with hindsight, there was no need to do so, happens automatically when the year end allowance is remeasured.

2.5 Aged receivables analysis

Preparing an aged receivables analysis is a method of attempting to assess the likelihood of bad debts or to make an assessment of doubtful receivables. This is an analysis for each individual credit customer of their total debtor balance, showing how long each invoice has been outstanding. A typical format for an aged receivables analysis is given below:

Illustration: Aged debtors (receivables) analysis

Customer	*Credit limit* Rs.	*Total owed* Rs.	*< 30 days* Rs.	*30 – 60 days* Rs.	*60 – 90 days* Rs.	*Over 90 days* Rs.
X	20,000	5,500	3,000	–	2,500	–
Y	15,000	2,700	–	1,000	1,000	700

If a customer has old amounts outstanding, these should be investigated and an attempt should be made to collect payment. However the investigation may indicate that the amount should either be written off as a bad debt, or that an allowance should be made for an irrecoverable debt. (In other words, the debt is not written off yet, but the chances of it being paid look doubtful.)

2.6 Summary of the rules on bad and doubtful debts

The rules for dealing with bad debts and doubtful debts at the end of the financial year can be summarised as follows.

Illustration:

Annual charge in the statement of comprehensive income:	Rs.
Bad debts written off	X
Less: bad debts recovered	(X)
Plus: increase in allowance for doubtful debts; or	X
Less: decrease in allowance for doubtful debts	(X)
	X

In the statement of financial position	Rs.
Trade receivables (net of bad debts written off)	X
Allowance for doubtful debts	X
Figure shown for trade receivables on the face of the statement of financial position	X

Example: Bell

Bell is a sole trader making up his accounts to 31 July each year.

At 31 July Year 6 the balance on the allowance for doubtful debts account was Rs.1,420,000. During the following financial period ending 31 July Year 7, Bell suffered a number of bad debts amounting to Rs.723,000, which he wrote off to the bad debts account.

At 31 July Year 7 Bell listed out all his receivables balances, which totalled Rs.32,456,000. After reviewing the list Bell decided that three balances - namely Lee Rs.230,000, Bee Rs.562,000 and Yee Rs.56,000 - were all doubtful and had to be allowed for as doubtful debts. In addition, he considered that 2% of all the remaining balances were doubtful and had to be provided for.

The ledger accounts reflecting the necessary adjustments, and the relevant extracts from the financial statements shall be as follows:

Workings

Allowance for doubtful debts at 31 July Year 7:	**Rs.(000)**
Specific allowances to be made (230 + 562 + 56)	848
General allowance: 2% x (32,456 - 848)	632
Total allowance at 31 July Year 7	1,480

Allowance for doubtful debts account

Date		Rs.(000)	Date		Rs.(000)
			1.8.Yr6	Balance b/d	1,420
31.7.Yr7	Balance c/d (see workings)	1,480	31.7.Yr7	Bad debt expense	60
		1,480			1,480
			1.8.Yr7	Balance b/d	1,480

Bad debts account

Date		Rs.(000)	Date		Rs.(000)
	Accounts receivable	723	31.7.Yr7	Statement of comprehensive income (bad debts written off)	783
31.7.Yr7	Allowance for bad debt	60			
		783			783

Extracts from financial statements

Statement of comprehensive income	Rs.(000)
Bad debts written off	723
Increase in allowance for doubtful debts	60

Statement of financial position Current assets	Rs.(000)
Trade receivables	32,456
Less: allowance for doubtful debts	(1,480)
	30,976

Practice question: Nelson 3

Nelson makes allowance for doubtful debts at varying percentages based on statistical analysis and the level of outstanding trade receivables. The result of this policy for the last three years is as follows.

Year to December	2010	2011	2012
	Rs.(000)	Rs.(000)	Rs.(000)
Trade receivables at the year end (before adjusting for any bad debts)	196,860	151,020	216,020
Estimated bad debts (accounts in liquidation)	1,860	1,020	6,020
Doubtful debts allowance (%)	5%	6%	7.5%

The doubtful debts allowance at 1 January 2010 was Rs.10,000.

Required:

a) Write up the bad debts expense account and doubtful debts allowance account for each of the three years.

b) Show the relevant extracts from the statement of financial position for each of the three years.

Practice question: Flander 4

At 30 June 2011 Flanders's receivables were Rs.50,000,000. He decided to establish a doubtful debts allowance balance based on 5% of account balances at the statement of financial position date. He made the first allowance at 30 June 2011.

The following relates to the years ended 30 June 2012 and 30 June 2013.

	Year ended	30 June
	2012	2013
	Rs.(000)	Rs.(000)
Credit sales	480,000	550,000
Cash received from customers	432,000	560,600
Bad debts written off	6,000	2,000

Required:

Write up the receivables account, the bad debts expense account and doubtful debts allowance account.

Practice question: Homer 5

Homer commenced trading on 1 April 2010. He extracted the following list of balances from his sales ledger as at 31 March 2011:

	Rs.
Bart	200,000
Lisa	400,000
Others	6,300,000
	6,900,000

In the year to 31 March 2011:

(1) Bart emigrated leaving numerous debts.

(2) Lisa is disputing certain invoices, amounting to Rs.100,000, which have been outstanding for more than six months. Homer estimates that Lisa will eventually pay half the disputed amount.

In the year to 31 March 2012:

The sales ledger listing as at 31 March 2012 is as follows:

	Rs.
Maggie	240,000
Marge	400,000
Lisa	60,000
Others	6,600,000
	7,300,000

(1) Maggie has been declared bankrupt and her debt is to be written off.

(2) Marge is experiencing cash flow difficulties. Homer considers a 50% allowance to be appropriate.

(3) Homer is no longer supplying goods to Lisa. The balance, which is in respect of last year's disputed invoices, is to be written off.

In the year to 31 March 2013:

(1) Total receivables per the sales ledger listing are Rs.7,500,000 as at 31 March 2013.

(2) There are no debts requiring specific allowance.

(3) Rs.50,000 has been received from Maggie.

Required:

Assuming that Homer requires a general allowance for doubtful debts of 5%, write up the bad and doubtful debt expense and allowance accounts for the three years to 31 March 2013.

Practice question: Lopez **6**

In his first year of trading to 31 December 2011 Lopez made credit sales of Rs.200,000 and received Rs.150,000 from his credit customers.

At the end of the year he decided to write off Ludmila's debt of Rs.8,000, make a specific allowance for Jozef's debt totalling Rs.3,500 and create a general allowance of 5% of remaining trade receivables.

During his second year of trading he made sales on credit of Rs.300,000 and received cash of Rs.280,000 including Rs.4,000 from Ludmila. At 31 December 2012, he decided to write off Jozef's debt, and create a specific allowance against 50% of Chokin's total debt of Rs.6,000. He decided that his general allowance should now be 8% of remaining accounts receivable.

In the year to 31 December 2013 Lopez made credit sales of Rs.500,000 and received cash of Rs.400,000. Separate from this he also received a cheque from Chokin for Rs.6,000.

At the year end he decided to create a specific allowance against Paulo's debt of Rs.50,000 and maintain his general allowance at 8%.

Required:

For each of the above years show the trade receivables account, bad debt expense account and allowance for doubtful debts account, and the statement of financial position extract as at each year end.

Practice question: Automan Enterprises **7**

Following balances were extracted from the records of Automan Enterprises:

	31 Dec 2017	31 Dec 2016
Trade receivables	Rs. 618,500*	Rs. 558,800

after writing off receivables of Rs. 32,000 during 2017

The following adjustments need to be made at 31 December 2017:

i. Cash of Rs. 17,850 was received from MJM Traders whose balance had been written off in 2016. The amount received was credited to suspense account.

ii. Receivable from Noor Merchant of Rs. 31,800 which had been specifically provided for in full in 2016 is to be written off.

iii. A specific provision at 75% is to be made against balance of QT Bakers amounting to Rs. 24,200.

iv. A general provision is always maintained at 4% of the remaining receivables.

Required:

Prepare following ledger accounts for the year ended 31 December 2017:

☐ Provision for doubtful receivables

☐ Bad debt expense

Practice question: Global Network Supplies

8

Following information pertains to Global Network Supplies (GNS) for the year ended 30 June 2017:

	Rs. in '000
Trade debtors – as at 1 July 2016	55,975
Transactions for the year ended 30 June 2017:	
– Sales (including cash sales which is 20% of credit sales)	540,000
– Sales returns pertaining to credit sales	6,300
– Collection from credit customers (including Rs. 8.1 million from customers who availed 10% discount)	438,000

GNS maintains specific provision for doubtful debts on the basis of assessment of its debtors. In addition, a general provision is maintained at 4% of the remaining customers' balances.

The status of debtors being considered for the purpose of specific provision is as under:

Customer's name	Balances as on		Specific provision as at 1 July 2016	Adjustments required as at 30 June 2017
	1 July 2016	30 June 2017*		
	——— Rs. in '000 ———			
Mehran Link	400	320	65	Mehran Link is facing severe cash flow difficulties; therefore, a provision at 30% of the outstanding balance is required.
Bolan Dialing	480	480	240	The entire amount needs to be written-off as Bolan Dialing has been declared bankrupt.
Khyber Cables	135	90	95	The balance is in respect of old disputed invoices and needs to be written-off.
Ravi Rays	460	460	-	Ravi Rays has stopped buying from GNS. It has been decided to set-off Rs. 120,000 payable by GNS to Ravi Rays and make provision at 25% of the remaining balance.
	1,475	1,350	400	

before adjustment

Required:

Prepare following ledger accounts for the year ended 30 June 2017:

(a) Trade debtors

(b) Provision for doubtful debts

(c) Bad debt expense

Practice question: Ravi Enterprises **9**

Ravi Enterprises (RE) maintains specific provision for doubtful debts on the basis of individual assessment of its major customers. A general provision is also made at 5% of the remaining month-end balances. Following information pertains to trade debtors and provision for doubtful debts for the month of August 2016:

i. Opening balance:

		Rs. in million
Trade debtors		200.00
Provision for doubtful debts:		
– Specific	BEE Traders, 100% of the balance	(8.00)
	RAY Brothers, 60% of the balance	(6.00)
– General	5% of the remaining balance	(9.10)
		176.90

ii. Credit sales for the month amounted to Rs. 900 million.

iii. Collections from customers were Rs. 850 million, which included:
   - a recovery of Rs. 4.5 million against trade debts written-off in previous years; and
   - an amount of Rs. 7.2 million received net of 10% discount in full and final settlement of invoices.

iv. RAY Brothers were declared bankrupt and their debt has to be written-off.

v. A customer, TAJ & Co. has disputed certain sales invoices aggregating Rs. 2.8 million which have been outstanding for more than one year. RE estimates that the customer will eventually pay half of the disputed amount.

vi. Amounts aggregating Rs. 1.5 million due from general customers are not recoverable and have to be written-off.

Required:

Prepare following ledger accounts for the month of August 2016:

a) Provision for doubtful debts

b) Bad debt expense

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

(a) **Bad debts expense a/c**

		Rs.(000)			Rs.(000)
31 Dec	Trade receivables a/c	55	31 Dec	Doubtful debts a/c	87
31 Dec	P&L	32			
		87			87

(b) **Doubtful debts allowance a/c**

		Rs.(000)			Rs.(000)
31 Dec	Bad debts expense a/c	87	1 Jan	Balance b/d	206
31 Dec	Balance c/d (2,440 – 55) × 5%	119			
		206			206

Solutions **2**

Journal

	Dr	*Cr*
Year 1	**Rs.(000)**	**Rs.(000)**
Bad debts expense a/c	1,000	
Trade receivables a/c		1,000
Bad debts written off during the year		
Bad debts expense a/c	265	
Doubtful debts allowance a/c		265
Increase in allowance (to 7.5% of Rs.(000)15,000)		
P&L a/c	1,265	
Bad debts expense a/c		1,265
Write off of bad debts expense		
Year 2		
Bad debts expense a/c	1,100	
Trade receivables a/c		1,100
Bad debts written off at 31 December		
Doubtful debts allowance a/c	180	
Bad debts expense a/c		180

Reduction in allowance (to 7.5% of Rs.(000)12,600)

P&L a/c	920	
Bad debts expense a/c		920

Debts written off to P&L

Bad debts expense a/c

Year 1		Rs.(000)			Rs.(000)
	Debts written off	1,000	31 Dec	P&L a/c (βal)	1,265
31 Dec	Doubtful debts allowance	265			
		1,265			1,265
Year 2					
31 Dec	Trade receivables a/c	1,100	31 Dec	Doubtful debts allowance	180
			31 Dec	P&L a/c (βal)	920
		1,100			1,100

Doubtful debts allowance a/c

Year 1		**Rs.(000)**			**Rs.(000)**
			1 Jan	Balance b/d	860
31 Dec	Balance c/d 15,000 x 7.5%	1,125	31 Dec	Bad debts expense a/c (Bal)	265
		1,125			1,125
Year 2					
31 Dec	Bad debts expense a/c (Bal)	180	1 Jan	Balance b/d	1,125
31 Dec	Balance c/d 13,700 – 1,100 x 7.5%	945			
		1,125			1,125

Solutions **3**

(a) **Doubtful debts allowance a/c**

2010		Rs.(000)	*2010*		Rs.(000)
31 Dec	Bad debts expense (Bal)	250	1 Jan	Balance b/d	10,000
	Balance c/d	9,750			
		10,000			10,000
2011			*2011*		
31 Dec	Bad debts expense	750	1 Jan	Balance b/d	9,750
	Balance c/d	9,000			
		9,750			9,750
2012			*2012*		
			1 Jan	Balance b/d	9,000
31 Dec	Balance c/d	15,750	31 Dec	Bad debts expense	6,750
		15,750			15,750
			2013		
			1 Jan	Balance b/d	15,750

Bad debts expense a/c

2010		Rs.(000)	*2010*		Rs.(000)
31 Dec	Trade receivables a/c	1,860	31 Dec	Doubtful debts	250
				P&L a/c (Bal)	1,610
		1,860			1,860
2011			*2011*		
31 Dec	Trade receivables a/c	1,020	31 Dec	Doubtful debts	750
				P&L a/c (Bal)	270
		1,020			1,020
2012			*2012*		
31 Dec	Trade receivables a/c	6,020			
	Doubtful debts	6,750	31 Dec	P&L a/c (Bal)	12,770
		12,770			12,770

(b) **Statement of financial position at 31 December (extracts) – All figures in Rs.(000)**

	2010	2011	2012
Current assets			
Trade receivables	195,000	150,000	210,000
Less Doubtful debts allowance	9,750	9,000	15,750
	185,250	141,000	194,250

Solutions **4**

(a) **Trade receivables a/c**

		Rs.(000)			Rs.(000)
1 Jul 2011	Balance b/d	50,000		Cash	432,000
	Sales	480,000		Bad debts	6,000
			30 Jun 2012	Balance c/d	92,000
		530,000			530,000
1 Jul 2012	Balance b/d	92,000		Cash	560,600
	Sales	550,000		Bad debts	2,000
30 Sep 2012	Debt “reinstated”	600	30 Jun 2013	Balance c/d	80,000
		642,600			642,600
1 Jul 2013	Balance b/d	80,000			

(b) **Doubtful debts allowance a/c**

		Rs.(000)			Rs.(000)
			1 Jul 2011	Balance b/d (W1)	2,500
30 Jun 2012	Balance c/d (W2)	4,600	30 Jun 2012	Bad debts (Bal)	2,100
		4,600			4,600
30 Jun 2013	Bad debts (Bal)	600	1 Jul 2012	Balance b/d	4,600
30 Jun 2013	Balance c/d (W3)	4,000			
		4,600			4,600
			1 Jul 2013	Balance b/d	4,000

(c) **Bad debts expense a/c**

		Rs.(000)			Rs.(000)
	Trade receivables (write off)	6,000	30 Jun 2012	P&L a/c	8,100
30 Jun 2012	Increase in doubtful debts a/c	2,100			
		8,100			8,100
	Trade receivables (write off)	2,000	30 Sep 2012	Trade receivables recovery	600
			30 Jun 2013	Decrease in doubtful debts a/c	600
			30 Jun 2013	P&L a/c	800
		2,000			2,000

Workings

(1) Allowance at 30 June 2011 = 5% × Rs.50,000,000 = Rs.2,500,000

(2) Allowance at 30 June 2012 = 5% × Rs.92,000,000 = Rs.4,600,000

(3) Allowance at 30 June 2013 = 5% × Rs.80,000,000 = Rs.4,000,000

Solutions **5**

Doubtful debts allowance a/c

		Rs.(000)			Rs.(000)
31.3.11	Balance c/d (W1)	365	(2)	Bad debts expense	365 (β)
		365			365
			1.4.11	Balance b/d	365
31.3.12	Balance c/d (W2)	530	(2)	Bad debts expense	165 (β)
		530			530
(2)	Bad debt expense	155 (β)	1.4.12	Balance b/d	530
31.3.13	Balance c/d (W3)	375			
		530			530
			1.4.13	Balance b/d	375

Bad debt expense a/c

		Rs.(000)			Rs.(000)
(1)	Write off – Bart	200	31.3.11	To P&L a/c	565
(2)	Allowance a/c	365			
		565			565
(1)	Write off – Maggie	240			
(3)	Write off – Lisa	60			
(2)	Allowance a/c	165	31.3.12	To P&L a/c	465
		465			465
			(3)	Maggie (CB receipt)	50
31.3.13	To P&L a/c	205	(2)	Allowance a/c	155
		205			205

Tutorial note: When Homer receives Rs.50,000 from Maggie there will be no balance on Maggie' a/c against which to allocate it so it has been credited to the expense a/c. Alternatively, if Homer credited the Rs.50,000 to the trade receivables a/c the debt would have to be reinstated ie

Dr Trade receivables

Cr Bad debt expense

Workings

(1) Allowance required 31.3.11

			Rs. (000)
Specific Allowance (Lisa):	½ × 100,000	=	50
General Allowance:	5% × 6,300,000	=	315
			365

(2) Allowance required 31.3.12

			Rs.(000)
Specific Allowance (Marge)	½ × 400,000	=	200
General Allowance:	5% × 6,600,000	=	330
			530

(3) Allowance required 31.3.13

			Rs.(000)
General Allowance:	5% × 7,500,000	=	375

Solutions **6**

Trade receivables

		Rs.			Rs.
2011			*2011*		
Sales revenue		200,000	Cash receipts		150,000
			Bad debt expense (w/o)		8,000
			31.12.99	Balance c/d	42,000
		200,000			200,000
2012			*2012*		
1.1.01	Balance b/d	42,000	Cash receipts		280,000
	Sales revenue	300,000	Bad debt expense (w/o)		3,500 (2)
	Bad debt expense (Ludmila)	4,000	31.12.01	Balance c/d	62,500
		346,000			346,000
2013			*2013*		
1.1.02	Balance b/d	62,500	Cash receipts		400,000
	Sales revenue	500,000	Cash (Chokin)		6,000 (3)
			31.12.02	Balance c/d	156,500
		562,500			562,500
2014					
1.1.03	Balance b/d	156,500			

Tutorial notes

(1) If the receipt from Ludmila was not included in the 280,000 but had been recognised as a receipt from a customer with whom Lopez is no longer trading, it could have been credited directly to the bad debt expense a/c (as a recovery).

(2) It is unnecessary to adjust the write-off of Jozef's balance against the allowance a/c just because it had previously been provided for. The allowance previously made is effectively "released" to the expense a/c because it is no longer required.

(3) Because Chokin's debt has only been provided against but not written off it would be wrong top make a "reinstatement" adjustment.

Bad debt expense a/c

	Rs.		Rs.
2011		*2011*	
Trade receivables (Ludmila)	8,000		
Allowance for doubtful debts	5,425	31.12.99 I&E a/c	13,425
	13,425		13,425
2012		*2012*	
Trade receivables (Jozef)	3,500	Trade receivables (Ludmila)	4,000
Allowance for doubtful debts	2,095	31.12.01 I&E a/c	1,595
	5,595		5,595
2013		*2013*	
Allowance for doubtful debts	51,000	31.12.02 I&E a/c	51,000

Allowance for doubtful debts a/c

	Rs.		Rs.
2011		*2011*	
31.12.99 Balance c/d (W1)	5,425	Bad debt expense	5,425
2012		*2012*	
31.12.01 Balance c/d (W2)	7,520	1.1.01 Balance b/d	5,425
		Bad debt expense	2,095
	7,520		7,520
2013		*2013*	
		1.1.02 Balance b/d	7,520
31.12.02 Balance c/d (W3)	58,520	Bad debt expense	51,000
	58,520		58,520

Workings

		Rs.
(1)	Allowances year 1	
	Specific (Jozef)	3,500
	General 5% × Rs.(42,000 – 3,500)	1,925
		5,425
(2)	Allowances year 2	
	Specific (Chokin) (50% × 6,000)	3,000
	General 8% × Rs.(62,500 – 6,000)	4,520
		7,520

(3) Allowances year 3

Specific (Paulo)	50,000
General 8% × (Rs.156,500 – 50,000)	8,520
	58,520

Statement of financial position extracts

	31 December 2011 Rs.	 2012 Rs.	 2013 Rs.
Trade receivables	42,000	62,500	156,500
Less Allowance for doubtful debts	(5,425)	(7,520)	(58,520)
	36,575	54,980	97,980

Solutions **7**

Bad debt expense

Description	Rs. in '000	Description	Rs. in '000
Provision for doubtful debts	51,570	Bad debts recovered - MJM Traders	17,850
		P & L **(Bal. figure)**	33,720
	51,570		**51,570**

Provision for doubtful receivables

Description	Rs. in '000	Description	Rs. in '000
Write off during the year	32,000	Opening balance **(W-1)**	52,880
Write off - Noor Merchant	31,800	Bad debts expense **(Bal. figure)**	51,570
Closing balance **(W-2)**	40,650		
	104,450		**104,450**

W-1: Opening provision for doubtful receivables		**Rs. in '000**
Specific - Noor merchant	31,800 × 100%	31,800
General	(558,800 – 31,800) × 4%	21,080
		52,880

W-2: Closing provision for doubtful receivables		**Rs. in '000**
Specific - QT Bakers	24,200 × 75%	18,150
General	(618,500 – 31,800 – 24,200) × 4%	22,500
		40,650

Solutions **8**

(a) **Trade debtors**

Date	Description	Rs. in '000	Date	Description	Rs. in '000
1-Jul-16	Balance b/d	55,975	30-Jun-17	Sales return	6,300
	Cr. Sales (540,000 ÷120×100)	450,000		Bank	438,000
				Discount exp. (8,100÷90%×10%)	900
				Account payable – Ravi Rays	120
				Provision for doubtful debts:	
				- Bolan Dialing (Write-off)	240
				- Khyber Cables (Write-off)	90
				Bad debt expense	
				- Bolan Dialing (Write-off)	240
				Balance c/f	60,085
		505,975			**505,975**

(b) **Provision for doubtful debts**

Date	Description	Rs. in '000	Date	Description	Rs. in '000
30-Jun-17	Trade debtors a/c (written-off)		1-Jul-16	Balance b/d	
	- Bolan Dialing	240		- General (55,975-400-480-135)×4%	2,198
	- Khyber Cables	90		- Specific provision	400
	Bad debt exp. a/c (Excess prov. written back)		30-Jun-17	Bad debt expense (Balancing - provision for the year)	295
	Khyber Cables (95-90)	5			
	Balance c/f:				
	- General provision **(W-1)**	2,377			
	- Specific: Mehran (320×30%)	96			
	Ravi (460–120)×25%	85			
		2,558			
		2,893			**2,893**

W-1: General provision for doubtful debts for the year		Rs. in '000
Trade debtors as at 30 June 2017	**As (a) above**	60,085
Less: Trade debtors closing balances subject to specific provision:		
- Mehran Link		(320)
- Ravi Rays	(460-120)	(340)
Trade debtors subject to gen. provision		**59,425**
General provision - closing balance	59,425×4%	**2,377**

(c)

Bad debt expense

Date	Description	Rs. in '000	Date	Description	Rs. in '000
30-Jun-17	Trade debtors (Written off)		30-Jun-17	Provision for doubtful debts;	
	Bolan Dialing	240		(reversal of excess provision)	
	Provision for doubtful debts	295		Khyber Cables (95-90)	5
				Profit or loss account **(Bal.)**	530
		535			**535**

Solutions

9

(a)

Provision for doubtful debts

Date	Particulars	Rs. in million	Date	Particulars	Rs. in million
(iv)	Trade debtors-RAY W. off	6.00	1-Aug	Balance b/d (8+6+9.1)	23.10
(vi)	Trade debtors (General debtors written-off)	1.50	(iii)	Bank (recovery of old written-off balance)	4.5
31-Aug	Bad debt exp. **(balancing)**	0.53	(v)	Bad debt exp. TAJ & Co.	1.40
31-Aug	Balance c/d **(W-1)**	20.97			
		29.00			**29.00**

	W-1: Trade debtors and provision of doubtful debts		**Dr./(Cr.)** **Rs. in million**
(i)	Opening balance		200.00
(ii)	Credit sales		900.00
(iii)	Collection from trade debtors	(850 – 4.5)	(845.50)
(iii)	Adj. for collection net of 10% payment discount (7.2 ÷ 90% × 10%)		(0.80)
(iv)	RAY's balance written off on declaration of its bankruptcy (6 ÷ 60%)		(10.00)
(vi)	Amount due from general debtors written-off		(1.50)
	Trade debtors balance as at 31-08-2016		242.20
(v)	**Less:** Trade debtors subject to specific provision:	- TAJ balance	(2.80)
		- BEE Traders (opening balance)	(8.00)
	Trade debtors subject to general provision		**231.40**
	General provision	(231.4× 5%)	11.57
	Specific provision: Taj & Co.	(2.8×50%)	1.40
	BEE Traders		8.00
	Provision for bad debts as at 31 August 2016		**20.97**

(b) **Bad debt expense**

Date	Particulars	Rs. in million	Date	Particulars	Rs. in million
(iv)	Trade debtors – RAY (6÷0.6–6)	4.00	31-Aug	Prov. for doubtful debts	0.53
(v)	Prov. for doubtful debts – TAJ	1.40	31-Aug	Profit or loss account **(bal)**	4.87
		5.40			**5.40**

3 OBJECTIVE BASED QUESTIONS

01. The opening balance of “allowance for doubtful debts account” is Rs. 1,000 whereas the closing balance of Receivables account is Rs. 100,000.

What amount of allowance for doubtful debts should be charged to statement of comprehensive income using a 5% allowance for doubtful debts for the current accounting period?

- **(a)** Rs. 4,000
- **(b)** Rs. 5,000
- **(c)** Rs. 2,000
- **(d)** Rs. 1,000

02. At December 31, 2018 a company’s receivable totaled Rs. 600,000 and an allowance for bad and doubtful debts of Rs. 60,000 had been brought down from last year.

It was decided to write off the debts totaling Rs. 25,000 and to adjust allowance for receivable @ 10% of the receivable.

At what amount receivables are to be shown in statement of financial position as at 31 December 2018?

- **(a)** Rs. 572,500
- **(b)** Rs. 517,500
- **(c)** Rs. 540,000
- **(d)** Rs. 575,000

03. A business has closing receivables balance is Rs. 75,000. It includes one of the accounts receivable named Ali, who is going through financial crisis. It is expected that he can pay 75% of his total debt of Rs. 5,000. Business has decided to calculate an allowance for doubtful debt at 5%.

What is the amount of allowance to be deducted from receivable in statement of financial position?

- **(a)** Rs. 3,500
- **(b)** Rs. 3,750
- **(c)** Rs. 7,250
- **(d)** Rs. 4,750

04. The nature of “Allowance for doubtful debt” account is:

- **(a)** Contra asset account
- **(b)** Asset account
- **(c)** Expense
- **(d)** Liability account

05. At the end of accounting period, KLM Company finds out that its total Receivables are Rs. 10,000. On scrutiny of accounts, it turned out that a bad debt amounting to Rs. 1,000 was not recorded in the books of accounts. Furthermore, having considered the current economic situation, management of the company decided to increase the allowance for doubtful debts by Rs. 500.

Find out what net amount to be expensed out in the statement of comprehensive income?

- **(a)** Rs. 10,000
- **(b)** Rs. 1000
- **(c)** Rs. 11,000
- **(d)** Rs. 1500

06. At January 1, 2017 the allowances for receivable of Sidra was Rs. 35,000. During the year ended 31 December 2017 debts totaling Rs. 15,000 were written off. It was decided that the allowance for doubtful debts should be Rs. 30,000 as at December 31, 2017.

What amount should be charged to statement of comprehensive income of Sidra for bad and doubtful debts expense?

(a) Rs. 30,000

(b) Rs. 45,000

(c) Rs. 15,000

(d) Rs. 10,000

07. Which of the following can be most relevant to calculation of allowance for doubtful debts?

(a) Total credit sales

(b) Total credit purchases

(c) Total current assets

(d) Total current liabilities

08. At January 1, 2017 the balance in allowance for receivable showed Rs. 16,000. At the end of the year it is decided to write off Rs. 9,000 and adjust allowance for receivable to Rs. 18,000.

What will be the effect of this decision on profit for the year?

(a) Decrease by Rs. 27,000

(b) Increase by Rs. 18,000

(c) Decrease by Rs. 11,000

(d) Decrease by Rs. 9,000

09. Sania creates allowance for doubtful debts after considering the length of time the debt remains outstanding.

She has provided following data as at 31st March 2018

Debt amount Rs.	Days outstanding	Allowance required
130,000	30 days	Nil
75,000	31-60	2%
50,000	Over 60 days	5%

Opening balance of allowance for doubtful debts was Rs. 3,500.

What is the amount to be charged to statement of comprehensive income for the year?

(a) Rs. 4,000

(b) Rs. 3,500

(c) Rs. 500

(d) Rs. 7,500

10. Which of the following Receivables have highest probability to default on trade debts?

- **(a)** Current month Receivables
- **(b)** Over 90 days old Receivables
- **(c)** 60 to 90 days old Receivables
- **(d)** 30 to 60 days old Receivables

11. A business has received an amount of Rs. 1,000 from a receivable that had been previously written off as irrecoverable.

What is the correct accounting entry to record the transaction?

- **(a)** Dr Cash 1,000 Cr Bad and doubtful debts expense a/c Rs. 1,000
- **(b)** Dr Cash 1,000 Cr Receivables Rs. 1,000
- **(c)** Dr Statement of comprehensive income Rs. 1,000 Cr Receivables Rs. 1,000
- **(d)** Dr Statement of comprehensive income Cr Cash Rs. 1,000

12. A business has provided following information;

	Rs.
Opening receivables	45,000
Credit sales	55,000
Cash sales	10,000
Cash received from customers	35,000
Bad debts written off	2,000
Discount received	3,000

The business maintains allowance at 2% of receivables each year.

What accounting entry is to be passed to record the increase/ decrease of allowance to the statement of comprehensive income?

- **(a)** Dr Bad and doubtful debts expense Rs. 360 Cr Allowance for doubtful debts Rs. 360
- **(b)** Dr Allowance for doubtful debts Rs. 360 Cr Bad and doubtful debts expense Rs. 360
- **(c)** Dr Bad and doubtful debts expense Rs. 360 Cr Receivables. 360
- **(d)** Dr Receivables Rs. 360 Cr Bad and doubtful debts expense Rs. 360

13. At year end, the receivable balance on 31 March 2019 is Rs. 93,000. This includes a debt of Rs. 1,800 which needs to be written off.

The business maintains allowance for doubtful debts at 5% of Receivable balance. And this year allowance has increased by 20% as compared to last year.

What was the balance of Allowance for doubtful debts at 1 April 2018?

- **(a)** Rs. 3,875
- **(b)** Rs. 5,472
- **(c)** Rs. 3,800
- **(d)** Rs. 4,560

14. At 30 September 2012 a company's allowance for receivables amounted to Rs. 38,000, which was five per cent of the receivables at that date.

At 30 September 2013 receivables totalled Rs. 868,500. It was decided to write off Rs. 28,500 of debts as irrecoverable and, based on past experience, to keep the allowance for receivables at 5% of receivables.

What should be the charge in the statement of comprehensive income for the year ended 30 September 2013 for the total of bad debts and the allowance for receivables?

(a) Rs. 42,000

(b) Rs. 33,925

(c) Rs. 70,500

(d) Rs. 32,500

15. The allowance for receivables in the accounts at 31 October 2011 was Rs. 9,000. During the year ended 31 October 2012, bad debts of Rs. 5,000 were written off.

The receivables balance at 31 October 2012 was Rs. 120,000 and, based on past experience, the company wishes to set the allowance at 5% of receivables.

What is the total charge for bad debts and the allowance for receivables in the statement of comprehensive income for the year ended 31 October 2011?

(a) Rs. 2,000

(b) Rs. 3,000

(c) Rs. 5,000

(d) Rs. 8,000

16. Hamza has following information available for his business for the year ended 31st December 2017:

Opening allowance for doubtful debts	Rs. 5,000
Bad debts written off during the year	Rs. 3,000
Bad debts recovered	Rs. 1,500
Closing receivables	Rs. 90,000
Closing allowance for doubtful debts	5%.

What is the net charge for irrecoverable and doubtful debts for statement of comprehensive income?

Rs. ___________

17. At June 30, 2016 a company's allowance for receivable amounted to Rs. 25,000 which was 2% of the trade receivables at that date.

At June 30, 2017 trade receivable amounted to Rs. 310,000. It was decided to write off Rs. 30,000 of debts as irrecoverable and to keep the allowance for receivable at 2% of trade receivable.

At what amount receivables would be shown in statement of financial position at 30 June 2017?

Rs. ___________

18. At July 1, 2017Mira's allowance for receivable was Rs. 65,000.

At June 30, 2018 trade receivable amounted to Rs. 650,000. It was decided to write off Rs. 95,000 of these debts and adjust the allowance for receivable to Rs. 75,000.

At what amount receivables (net) to be appear in statement of financial position?

Rs. ___________

19. At January 1, 2018 the balance in allowance for receivable showed Rs. 38,000. At the end of the year it is decided to write off Rs. 16,000 and adjust allowance for receivable to Rs. 35,000.

What will be the charge for irrecoverable and doubtful debts for the year?

Rs. ___________

20. After writing off bad debts, Rashid has outstanding receivables of Rs. 238,750. He identifies two specific amounts for which he wishes to make full allowance:

- Rs. 450 owing by Syed
- Rs. 1,200 owing by Raja

Rashid also wishes to maintain a general allowance of 5% of outstanding receivables.

What amount is shown on Rashid's statement of financial position in respect of receivables?

Rs. ___________

21. Which of the following is the effect on net profit if a business decreases provision for doubtful debts?

(a) It will increase net profit

(b) It will decrease net profit

(c) It will increase gross and net profit

(d) No effect

22. What is the nature of allowance for doubtful debt account?

(a) An asset

(b) A liability

(c) An equity

(d) Contra asset account

23. Is there a difference in bad and double debts?

(a) No, they are inter-changeable

(b) Yes, bad debt refers to an account receivable that has been clearly identified as not being collectible. Whereas a doubtful debt is an account receivable that might become a bad debt at some point in the future

(c) Yes, doubtful debt refers to an account receivable that has been clearly identified as not being collectible. Whereas a bad debt is an account receivable that might become a bad debt at some point in the future

(d) They are synonymous

24. What is the double entry for recording write-off of doubtful debts?

(a) Bad debt expense (debit) and allowance for doubtful debts (credit)

(b) Bad debt expense (debit) and accounts receivable (credit)

(c) Allowance for doubtful debts (debit) and accounts receivable (credit)

(d) None of the above

25. On June 1, Rs.800,000 of goods are sold with credit terms of 1/10, n/30. How much should the seller expect to receive if the buyer pays on June 8?

(a) 720,000

(b) 768,000

(c) 792,000

(d) No change

26. On June 1, Rs.800,000 of goods are sold with credit terms of 1/10, n/30. On June 3, the customer returned Rs.100,000 of the goods.

How much should the seller expect to receive if the buyer pays on June 8?

(a) 692,000

(b) 693,000

(c) 694,000

(d) 700,000

27. Which account should be credited for Rs180,000 when writing off the account?

(a) Accounts receivable

(b) Allowance for doubtful debts

(c) Bad debts expense

(d) None of the above

28. Sorting a company's accounts receivable into classifications such as current, 1-30 days past due, and 31-60 days past due etc. is known as the?

(a) Ratio analysis

(b) Trend analysis

(c) Debtor's analysis

(d) Aging analysis

29. The opening balance of "allowance for doubtful debts account" is Rs.1,000 whereas the closing balance of Receivables account is Rs.100,000.

What amount of allowance for doubtful debts should be charged to statement of profit or loss using a 5% allowance for doubtful debts for the current accounting period?

(a) Rs.3,000

(b) Rs.4,000

(c) Rs.5,000

(d) Rs.6,000

30. The Allowance for doubtful debts account has a year-end credit balance, prior to adjustment of Rs.500. The bad debts are estimated at 7% of Rs.60,000 of outstanding accounts receivable.

After the appropriate adjusting entry to recognize the bad debt expense, the Allowance for Doubtful Accounts should have a ___________ credit balance.

(a) Rs.4,200

(b) Rs.3,700

(c) Rs.3,200

(d) Rs.4,500

3 OBJECTIVE BASED ANSWERS

<table>
<tr><td>01.</td><td>(a)</td><td>Closing allowance = Rs. 100,000x5% = Rs. 5,000
Charge to statement of profit or loss = 5,000 - 1,000= Rs. 4,000</td></tr>
<tr><td>02.</td><td>(b)</td><td><table>
<tr><td></td><td></td><td>Rs.</td></tr>
<tr><td>Closing receivables</td><td>600,000 - 25,000</td><td>575,000</td></tr>
<tr><td>Closing allowance</td><td>575,000x10%</td><td>57,500</td></tr>
<tr><td>Carrying amount of receivables</td><td>575,000 - 57,500</td><td>517,500</td></tr>
</table></td></tr>
<tr><td>03.</td><td>(d)</td><td>Closing allowance = (Rs. 75,000 - 5000) x5% = Rs. 3,500 + (Rs. 5,000 x 25%) = Rs. 4,750</td></tr>
<tr><td>04.</td><td>(a)</td><td></td></tr>
<tr><td>05.</td><td>(d)</td><td>Expense = Irrecoverable debts + increase in allowance = Rs. 1,000+500= Rs. 1,500</td></tr>
<tr><td>06.</td><td>(d)</td><td>Charge = Closing allowance-Opening allowance + debts written off
= Rs. 30,000 - Rs. 35,000 + Rs. 15,000 = Rs. 10,000</td></tr>
<tr><td>07.</td><td>(a)</td><td>Allowance for doubtful debts are calculated usually on the basis of receivables. However, second most reliable amount is of credit sales as debt arises because of credit sales and then the chance of recoverability is calculated.</td></tr>
<tr><td>08.</td><td>(c)</td><td>Expense = Rs. 9,000+ (Rs. 18,000-16,000) = Rs. 11,000 therefore, decrease the profit by Rs. 11,000</td></tr>
<tr><td>09.</td><td>(c)</td><td>Closing allowance =(Rs. 75,000 x 2%) +(Rs. 50,000 x 5%) = Rs. 4,000
Charge to statement of profit or loss = Rs. 500</td></tr>
<tr><td>10.</td><td>(b)</td><td>The older the debt, the higher the chances of default.</td></tr>
<tr><td>11.</td><td>(a)</td><td>The correct treatment is to reduce the expense previously recognised.</td></tr>
<tr><td>12.</td><td>(a)</td><td>Increase in allowance = Closing allowance – opening allowance
= (Rs. 63,000x2%) - (45,000x2%) = Rs. 360
Closing receivables = 45,000 + 55,000 - 35,000 - 2,000 = Rs. 63,000</td></tr>
<tr><td>13.</td><td>(c)</td><td>Closing balance of allowance
Rs. 93,000 – 1,800 irrecoverable = Rs. 91,200 x 5% = Rs. 4,560
Opening balance of allowance
Rs. 4,560 x 100/120 = Rs. 3,800</td></tr>
<tr><td>14.</td><td>(d)</td><td><table>
<tr><td></td><td>Rs.</td></tr>
<tr><td>Irrecoverable debts</td><td>28,500</td></tr>
<tr><td>Allowance c/f (5% × (Rs. 868,500 – Rs. 28,500))</td><td>42,000</td></tr>
<tr><td>Allowance b/f</td><td>(38,000)</td></tr>
<tr><td></td><td>4,000</td></tr>
<tr><td>Increase in allowance</td><td>32,500</td></tr>
</table></td></tr>
</table>

15.	**(a)**	**Rs.** Allowance at end of year (5% of Rs. 120,000) 6,000 Allowance at start of year 9,000 Decrease in allowance (3,000) Irrecoverable debts written off 5,000 Charge to SPL 2,000
16.	**Rs. 1,000**	Closing allowance = Rs. 90,000x5% = Rs. 4,500 Bad debts are not to be deducted because already written off. Charge for Statement of profit or loss **Rs.** Decrease in allowance (Rs. 500) Irrecoverable debts 3,000 Bad debts recovered (1,500) Profit or loss 1,000
17.	**Rs. 274,400**	Receivables = (Rs. 310,000-Rs. 30,000) = Rs. 280,000 Carrying amount = Rs. 280,000 – (Rs. 280,000x2%) = Rs. 274,400
18.	**Rs. 480,000**	**Rs.** Receivables Rs. 650,000 – 95,000 = 555,000 Less: Allowance (75,000) 480,000
19.	**Rs. 13,000**	= Rs. 16,000 irrecoverable -Rs. 3,000 decrease in allowance =Rs. 13,000
20.	**Rs. 225,245**	**Allowance** **Rs.** **Rs.** Receivables 238,750 Specific allowance Syed (450) 450 Raja (1,200) 1,200 General allowance @5% 237,100 11,855 Total allowance 13,505 Receivables (Statement of Financial Position) Rs. 238,750 – Rs. 13,505 = Rs. 225,245
21.	**(a)**	
22.	**(d)**	
23.	**(b)**	
24.	**(b)**	

f25.	**(c)**	
26.	**(b)**	
27.	**(a)**	
28.	**(d)**	
29.	**(b)**	
30.	**(a)**	

CHAPTER

7

Accruals and prepayments

Contents

1 ACCRUALS AND PREPAYMENTS INTRODUCED

Section overview

- The accruals concept (matching concept)
- Accruals and prepayments

1.1 The accruals concept (matching concept)

Financial statements are prepared using the accruals basis of accounting rather than on a cash basis. Under Accruals basis of accounting, income must be recorded in the accounting period in which it is earned. Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received. Conversely, prepaid income must be not be shown as income in the accounting period in which it is received but instead it must be presented as such in the subsequent accounting periods in which the services or obligations in respect of the prepaid income have been performed.

Expenses, on the other hand, must be recorded in the accounting period in which they are incurred. Therefore, accrued expense must be recognized in the accounting period in which it occurs rather than in the following period in which it will be paid. Conversely, prepaid expense must be not be shown as expense in the accounting period in which it is paid but instead it must be presented as such in the subsequent accounting periods in which the services in respect of the prepaid expense have been performed.

This means that:

- ☐ sales are recognised in the same period as the related cost of making the sale;
- ☐ income is recognised in the statement of comprehensive income in the same period as the transaction that gave rise to it (not necessarily when cash is received); and
- ☐ expenses are recognised in the statement of comprehensive income as they arise (not as they are paid).

For example, the cost of rental charges on office accommodation should be spread over the period of time to which the rental payments relate, regardless of when the actual payment of rent occurs.

Illustration: Accruals basis

A business pays annual rental in advance on 1 June each year.

Rent paid on 1 June 2012 = Rs. 240,000

Rent paid on 1 June 2013 = Rs. 300,000

The financial year ends on 30 September.

The rental expense for the year ended 30 September 2013 is:

Period:	**Rs.**
1 October 2012 to 31 May 2013	
$^{8}/_{12}$ of 240,000 (the last 8 months of the rental year)	160,000
1 June 2013 to 30 September 2013	
$^{4}/_{12}$ of 300,000 (the first 4 months of the rental year)	100,000
	260,000

1.2 Accruals and prepayments

Accruals

A business might incur an expense before the year end but not receive an invoice until after the year-end. If this is the case the business must estimate the amount of the expense and recognise it as an expense and a liability.

The liability is known as an accrual. The business is said to be making an accrual for the expense or accruing for the expense.

Prepayments

A business might pay or at least be invoiced for some expenses in advance.

When the invoice is received the business will recognise the full liability as a debit in an expense account. It would be wrong to then clear all of this to the statement of comprehensive income in the current period. Some of it relates to the next period. This part must be recognised as an asset (it represents a right to receive some kind of service in the next period) called a prepayment.

There are two approaches to accounting for both accruals and prepayments:

- Method 1 – using two accounts; and
- Method 2 – using one account.

Each of these will be explained in turn.

2 ACCRUALS

Section overview

- Accrued expenses (accruals)
- Method 1: the two account approach for accrued expenses
- Method 2: the one account approach for accrued expenses

2.1 Accrued expenses (accruals)

A business might incur expenses during a period but may not have been sent the invoice by the period end.

Since there has been no payment and no invoice, a financial transaction has not yet occurred and there is not yet anything to record as a book-keeping entry in the ledgers. However, to apply the accruals basis of accounting, the expense must be charged in the statement of comprehensive income for the accounting period to which the expense relates. This is done by creating an accrued expense at the end of the accounting period.

An accrued expense (accrual) is an estimate of the cost that has been incurred in the financial period, and it is included in expenses in the statement of comprehensive income for the period and recognised as a liability (called an accrual) in the statement of financial position.

Accruals are often necessary when expenses are paid in arrears (i.e. at the end of a period of expense).

Example:

Wasif set up in business on 1 January Year 1. The business has a 31 December year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 three months in arrears and telephone invoices received in Year 1 are as follows:

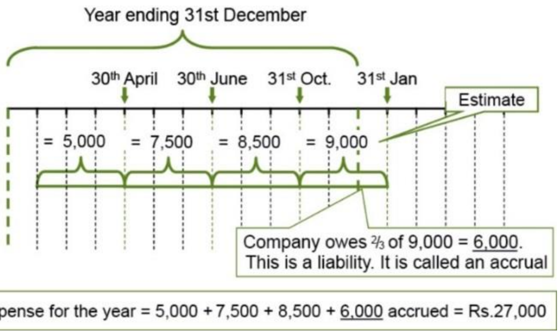
	Rs.
30 April	**5,000**
31 July	**7,500**
31 October	**8,500**

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be Rs. 9,000.

The accrual for November and December Year 1 should be Rs. 6,000 (Rs. 9,000 × $^2/_3$).

This can be represented as follows:



Company owes ⅔ of 9,000 = 6,000.
This is a liability. It is called an accrual

∴ Expense for the year = 5,000 + 7,500 + 8,500 + 6,000 accrued = Rs.27,000

There are two ways of accounting for accruals at the end of an accounting period. These will be explained in turn.

2.2 Method 1: the 'two account' approach for accrued expenses

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The accrued expense is recorded in an accrued expenses account. The double entry for this adjustment is as follows

Illustration: Accruals using two accounts

	Debit	Credit
Expense account	X	
Accruals account		X

This adds the accrued expense to the expenses recognised as the result of having received invoices earlier in the current accounting period.

The credit balance on the accruals account is a liability, and is included in the statement of financial position as a current liability.

Example (continued): Year 1

Payments in the year were:

	Rs.
30 April	5,000
31 July	7,500
31 October	8,500

The accrual for November and December Year 1 is Rs. 6,000 (Rs. 9,000 × $^2/_3$).

Method 1: two account approach

Telephone expenses account

Year 1	Rs.		Rs.
Bank	5,000	Statement of comprehensive income	27,000
Bank	7,500		
Bank	8,500		
Accrued expense (accruals account)	6,000		
	27,000		27,000
Year 2			
		Accruals account	6,000

Accruals account

Year 1	Rs.		Rs.
Closing balance c/d	6,000	Telephone expenses	6,000
	6,000		6,000
Year 2			
		Opening balance b/d	6,000

The expense in the statement of comprehensive income for Year 1 is Rs. 27,000 and the accrued expense of Rs. 6,000 is included in the statement of financial position as a current liability at the end of Year 1.

Reversal of the accrual

There is a complication. At the year end the expense account is cleared to the statement of comprehensive income and there is a credit balance carried down on the accruals account.

Assume that the invoice that arrives in January is Rs. 9,500. The accounting system will record the following double entry:

Example: January invoice received

	Debit	Credit
Expense account	9,500	
Liability		9,500

However, an expense of Rs. 6,000 and a liability of Rs. 6,000 has already been recognised in respect of this invoice. If no further adjustment is made the 6,000 is being included twice.

There is a simple way to prevent this. The double entry that set up the accrual at the end of the last period is reversed:

Example: Reversal of the accrual (start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Accruals account	6,000	
Expense account		6,000

This removes the accrual so that it is not counted twice as a liability and the balance on the expense account is adjusted down to the amount that has not yet been expensed for this invoiced.

Telephone expense account

Year 2			
		Accruals (reversal)	6,000
Payables	9,500		

Accruals

Year 2 (at start of the year)			
Telephone expense	6,000	Balance b/d	6,000

Example: Year 2

In Year 2, the telephone invoices are as follows:

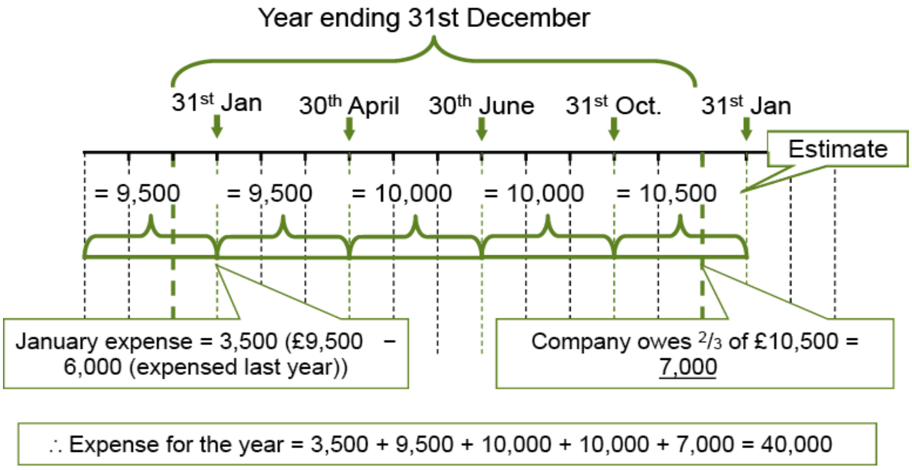
	Rs.
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be Rs. 10,500.

The accrual for November and December Year 1 should be Rs. 7,000 (Rs. 10,500 × $^2/_3$).

This can be represented as follows:



Example: Year 2

In Year 2, the telephone invoices are as follows:

	Rs.
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be Rs. 10,500.

The accrual for November and December Year 1 should be Rs. 7,000 (Rs. 10,500 × $^2/_3$).

Method 1: two account approach

Telephone expenses account

Year 2	**Rs.**		**Rs.**
Bank	9,500	Accruals account (reversal of year 1 accrual)	6,000
Bank	9,500	Statement of comprehensive income	
Bank	10,000	(balancing figure)	40,000
Bank	10,000		
Accrued expense (accruals account)	7,000		
	46,000		46,000
Year 3			
		Accruals account	7,000

Accruals account

Year 2	**Rs.**		**Rs.**
Telephone expense account (reversal of Year 1 accrual)	6,000	Opening balance b/d	6,000
Closing balance c/d	7,000	Telephone expenses account	7,000
	13,000		13,000
		Opening balance b/d	7,000

The expense in the statement of comprehensive income for Year 2 is Rs. 40,000 and the accrued expense of Rs. 7,000 is included in the statement of financial position as a current liability at the end of Year 2.

2.3 Method 2: the 'one account' approach for accrued expenses

This approach is trickier to understand. The accrual is recognised in the expense account.

There are two ways of achieving this.

- The total expense can be calculated and transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) leaving a balancing figure on the expense account as an accrual; or
- The accrual can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) as a balancing figure

Example: Year 1

Wasif set up in business on 1 January Year 1. The business has a 31 December year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 three months in arrears and telephone invoices received in Year 1 are as follows:

	Rs.
30 April	5,000
31 July	7,500
31 October	8,500

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be Rs. 9,000.

The accrual for November and December Year 1 should be Rs. 6,000 (Rs. 9,000 × $^{2}/_{3}$).

Method 2: one account approach

Telephone expenses account

Year 1	Rs.		Rs.
Bank	5,000	Statement of comprehensive income	27,000
Bank	7,500		
Bank	8,500		
Closing balance (accrued expense) c/d	6,000		
	27,000		27,000
		Opening balance b/d	6,000

In order to make the above work either:

1) Calculate the expense transferred to the statement of comprehensive income (27,000) and calculate the accrual taken as a balancing figure; or

2) Calculate the accrual needed (6,000) and then calculate the expense transferred to the statement of comprehensive income (27,000) as a balancing figure (6,000). This is usually the easiest way.

There is no need to reverse the accrual using the one account method as it is already in the expense account at the start of the next year.

Example (continued): Year 2

In Year 2, the telephone invoices are as follows:

	Rs.
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be Rs. 10,500.

The accrual for November and December Year 1 should be Rs. 7,000 (Rs. 10,500 × $^{2}/_{3}$).

Method 2: one account approach

Telephone expenses account

Year 2	**Rs.**		**Rs.**
Bank	9,500	Opening balance b/d	6,000
Bank	9,500	**Statement of comprehensive income**	**40,000**
Bank	10,000		
Bank	10,000		
Closing balance (accrued expense) c/d	7,000		
	46,000		46,000
		Opening balance b/d	7,000

In order to make the above work either:

1) Calculate the expense transferred to the statement of comprehensive income (40,000) and calculate the accrual taken as a balancing figure (7,000); or

2) Calculate the accrual needed (7,000) and then calculate the expense transferred to the statement of comprehensive income (40,000) as a balancing figure. This is usually the easiest way.

Calculating the expense for the statement of comprehensive income

Method 2 requires the calculation of either the closing accrual or the charge to the statement of comprehensive income, the other number being taken as a balancing figure. It is almost always easier to calculate the accrual.

The amount charged to the statement of comprehensive income can be calculated as follows. It is worth spending a little time trying to understand this.

Example: Charge to the statement of comprehensive income

From first principles

	Year 1
January	0
February to April	5,000
May to July	7,500
August to October	8,500
November and December (accrual)	6,000
	27,000

	Year 2
November to January	9,500
Less amount already expensed last year for November and January	(6,000)
Therefore: January	3,500
February to April	9,500
May to July	10,000
August to October	10,000
November and December (accrual)	7,000
	40,000

In fact, what is going on above can be represented by the following:

Illustration:

	Rs.
Invoices/payments for the year	X
+ Closing accrued expense	X
	X
– Opening accrued expense	(X)
= Expense for the year	X

Example:

	Year 1	Year 2
Invoices/payments for the year:		
January	0	9,500
February to April	5,000	9,500
May to July	7,500	10,000
August to October	8,500	10,000
+ Closing accrued expense	6,000	7,000
	27,000	46,000
– Opening accrued expense	0	(6,000)
= Expense for the year	27,000	40,000

3 PREPAYMENTS

Section overview

- Prepayments (prepaid expenses)
- Method 1: the two accounts method
- Method 2: the one account method
- Prepaid expenses: calculating the expense for the statement of comprehensive income

3.1 Prepayments (prepaid expenses)

Prepaid expenses are expenses that are recorded in the accounts in the current period, because a purchase invoice has been received or a payment has been made, but all or part of the expense relates to a future accounting period.

Prepaid expenses occur whenever payments are made in advance for an expense item.

To apply the accruals basis of accounting, the expenses that have been recorded in the accounts but that relate to a future accounting period should be:

- ❑ excluded from the expenses in the statement of comprehensive income for the current year and recognised as an asset (a prepayment) at the year-end; and then
- ❑ included in the expenses for the next financial period (which is the period to which they relate).

Example: Year 1

Fahad set up in business on 1 January Year 1 preparing financial statements to 31 December each year..

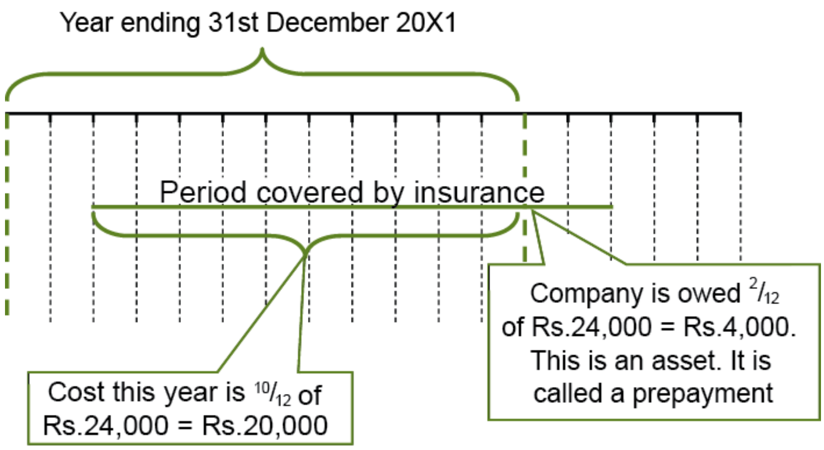
On 1 March he obtains annual insurance on his office building, starting from 1 March at cost of Rs. 24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of comprehensive income for insurance in Year 1 should therefore be Rs. 20,000 (Rs. 24,000 × $^{10}/_{12}$).

The prepaid expense for Year 2 is Rs. 4,000 (Rs. 24,000 × $^{2}/_{12}$).

This can be represented as follows:



There are two ways of accounting for prepayments at the end of an accounting period. These will be explained in turn.

3.2 Method 1: the two accounts method

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The prepayment is estimated and then transferred from the expense account to a prepayment account:

Illustration: Prepayment using two accounts.

	Debit	Credit
Prepayment account (an asset)	X	
Expense account		X

The prepayment is a credit entry in the expense account therefore reducing the expense recognised in the current period.

The debit balance on the prepayments account is included in the statement of financial position as a current asset.

Example: Year 1

Fahad set up a business on 1 January Year 1 preparing financial statements to 31 December each year.

On 1 March he obtains annual insurance on his office building, starting from 1 March at cost of Rs. 24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of comprehensive income for insurance in Year 1 should therefore be Rs. 20,000 (Rs. 24,000 × $^{10}/_{12}$).

The prepaid expense for Year 2 is Rs. 4,000 (Rs. 24,000 × $^{2}/_{12}$).

Method 1: two accounts approach

Insurance expense

Year 1	Rs.		Rs.
Bank	24,000	Prepayments	4,000
		Statement of comprehensive income	20,000
	24,000		24,000

Prepayments account

Year 1	Rs.		Rs.
Insurance expense	4,000	Closing balance c/d	4,000
	4,000		4,000

Reversal of the prepayment

At the beginning of the next accounting period, the balance in the prepayments account is transferred back to the expense account so that it will be recognised as an expense in the next accounting period.

Example (continued): Reversal of the prepayment (at the start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Insurance expense	4,000	
Prepayments		4,000

This reinstates the prepayment as an expense that relates to the second year.

Insurance expense

Year 2			
Prepayments (reversal)	4,000		

Prepayments

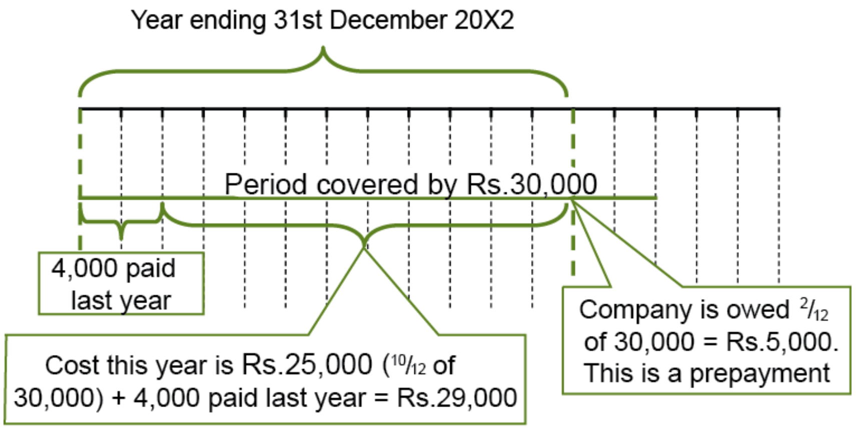
Year 2 (at start of the year)			
Balance b/d	4,000	Insurance expense	4,000

Example (continued): Year 2

In Year 2, the annual insurance premium payable on 1 March is Rs. 30,000 for the year to 28 February Year 3.

The prepaid expense at the end of Year 2 is therefore Rs. 5,000 (Rs. 30,000 × $^2/_{12}$) and the insurance expense in Year 2 is accounted for as follows:

This can be represented as follows:



Example (continued): Year 2

In Year 2, the annual insurance premium payable on 1 March is Rs. 30,000 for the year to 28 February Year 3.

The prepaid expense at the end of Year 2 is therefore Rs. 5,000 (Rs. 30,000 × $^{2}/_{12}$) and the insurance expense in Year 2 is accounted for as follows:

Method 1: two accounts approach

Insurance expense

Year 2	Rs.		Rs.
Prepayments	4,000	Prepayments	5,000
Bank	30,000	Statement of comprehensive income	
		(balancing figure)	29,000
	34,000		34,000
Year 3			
Prepayments (reversal)	5,000		

Prepayments

Year 2	Rs.		Rs.
Opening balance b/d	4,000	Insurance expenses	4,000
Insurance expenses account	5,000	Closing balance c/d	5,000
	9,000		9,000
Year 3			
Opening balance b/d	5,000	Insurance expenses (reversal)	5,000

The expense in the statement of comprehensive income is Rs. 29,000.

This consists of the prepayment at the beginning of the year (Rs. 4,000 for January and February) plus the expense for the 10 months from March to December ((Rs. 30,000 × $^{10}/_{12}$) = Rs. 25,000).

The prepaid expense of Rs. 5,000 at the end of Year 2 is included in the statement of financial position as a current asset.

3.3 Method 2: the one account method

This approach is trickier to understand. The prepayment is recognised in the expense account.

There are two ways of achieving this.

☐ The total expense can be calculated and transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) leaving a balancing figure on the expense account as a prepayment; or

☐ The prepayment can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Statement of comprehensive income; Cr Expense account) as a balancing figure.

Example: Year 1

Fahad set up a business on 1 January Year 1 preparing financial statements to 31 December each year.

On 1 March he obtains annual insurance on his office building, starting from 1 March at cost of Rs. 24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of comprehensive income for insurance in Year 1 should therefore be Rs. 20,000 (Rs. 24,000 × $^{10}/_{12}$).

The prepaid expense for Year 2 is Rs. 4,000 (Rs. 24,000 × $^{2}/_{12}$).

Method 2: one account approach

Insurance expenses

Year 1	**Rs.**		**Rs.**
Bank	24,000	Statement of comprehensive income	20,000
		Closing balance c/d	
		(prepayment)	4,000
	24,000		24,000
Year 2			
Opening balance b/d	4,000		

The expense in the statement of comprehensive income is Rs. 20,000 and the prepaid expense is included in the statement of financial position as a current asset at the end of Year 1.

There is no need to reverse the prepayment using the one account method as it is already in the expense account at the start of the next year.

Example (continued): Year 2

In Year 2, the annual insurance premium payable on 1 March is Rs. 30,000 for the year to 28 February Year 3.

The prepaid expense at the end of Year 2 is therefore Rs. 5,000 (Rs. 30,000 × $^{2}/_{12}$) and the insurance expense in Year 2 is accounted for as follows:

Method 2: one account approach

Insurance expenses

Year 2	**Rs.**		**Rs.**
Opening balance b/d	4,000	Statement of comprehensive income	
Bank	30,000	(balancing figure)	29,000
		Closing balance c/d	5,000
	34,000		34,000
Year 3			
Opening balance b/d	5,000		

3.4 Prepaid expenses: calculating the expense for the statement of comprehensive income

Method 2 requires the calculation of either the closing prepayment or the charge to the statement of comprehensive income, the other number being taken as a balancing figure. **It is almost always easier to calculate the prepayment.**

The amount charged to the statement of comprehensive income can be calculated as follows. It is worth spending a little time trying to understand this.

Example: Charge to the statement of comprehensive income

	Year 1
January, February	0
March to December:	
$^{10}/_{12}$ of 24,000	20,000
	20,000
January, February:	**Year 2**
$^{2}/_{12}$ of 24,000	4,000
March to December:	
$^{10}/_{12}$ of 30,000	25,000
	29,000

The expense may also be calculated as follows:

Illustration:

	Rs.
Invoices/payments for the year	X
+ Opening prepaid expense	X
	X
– Closing prepaid expense	(X)
= Expense for the year	X

Example:

	Rs.	Rs.
Invoices/payments for the year	24,000	30,000
+ Opening prepaid expense	0	4,000
	24,000	34,000
– Closing prepaid expense	(4,000)	(4,000)
= Expense for the year	20,000	30,000

Example: Spock

Spock owns a removal business and runs a small fleet of vans. He prepares his accounts to 31 December each year.

The following transactions occur in relation to insurance for the year 2013.

1 January	The amount prepaid for insurance was Rs.1,140,000.
1 April	He paid Rs.840,000 insurance for the year ended 31 March 2014 on six of the vans
1 May	He paid Rs.3,540,000 insurance for twenty vans for the year ended 30 April 2014
1 July	He paid Rs.560,000 insurance for the remaining vans for the year ended 30 June 2014

The insurance account for the year ended 31 December 2013 shall be drawn as follows:

Insurance a/c

2013		Rs.(000)	*2013*		Rs.(000)
1 Jan	Balance b/d	1,140		P&L a/c	4,410 (βal)
1 Apr	Bank a/c	840	31 Dec	Balance c/d (W1)	1,670
1 May	Bank a/c	3,540			
1 Jul	Bank a/c	560			
		6,080			6,080
2013					
1 Jan	Balance b/d	1,670			

Prepayment a/c *

2013		Rs.(000)	*2013*		Rs.(000)
31 Dec	Insurance	1,670	31 Dec	Balance c/d	1,670
1 Jan	Balance b/d	1,670	1 Jan	Insurance (reversal)	1,670

Workings

		Rs.(000)
(1)	**Prepayment at the end of the year**	
	Insurance on six vans paid 1 April 2013 $^{3}/_{12}$ × Rs.840,000	210
	Insurance of twenty vans paid 1 May 2013 $^{4}/_{12}$ × Rs.3,540,000	1,180
	Insurance on remaining vans paid 1 July 2013 $^{6}/_{12}$ × Rs.560,000	280
		1,670

PROOF

Charge for the year	Rs.(000)
Prepayment	1,140
Insurance $^{9}/_{12}$ × Rs.840,000	630
Insurance $^{8}/_{12}$ × Rs.3,540,000	2,360
Insurance $^{6}/_{12}$ × Rs.560,000	280
	4,410

Practice question: Kirk **1**

Kirk started a business on 1 January 2012.

Accounting year ended 31 December 2012:

A new warehouse was acquired on 31 March 2012. On 21 April 2012, Kirk received a water bill demand for Rs.1,000,000 for the 12 months to 31 March 2013. Payment was made, in full, on 30 April 2012.

Accounting year ended 31 December 2013:

An office extension was built. The water bill demand for the 12 months to 31 March 2014 was Rs.1,600,000. Kirk paid the full amount on 1 June 2013.

Required:

(a) Write up the water expense ledger account for 2012 and for 2013.

(b) Assuming now that payments were made annually in arrears (ie Rs.1,000,000 on 31 March 2013 and Rs.1,600,000 on 31 March 2014), write up the water expense ledger account for each of the two accounting years.

Practice question: Ninja Enterprises **2**

The details of two office buildings acquired on rent by Ninja Enterprises (NE) are as follows:

i. On 1 April 2016, Building I was acquired on annual rent of Rs. 2,400,000. Effective from 1 October 2017 the rent was increased by 20%. NE pays rent on half yearly basis in advance.

ii. On 1 September 2016, Building II was acquired on annual rent of Rs. 900,000. Payments were made on quarterly basis in advance. However, the quarterly payment due on 1 December 2017 was made on 15 January 2018.

NE's financial year ends on 31 December each year.

Required:

Prepare rent expense account for the year ended 31 December 2016 and 2017.

Practice question: Uhura

3

The following is an extract from the trial balance of Uhura at 31 December 2013.

	Dr	Cr
	Rs.(000)	Rs.(000)
Stationery	560	
Rent	900	
Rates	380	
Lighting and heating	590	
Insurance	260	
Wages and salaries	2,970	

There was stationery still in hand at 31 December 2013 which had cost Rs.15,000.

Rent of Rs.300,000 for the last three months of 2013 had not been paid and no entry has been made in the books at all for it.

Of the rates, Rs.280,000 was for the year ended 31 March 2014. The remaining Rs.100,000 was for the three months ended 31 March 2013.

Fuel had been delivered on 18 December 2013 at a cost of Rs.15,000 and had been consumed before the end of 2013. No invoice had been received for the Rs.15,000 fuel in 2013 and no entry has been made in the records of the business.

Rs.70,000 of the insurance paid was in respect of insurance cover for the year 2014.

Nothing was owing to employees for wages and salaries at the close of 2013.

Required:

Record the above information in the relevant accounts for the year ended 31 December 2012 and close the accounts.

4 UNEARNED AND ACCRUED INCOME

Section overview

- Introduction
- Unearned income
- Accrued income

4.1 Introduction

A business may have miscellaneous forms of income, for example, from renting out property.

When a business entity has income from sources where payments are made in advance or in arrears. The accruals basis of accounting applies, and the amount of income to include in profit and loss for a period is the amount of income that relates to that period. It may therefore be necessary to apportion income on a time basis and there may be unearned income or accrued income to account for.

Unearned income

This is where a business has received income in advance. For example, a business might rent out a property for which the tenant must pay in advance.

Only the income that relates to the period is recognised in the statement of comprehensive income and the balance is recognised as a liability of the business. (Note that it is an asset of the tenant).

Accrued income

This is where a business receives income in arrears.

For example, a business might rent out a property for which the tenant must pay in arrears. The tenant might owe the business money at the business's year-end.

All of the income that relates to the period must be recognised in the statement of comprehensive income. It is necessary to recognise the amount owed to the business as an asset at the year-end.

4.2 Unearned income

The method of calculating income for the year when there is unearned income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.

Example: Unearned income

A business rents out a part of its premises.

The rent is payable every six months, on 1 May and 1 November in advance.

The company has a year end of 31 December.

The annual rental for the year to 30 April 2013 was Rs. 48,000 (received in two amount so of Rs.24,000 on 1 May 2012 and 1 November 2012).

The annual rental and Rs. 60,000 for the year to 30 April 2014 (received in two amount so of Rs.30,000 on 1 May 2013 and 1 November 2013).

Income for the year ending 31 December 2013 is:

	Rs.
For the 4 months 1 January – 30 April 2013: $^{4}/_{12} \times$ Rs. 48,000	16,000
For the 8 months 1 May – 31 December 2013: $^{8}/_{12} \times$ Rs. 60,000	40,000
Rental income for the year to 31 December 2013	56,000

At 31 December 2012 there was unearned rental income for the period 1 January – 30 April 2013.

The amount of unearned income is $^4/_{12}$ of the Rs. 24,000 received on 1 November 2012 which came to Rs. 16,000. (This represents 4 months at Rs. 4,000 per month)

This was included as a current liability in the statement of financial position as at the end of the last financial year.

At 31 December 2013 there is unearned rental income for the period 1 January – 30 April 2014.

The amount of unearned income is $^4/_{12}$ of the Rs. 30,000 received on 1 November 2013 which comes to Rs. 20,000. (This represents 4 months at Rs. 5,000 per month)

This is recognised as a current liability as at the end of the financial year.

Unearned income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used the closing unearned income liability must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: Two accounts method

Income has been paid to the business but some of it relates to the next period. This amount must be transferred from the income account to a liability account

Example: Unearned income

	Debit	Credit
Income	X	
Unearned income (liability)		X

Example (continued): Unearned income

The double entry is as follows:

Rental income

		Unearned income (reversal of 2012 unearned income)	16,000
		Cash (1 May 2013)	30,000
Unearned income (to be recognised in 2014)	20,000	Cash (1 November 2013)	30,000
Statement of comprehensive income	56,000		
	76,000		76,000

Unearned income

		Balance b/d (at 1st January 2013)	16,000
Rental income (reversal of 2012 unearned income)	16,000		
Balance c/d	20,000	Rental income	20,000
	36,000		36,000
		Balance b/d	20,000

Method 2: One account method

The unearned income is brought down as a liability on the income account.

There are two ways of achieving this.

- ❑ The total income for the period can be calculated and transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) leaving a balancing figure on the expense account as the unearned income liability; or
- ❑ The unearned income liability can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) as a balancing figure

Example (continued): Unearned income (One account approach)

The double entry is as follows:

Rental income

		Balance b/d	16,000
		Cash (1 May 2013)	30,000
Statement of comprehensive income	56,000	Cash (1 November 2013)	30,000
Balance c/d	20,000		
	76,000		76,000
		Balance b/d	20,000

4.3 Accrued income

The method of calculating income for the year when there is accrued income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.

Example: Accrued income

A business rents out a part of its premises.

Rentals are payable each quarter in arrears on 31 January, 30 April, 31 July and 31 October.

The company has a year end of 31 December.

The annual rental was Rs. 30,000 per year until 31 October 2013 (or Rs. 2,500 per month received in 4 amounts of Rs.7,500 on 31 January, 30 April, 31 July and 31 October).

The annual rental was increased to Rs. 36,000 per year from 1 November 2013 (or Rs. 3,000 per month received in 4 amounts of Rs.9,000 on 31 January, 30 April, 31 July and 31 October).

Income for the year ending 31 December 2013 is:

	Rs.
For the 10 months 1 January – 31 October 2013: $^{10}/_{12} \times$ Rs. 30,000	25,000
For the 2 months 1 November – 31 December 2013: $^{2}/_{12} \times$ Rs. 36,000	6,000
Rental income for the year to 31 December	31,000

At 31 December 2012 there was rental earned but not yet received.

This is the rental income for November and December 2012, which will not be received until 31 January 2013.

The amount of the accrued income is Rs. 5,000 ($^{2}/_{3}$ of 7,500 or 2 months at Rs. 2,500 per month) and was included in last year's income and recognised as a current asset at the end of last year financial year.

At 31 December 2013 there is rental earned but not yet received.

This is the rental income for November and December 2013, which will not be received until 31 January 2014.

The amount of the accrued income is Rs. 6,000 ($^{2}/_{3}$ of 9,000 or 2 months at Rs. 3,000 per month) and is included in income and recognised as a current asset at the end of the financial year.

Accrued income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used the closing accrued income asset must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: Two accounts method

Income has been earned in the current period. This amount must be recognised.

Example: Accrued income

	Debit	Credit
Accrued income (asset)	X	
Income		X

The double entry is as follows:

Rental income

Accrued income (reversal of 2012 accrued income)	5,000	Cash (31 January 2013)	7,500
		Cash (30 April 2013)	7,500
		Cash (31 July 2013)	7,500
		Cash (31 October 2013)	7,500
Statement of comprehensive income	31,000	Accrued income (for November and December 2013)	6,000
	36,000		36,000

Accrued income

Balance b/d (at 1st January 2013)	5,000		
		Rental income (reversal of 2012 accrued income)	5,000
Rental income	6,000	Balance c/d	6,000
	11,000		11,000
Balance b/d	6,000		

Method 2: One account method

The accrued income is brought down as an asset on the income account.

There are two ways of achieving this.

- ☐ The total income for the period can be calculated and transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) leaving a balancing figure on the expense account as the accrued income asset; or
- ☐ The accrued income asset can be calculated and recognised in the expense account leaving the amount transferred to the statement of comprehensive income (Dr Income account; Cr Statement of comprehensive income) as a balancing figure

Example (continued): Accrued income (One account approach)

The double entry is as follows:

Rental income

Balance b/d	5000	Cash (31 January 2013)	7,500
		Cash (30 April 2013)	7,500
		Cash (31 July 2013)	7,500
Statement of comprehensive income	31,000	Cash (31 October 2013)	7,500
		Balance c/d	6,000
	36,000		36,000
Balance b/d	6,000		

Practice question: Bones 4

Bones owns various properties which he rents; some tenants pay in advance, some in arrears. Similarly with his various borrowings the interest is paid in arrears and in advance.

During 2013 rent collected was Rs.229,500 and interest charged to the statement of comprehensive income was Rs.52,500.

Rents receivable and paid in advance together with amounts of interest prepaid and payable at the statement of financial position dates were as follows.

	31 December	
	2012	2013
	Rs.	Rs.
Rents owed by tenants	34,200	40,500
Rents prepaid by tenants	20,700	15,300
Prepaid interest	3,500	5,600
Interest payable	9,800	7,000

Required:

Write up the rent receivable account and the interest payable account for the year ended 31 December 2013.

Practice question: Zamil Traders **5**

(a) What do you understand by accrual basis of accounting? Identify the main advantage of following the accrual basis of accounting.

(b) Zamil Traders (ZT) commenced business on 1 January 2016 and is maintaining its accounting records under ‘cash basis’. The following transactions are appearing in its records:

Transaction date	Description
8-Jan-2016	One year's office rent was paid in advance, amounting to Rs. 1.2 million.
15-Jan-2016	Advance payment of Rs. 20 million was made against a purchase order. 60% of the ordered goods were received in January 2016.
21-Jan-2016	Rs. 5 million were received against supply of goods in January 2016. Goods amounting to Rs. 3 million could not be delivered in time because of a transport strike.
31-Jan-2016	Sale was booked on receipt of a cheque amounting to Rs. 0.9 million which represents the price of goods supplied net of 10% cash discount.
1-Feb-2016	Payment of salaries and wages for the month of January 2016 amounted to Rs. 0.5 million. This amount includes Rs 0.02 million paid to an employee as advance salary for the month of February 2016.
15-Feb-2016	Payment of utility bills for the month of January 2016 amounted to Rs. 0.3 million.

Required:

Prepare adjusting entries to enable ZT to finalise its monthly financial statements for the month of January 2016 under ‘accrual basis’ of accounting.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

(a) **Water expense a/c**

		Rs.(000)			Rs.(000)
30.4.12	Cash	1,000		P&L a/c (W1)	750
			31.12.12	Balance c/d	250 β
		1,000			1,000
1.1.13	Balance b/d	250		P&L a/c	1450 β
1.6.13	Cash	1,600	31.1.13	Balance c/d (W2)	400
		1,850			1,850
1.1.11	Balance b/d	400			

β denotes balancing figure.

Workings

1) Expense for period 1.4.12 – 31.12.12: $^{9}/_{12} \times$ Rs.1,000,000 = Rs.750,000

2) 3 months prepaid: $^{3}/_{12} \times$ Rs.1,600,000 = Rs.400,000

(b) **Water expense a/c**

		Rs.(000)			Rs.(000)
31.12.12	Balance c/d	750 β		P&L a/c	750 †
		750			750
31.4.13	Cash	1,000	1.1.13	Balance b/d	750
31.12.13	Balance c/d	1,200		P&L a/c	1,450 †
		2,200			2,200
			1.1.14	Balance b/d	1,200

† Tutorial note: The P&L a/c charges must be the same as determined in (a)!

Solutions **2**

Rent expense - 2016

Date	Description	Rs. in '000	Date	Description	Rs. in '000
1-Apr-16	Cash - B1	1,200	31-Dec-16	Expense - P&L – B1	1,800
1-Sep-16	Cash - B2	225	31-Dec-16	Expense - P&L – B2	300
1-Oct-16	Cash - B1	1,200	31-Dec-16	Closing prepaid– B1 (1,200/6×3)	600
1-Dec-16	Cash - B2	225	31-Dec-16	Closing prepaid– B2 (225/3×2)	150
		2,850			**2,850**

Rent expense - 2017

Date	Particulars	Rs. in '000	Date	Particulars	Rs. in '000
1-Jan-17	Opening prepaid - B1	600	31-Dec-17	Expense - P&L – B1	2,520
1-Jan-17	Opening prepaid - B2	150	31-Dec-17	Expense - P&L – B2	900
1-Mar-17	Cash - B2	225	31-Dec-17	Closing prepaid - B1(1,440/6×3)	720
1-Apr-17	Cash - B1	1,200			
1-Jun-17	Cash - B2	225			
1-Sep-17	Cash - B2	225			
1-Oct-17	Cash - B1 (1,200×1.2%)	1,440			
31-Dec-17	Closing accrued - B2 (225/3×1)	75			
		4,140			**4,140**

Solutions **3**

Stationery a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance per TB	560	31 Dec	P&L a/c	545
			31 Dec	Balance c/d	15
		560			560
1 Jan	Balance b/d	15			

Rent a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance per TB	900	31 Dec	P&L a/c	1,200
31 Dec	Balance c/d	300			
		1,200			1,200
			1 Jan	Balance b/d	300

Rates a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance per TB	380	31 Dec	P&L a/c	310
			31 Dec	Balance c/d	70
		380			380
1 Jan	Balance b/d	70			

Lighting and heating a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance per TB	590	31 Dec	P&L a/c	605
31 Dec	Balance c/d	15			
		605			605
			1 Jan	Balance b/d	15

Insurance a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance per TB	260	31 Dec	P&L a/c	190
			31 Dec	Balance c/d	70
		260			260
1 Jan	Balance b/d	70			

Wages and salaries a/c

		Rs.(000)			Rs.(000)
31 Dec	Balance per TB	2,970	31 Dec	P&L a/c	2,970

Prepayments a/c

		Rs.(000)			Rs.(000)
31 Dec	Stationery	15			
31 Dec	Rates	70			
31 Dec	Insurance	70	31 Dec	Balance c/d	155
		155			155
1 Jan	Balance b/d	155			

Accrued expenses a/c

		Rs.(000)			Rs.(000)
			31 Dec	Rent	300
31 Dec	Balance c/d	315	31 Dec	Light and heat	15
		315			315
			1 Jan	Balance b/d	315

Solutions

4

a **Rent receivable**

2013		**Rs.**			**Rs.**
1 Jan	Accrued income reversal	34,200	1 Jan	Deferred income reversal	20,700
	Statement of comprehensive income (calculated as a balancing figure)	241,200		Cash	229,500
31 Dec	Deferred income	15,300	31 Dec	Accrued income	40,500
		290,700			290,700
1 Jan	Accrued income reversal	40,500	1 Jan	Deferred income reversal	15,300

b **Interest payable**

2013		**Rs.**			**Rs.**
1 Jan	Prepayment reversal	3,500	1 Jan	Accrual reversal	9,800
	Bank (calculated as a balancing figure)	57,400		Statement of comprehensive income	52,500
31 Dec	Accrual	7,000	31 Dec	Prepayment	5,600
		67,900			67,900
1 Jan	Prepayment reversal	5,600	1 Jan	Deferred income reversal	7,000

Solutions **5**

(a) Accrual basis of accounting:

Under accrual basis of accounting:

- Revenue is recognised when it is earned, irrespective of the date of receipt.
- Expense is recognised in the period in which it is incurred irrespective of the date of payment.

Main advantage of accrual basis of accounting:

The accrual basis of accounting gives a better measurement of profitability than does the cash basis. Because accrual basis matches revenues with expenses that an entity incurred to earned it.

(b) Zamil Traders

Adjusting entries for the month of January 2016

Date	Description	Debit	Credit
		—— Rs. in million ——	
31-Jan-2016	Prepaid rent	1.1	
	Rent expense		1.1
	(Rent for the period Feb-Dec. 2016 debited to prepayment account)		
31-Jan-2016	Advance to suppliers/Goods in transit 20×40%	8.00	
	Purchases		8.00
	(Purchases adjusted for the goods not yet received)		
31-Jan-2016	Sales	3.00	
	Advance from customers		3.00
	(Sales adjusted for the goods not yet delivered)		
31-Jan-2016	Discount expense (0.9÷0.9) – 0.9	0.10	
	Sales		0.10
	(Correction of sales recorded net of payment discount)		
31-Jan-2016	Salaries and wages expense 0.5 – 0.02	0.48	
	Salaries and wages payable		0.48
	(Salaries and wages for the month of January 2016 paid in February 2016)		
31-Jan-2016	Utility expenses	0.30	
	Utility bills payable		0.30
	(Utility bills for the month of January 2016 received and paid in February 2016)		

5 OBJECTIVE BASED QUESTIONS

01. In the year to 31 December 2018, Saira received Rs. 50,800 rental income. The amounts of rent received in advance and due in arrears were as follows:

	31 Dec 2018	**31 Dec 2017**
	Rs.	**Rs.**
Rent received in advance	4,000	3,000
Rent due in arrears (accrued)	2,500	1,700

What figure for rental income should be recorded in the statement of profit or loss for the year ended 31 December 2018?

(a) Rs. 50,800

(b) Rs. 50,600

(c) Rs. 54,500

(d) Rs. 56,000

02. On 1 March 2017, Zahra pays an insurance premium of Rs. 2,400 for the period to 28 February 2018.

What is the charge to the statement of profit or loss for the year ended 31 October 2017 and prepayment in the Statement of Financial Position as at that date?

(a) Charge for SPL Rs. 800 and Prepayment Rs. Rs. 1,600

(b) Charge for SPL Rs. 1,600 and Prepayment Rs. 800

(c) Charge for SPL Rs. 2,400 and Prepayment 0

(d) Charge for SPL 0 and Prepayment Rs. 2,400

03. Zahra determines at year end that Salaries paid during the year include Rs. 10,000 in advance.

What is the correct year end adjustment for advance salary to be made?

(a) Dr Salaries Rs. 10,000 Cr Advance salaries Rs. 10,000

(b) Dr Salaries Rs. 10,000 Cr Accrued salaries Rs. 10,000

(c) Dr Advance salaries Rs. 10,000 Cr Salaries expense Rs. 10,000

(d) No entry required

04. On year end a business has outstanding electricity bills of Rs. 15,000. During the year electricity bills paid are Rs. 190,000.

What adjustment will be required to utilities expense account regarding the outstanding bills?

(a) Cr Rs. 15,000

(b) Dr Rs. 15,000

(c) No impact

(d) Dr Rs. 190,000

05. Atif finalized his draft accounts and ignored a prepayment for Rs. 100 and accrued expense Rs. 300.

What will be the impact on profit for the year?

(a) Understated by Rs. 100

(b) Overstated by Rs. 100

(c) Overstated by Rs. 200

(d) Understated by Rs. 200

06. On finalizing the draft accounts Minhas identified that he has Rs. 1,000 rental income receivable. Rental income received and recorded during the year is Rs. 11,000.

What is the correct entry to record the accrued income?

(a) Dr Rental income Rs. 1,000 Cr Accrued income Rs. 1,000

(b) Dr Cash Rs. 12,000 Cr Rental income Rs. 12,000

(c) Dr Cash Rs. 11,000 Cr Rental income Rs. 11,000

(d) Dr Accrued income Rs. 1,000 Cr Rental income Rs. 1,000

07. Which of the following is asset account?

(a) Prepaid expense

(b) Accrued expense

(c) Unearned income

(d) Rent payable

08. After finalizing the draft accounts of a business it was identified that salary expense payable for Rs. 9,000 has been ignored. Salary expense paid during the year was Rs. 110,000.

What will be the impact of recording the salaries payable?

(a) Profit will be reduced by Rs. 9,000

(b) Profit will be increased by Rs. 9,000

(c) Profit will be reduced by Rs. 110,000

(d) Profit will be increased by Rs. 110,000

09. Jasia has taken a loan of Rs. 250,000 from HBL as on 1st March 2018 for the construction of her office building. The construction is completed as on June 30, 2018. She rented a portion of her office for Rs. 4,500 per month on July 1. Interest is accrued and paid annually @ 15% per annum on December each year.

What amount of interest expenses and rent income should be shown in the statement of Profit or Loss of Jasia's business prepared on December 31, 2018?

(a) Interest expense Rs. 54,000, Rental income Rs. 37,500

(b) Interest expenseRs. 37,500, Rental income Rs. 54,000

(c) Interest expense Rs. 31,250, Rental income Rs. 27,000

(d) Interest expenseRs. 37,500, Rental income Rs. 4,500

10. What is the treatment of Pre - received income in the Statement of Financial Position of the business?

(a) Treated as a non – current asset

(b) Treated as a current asset

(c) Treated as a non – current liability

(d) Treated as a current liability

11. The annual rent expense for TTT for the period 1 July 2018 to 30 June 2019 is Rs. 35,000, which is 25% more than the previous year. Rent expense is paid on 1 July.

What is the charge of rent expense in the statement of profit or loss for the year ended 31 December 2018?

(a) Rs. 28,000

(b) Rs. 31,500

(c) Rs. 35,000

(d) Rs. 7,000

12. Which of the following statements is incorrect?

(a) Income received in advance is a current liability

(b) Accrued income is a current asset

(c) Prepaid insurance is a current liability

(d) Salaries payable is a current liability

13. After finalizing the draft accounts Arsalan identified that he has treated prepaid insurance of Rs. 1,000 as accrued expense.

What will be the impact of correction?

(a) Profit will be increased by Rs. 2,000

(b) Profit will be increased by Rs. 1,000

(c) Profit will be reduced by Rs. 1,000

(d) Profit will be reduced by Rs. 2,000

14. A business pays rent quarterly in arrears on 1 January, 1 April, 1 July and 1 October each year. The rent was increased from Rs. 150,000 per year to Rs. 180,000 per year as from 1 October 2007.

What rent expense and accrual should be included in the company's financial statements for the year ended 31 January 2008?

	Rent expense Rs.	**Accruals Rs.**
(a)	110,000	10,000
(b)	80,000	15,000
(c)	160,000	15,000
(d)	100,000	10,000

15. Helix Corporation has sublet part of its office and in the year ended 30 November 2008 the rent receivable was:

Until 30 June 2008	Rs. 9,000 per year
From 1 July 2008	Rs. 12,000 per year

Rent was received quarterly in advance on 1 January, April, July, and October each year.

What amounts should appear in the company's financial statements for the year ended 30 November 2008?

	Rental income	**Statement of Financial Position**
(a)	Rs. 10,800	Rs. 1,000 in sundry payables
(b)	Rs. 10,900	Rs. 1,000 in sundry payables
(c)	Rs. 10,250	Rs. 1,000 in sundry receivables
(d)	Rs. 9,900	Rs. 2,000 in sundry receivables

16. Sitara Industries has taken a loan from Crescent Bank. Interest on the loan is payable every quarter i.e. on March 31, June 30, September 30 and December 31. Face amount of the loan is 500,000 and the rate of interest is 10% per annum. Due to financial problems, two installments were not paid on September 30 and December 31.

What is the amount of the interest liability to be shown in the Statement of Financial Position prepared as on December 31?

Rs. ___________

17. Rent paid on 1 September 2017 for the year to 31 August 2018 was Rs. 15,000, and rent paid on 1 September 2018 for the year to 31 August 2019 was Rs. 18,000.

What figure for rent expense should be shown in the statement of profit or loss for the year ended 31 December 2018?

Rs. ___________

18. A business had deposited Rs. 500,000 into an annual fixed deposit on May 1, 2018. Interest is accrued quarterly on March 31, June 30, September 30 and December 31 each year. Interest will be paid only on maturity. Monthly interest amount is Rs. 3,000.

What amount of interest receivable should be shown in the Statement of Financial Position prepared as on December 31, 2018?

Rs. ___________

19. A business has paid an annual salary of Rs. 36,000 in advance to one of its employees on 31 August 2017.

What is the amount of prepaid salaries at the end of the year on 31 December 2017?

Rs. ___________

20. A business was started on January 1, 2008 in a building which is on a 25 years lease. The rent of the building is payable quarterly in advance. Payments of rent was made during the year as follows:

January 1, 2008	Rs. 7,500
March 29, 2008	Rs. 7,500
June 28, 2008	Rs. 7,500
September 30, 2008	Rs. 7,500
December 30, 2008	Rs. 7,500

What will be the rent expense charged to statement of profit or loss for the year ended December 31, 2008?

Rs. ___________

21. An accrual is:

(a) An expense relating to next year but not paid in current year

(b) An expense relating to the current year and paid within current year

(c) An expense relating to the current year but not paid in current year

(d) An expense relating to next year and already paid in current year

22. Earned but not yet received income is treated as

(a) Asset

(b) Liability

(c) Capital

(d) Loss

23. Unearned income is classified as

- **(a)** Assets
- **(b)** Liability
- **(c)** Equity
- **(d)** Loss

24. A prepayment can be defined as:

- **(a)** Payments for expenses for that are not yet incurred and classified as non-current asset
- **(b)** Expenses incurred but not yet paid and classified as current asset
- **(c)** Payments for expenses for that are not yet incurred and classified as current asset
- **(d)** None

25. Expenses relevant to the accounting period which remain unpaid by period end should be:

- **(a)** Included with expenses paid and shown as an asset at the period end
- **(b)** Ignored until they are paid for in the next period
- **(c)** Deducted from amount already paid and shown as a liability at the period end
- **(d)** Include in with the expenses and shown as a liability at the period end

26. Which of the following is not true?

- **(a)** An accrual is an amount owing at the end of a period; a prepayment is an amount paid in advance
- **(b)** An accrual is a liability; a prepayment is an asset
- **(c)** An accrual is a liability; a prepayment is a non-current asset
- **(d)** An accrual is a current liability; a prepayment is a current asset

27. Staff salary remaining unpaid as at the year-end should be accounted for as:

- **(a)** Prepaid salary (debit) and Staff salary expense (credit)
- **(b)** Staff salary expense (debit) and Cash (credit)
- **(c)** Accrued Salary (debit) and Staff salary expense (credit)
- **(d)** Staff salary expense (debit) and accrued salary (credit)

28. A business has a year ended 30 September and receives an invoice for rent of Rs.600,000 for the six months to 31 December. What accrual or prepayment is required for the invoice in the year end accounts?

(a) Prepaid rent = Rs.300,000

(b) Accrued rent = Rs.300,000

(c) Prepaid rent = Rs.600,000

(d) Accrued rent = Rs.600,000

29. During the year, a business paid an electricity bill for Rs.900,000 for the 3 months to November. The year end of the business is 30 September, what accrual or prepayment is needed at the year end?

(a) Prepaid electricity = Rs. 600,000

(b) Accrued electricity = Rs. 600,000

(c) Prepaid electricity = Rs. 300,000

(d) Accrued electricity = Rs. 300,000

30. A business has a beginning utilities accrual of Rs.50,000, an ending accrual of Rs.60,000, and during the year, it pays for utilities of Rs. 80,000. What is the amount of utilities expense?

(a) Rs. 70,000

(b) Rs. 80,000

(c) Rs. 90,000

(d) Rs. 140,000

31. On 31 October 2019, a business pays annual insurance premium of Rs.600,000. What is the prepayment at the end of the year (31 December 2019)?

(a) Nil

(b) Rs. 100,000

(c) Rs. 300,000

(d) Rs. 500,000

32. XYZ Ltd. receives interest of Rs.100,000 on bank deposit for the month of December 2011 on 3rd January 2011. XYZ Ltd has an accounting year end of 31st December.

What would be the accounting entry for such transaction?

(a) Prepaid interest (debit) = Rs.100,000 and Interest income (credit) = Rs.100,000

(b) Cash (debit) = Rs.100,000 and Interest income (credit) = Rs.100,000

(c) Cash (debit) = Rs.100,000 and Prepaid interest (credit) = Rs.100,000

(d) Interest receivable (debit) = Rs.100,000) and interest income (credit) = Rs.100,000

33. XYZ Ltd. receives interest of Rs.100,000 on bank deposit for the month of December 2011 on 3rd January 2011. XYZ Ltd has an accounting year end of 31st December.

What would be the accounting entry when subsequently on 3rd January, payment for interest is received?

- **(a)** Prepaid interest (debit) = Rs.100,000 and Interest income (credit) = Rs.100,000
- **(b)** Cash (debit) = Rs.100,000 and Interest receivable (credit) = Rs.100,000
- **(c)** Cash (debit) = Rs.100,000 and Prepaid interest (credit) = Rs.100,000
- **(d)** Interest receivable (debit) = Rs.100,000) and interest income (credit) = Rs.100,000

34. ABC Limited receives advance rent from its tenant of Rs.1 million on 31st December in respect of office rent for the following year.

ABC Ltd. has an accounting year end of 31st December. What accounting entry is to be passed in this year?

- **(a)** Cash (debit) = Rs.1 million and Advance rent – liability (credit) = Rs.1 million
- **(b)** Cash (debit) = Rs.1 million and Accrued rent (credit) = Rs.1 million
- **(c)** Cash (debit) = Rs.1 million and Rent income (credit) = Rs.1 million
- **(d)** None

35. ABC Limited receives advance rent from its tenant of Rs.1 million on 31st December in respect of office rent for the following year.

What would be the accounting entry in the following year?

- **(a)** Accrued rent (debit) = Rs.1 million and rental income (credit) = Rs.1 million
- **(b)** Advanced rent (debit) = Rs.1 million and rental income (credit) = Rs.1 million
- **(c)** Accrued rent (debit) = Rs.1 million and prepaid rent (credit) = Rs.1 million
- **(d)** None

5 OBJECTIVE BASED ANSWERS

<table>
<tr><td>01.</td><td>(b)</td><td>
<table>
<tr><th colspan="4">Rent</th></tr>
<tr><th>Particulars</th><th>Rs.</th><th>Particulars</th><th>Rs.</th></tr>
<tr><td>Bal. b/d (accrued)</td><td>1,700</td><td>Bal. b/d (Advance)</td><td>3,000</td></tr>
<tr><td><i>Profit or loss</i></td><td><i>50,600</i></td><td>Cash received</td><td>50,800</td></tr>
<tr><td>Bal. c/d (Advance)</td><td>4,000</td><td>Bal. c/d (Accrued)</td><td>2,500</td></tr>
<tr><td></td><td>56,300</td><td></td><td>56,300</td></tr>
</table>
</td></tr>
<tr><td>02.</td><td>(b)</td><td>Charge for SPL = Rs. 2,400/12x8 = Rs. 1,600
Prepayment = Rs. 24,00 - Rs. 1,600= Rs. 800</td></tr>
<tr><td>03.</td><td>(c)</td><td>Advance salaries are prepayment and an asset, so must be debited. This reduces the current year expense, which shall be credited.</td></tr>
<tr><td>04.</td><td>(b)</td><td>The expense must be recorded (debited) under matching concept in the year it has been incurred, even if the bill is outstanding.</td></tr>
<tr><td>05.</td><td>(c)</td><td>Prepayments are deducted from expenses and profit is increased and accruals are added to the expenses and profit is reduced as a result. Therefore, the profit has been overstated due to omissions.</td></tr>
<tr><td>06.</td><td>(d)</td><td>Accrued income is income receivable and must be recorded as an asset and corresponding increase in income (credited).</td></tr>
<tr><td>07.</td><td>(a)</td><td></td></tr>
<tr><td>08.</td><td>(a)</td><td>Rs. 110,000 is already recorded only further Rs. 9,000 is to be recorded as expense on accrual basis, reducing the profit by Rs. 9,000.</td></tr>
<tr><td>09.</td><td>(c)</td><td>Interest expense = (Rs. 250,000x15%) x10/12=Rs. 31,250
Rental income = Rs. 4,500 x 6 = Rs. 27,000</td></tr>
<tr><td>10.</td><td>(d)</td><td>Income received in advance is an obligation to deliver goods or services in future and therefore a liability. As such advances are not for long term, it is treated as current liability.</td></tr>
<tr><td>11.</td><td>(b)</td><td>
<table>
<tr><th>Rent</th><th>Rs.</th><th>Rs.</th></tr>
<tr><td>1 Jan 18 – 30 June 18</td><td>(35,000/100 x 125)/12 x 6</td><td>14,000</td></tr>
<tr><td>1 July 18 – 31 Dec 18</td><td>35,000/12x6</td><td>17,500</td></tr>
<tr><td></td><td></td><td>31,500</td></tr>
</table>
</td></tr>
<tr><td>12.</td><td>(c)</td><td>Prepaid insurance is an asset as it is right to receive benefit from insurance services in the future.</td></tr>
<tr><td>13.</td><td>(a)</td><td>Rs. 1,000 accrual will be reversed (reduction in expense and increase in profit) & Rs. 1,000 prepayment will be recorded (reduction in expense and increase in profit)</td></tr>
<tr><td>14.</td><td>(c)</td><td>
<table>
<tr><th>Rent expense</th><th>Rs.</th><th>Rs.</th></tr>
<tr><td>1st Feb 2007 – 30 Sep 2007</td><td>150,000/12 x 8</td><td>100,000</td></tr>
<tr><td>1st Oct2007 – 31 Jan 2008</td><td>180,000/12 x 4</td><td>60,000</td></tr>
<tr><td></td><td></td><td>160,000</td></tr>
</table>
Accrued rent = 180,000/12 = Rs. 15,000
</td></tr>
</table>

<table>
<tr><td>15.</td><td>(c)</td><td><table>
<tr><td>Rental income</td><td>Rs.</td><td>Rs.</td></tr>
<tr><td>1st Dec 2007 – 30 June 2008</td><td>9,000/12 x 7</td><td>5,250</td></tr>
<tr><td>1st July 2008 – 30 Nov 2008</td><td>12,000 12 x 5</td><td>5,000</td></tr>
<tr><td></td><td></td><td>10,250</td></tr>
</table>One month rent is receivable; Rs 12,000/12 = Rs. 1,000</td></tr>
<tr><td>16.</td><td>Rs. 25,000</td><td>Interest per quarter = Rs. 500,000x10%=Rs. 50,000/4 Quarters
= Rs. 12,500x2 quarters =Rs. 25,000</td></tr>
<tr><td>17.</td><td>Rs. 16,000</td><td>Rent for Jan to Aug 2018 = (Rs. 15,000/12x8)= Rs. 10,000
Rent for Sep to Dec 2018= (Rs. 18,000/12x4)=Rs. 6,000
Total = Rs. 16,000</td></tr>
<tr><td>18.</td><td>Rs. 24,000</td><td>= Rs. 3,000x8 months = Rs. 24,000
All interest will be received on maturity, therefore, all is accrued.</td></tr>
<tr><td>19.</td><td>Rs. 24,000</td><td>Advance salary = Rs. 36,000 x 8 /12 = 24,000
Four month salary is no more prepaid (services have been received against that).</td></tr>
<tr><td>20.</td><td>Rs. 30,000</td><td>Rent<table>
<tr><td>Particulars</td><td>Rs.</td><td>Particulars</td><td>Rs.</td></tr>
<tr><td></td><td></td><td>SPL</td><td>30,000</td></tr>
<tr><td>Cash 7,500 x 5</td><td>37,500</td><td>c/d - advance</td><td>7,500</td></tr>
<tr><td></td><td>37,500</td><td></td><td>37,500</td></tr>
</table></td></tr>
<tr><td>21.</td><td>(c)</td><td></td></tr>
<tr><td>22.</td><td>(a)</td><td></td></tr>
<tr><td>23.</td><td>(b)</td><td></td></tr>
<tr><td>24.</td><td>(c)</td><td></td></tr>
<tr><td>25.</td><td>(d)</td><td></td></tr>
<tr><td>26.</td><td>(c)</td><td></td></tr>
<tr><td>27.</td><td>(d)</td><td></td></tr>
<tr><td>28.</td><td>(b)</td><td></td></tr>
<tr><td>29.</td><td>(a)</td><td></td></tr>
<tr><td>30.</td><td>(c)</td><td></td></tr>
<tr><td>31.</td><td>(d)</td><td></td></tr>
<tr><td>32.</td><td>(d)</td><td></td></tr>
<tr><td>33.</td><td>(b)</td><td></td></tr>
<tr><td>34.</td><td>(a)</td><td></td></tr>
<tr><td>35.</td><td>(b)</td><td></td></tr>
</table>

CHAPTER

8

Bank reconciliations

Contents

1 BANK RECONCILIATIONS

Section overview

- The cash book (bank account in the general ledger) and bank statements
- Differences and the need for a reconciliation
- Possible cause of confusion
- Format of a bank reconciliation statement
- Bank reconciliations and overdrawn balances

1.1 The cash book (bank account in the general ledger) and bank statements

Chapter 5 explained that the cash book is a book of prime entry used to record all receipts and payments of cash.

There are many different methods by which a business might make payment to suppliers and receive payment from customers.

Methods include

- ☐ Cash is ready money. For accounting purposes, cash includes money in hand and petty cash;
- ☐ Cheques - A cheque is an agreement of payment between two individuals or organizations. So when you write a cheque, you are agreeing to pay another individual or organization money that you owe them and you are instructing your bank to make that payment. But a cheque is not secured as it contains a chance of dishonouring due to the fact that signature may differ or the writer has insufficient balance in the bank account
- ☐ Pay order – It is a financial instrument issued by the bank on behalf of customer stating an order to pay a specified amount to a specified person within the same city. In payment order is pre-printed with the word "Not Negotiable" . There is no chance of dishonoring as the amount is prepaid. Once issued pay order will be valid for three months.
- ☐ Bank transfers – An amount transferred directly from a bank account holder's account to the bank account of another party on the instruction of the first person.
- ☐ Credit and debit cards – People often use these to pay for goods and services purchased from businesses. Once a sale is made the business asks the credit (debit) card company to make the payment on behalf of the card holder. The credit (debit) card company then recovers the cash from the card holder.
- ☐ Many modern businesses now accept online payment for sales of goods and provision of services. Payment is often received through the use of credit cards and debit cards in the usual way or thorough the action of a third party (for example Pay pal).
- ☐ Standing order – An instruction a bank account holder (the payer) gives to their bank to pay a set amount at regular intervals to another party's (the payee's) account.
- ☐ Direct debit – A method of payment in which, a person (payer) allows another party to collect amount from payer's account on regular basis on specific date. Payer has to give instructions to his bank for these payments. This method is normally used for monthly utility bills or credit card bills.

  Both standing orders and direct debits are very common methods of making monthly payments. A standing order allows for payment of the same amount on each payment date as the payer instructs the bank to pay this amount. A direct debit allows for different payments at each payment date as the payer instructs the bank to pay the amount the payee asks for.

Posting

Periodically, totals are posted from the cash book to the general ledger accounts. One of these accounts is the cash account. For the purposes of this section we will describe this more specifically as the cash at bank account. (A business usually also has a cash in hand account to record cash amounts physically held but the majority of cash receipts and payments are usually through the cash at bank account).

The cash at bank account in the general ledger is used to record receipts and payments of cash through the bank account. The balance on this account is the amount that the business believes that it has in its bank account (debit balance) or the size of its bank overdraft (credit balance).

The bank sends regular bank statements to a business entity. A bank statement lists all the transactions that the bank has recorded in the account for the entity since the previous statement and the current balance on the account.

Many businesses now have on-line access to their bank statements so can access a bank statement at any time.

Reconciliation

The term reconciliation refers to a process that compares two sets of records (usually the balances of two accounts, in this case the balance on the cash at bank account and the balance on the bank statement) and explains the reason for any difference between them.

A bank reconciliation compares the balance on the general ledger cash at bank account to the balance on the bank statement at a given point in time. This should be done at regular intervals (say at the end of each month).

Often the balance on the cash at bank account is referred to as the balance on the cash book. This can be confusing but remember that the reconciliation always agrees the balance on the cash at bank account to the balance on the bank statement.

Bank reconciliations are a useful check on the accuracy of accounting records for cash. In principle, the balance in the cash at bank account or cash book in the general ledger and the balance shown in the bank statement should be the same but there are often differences and some of these might relate to transactions which the business has not yet accounted for or errors which must be corrected.

1.2 Differences and the need for the reconciliation

The balance on the general ledger cash at bank account and that shown for the business in its bank statement, at a point in time, will rarely be the same.

Differences might be caused by any of the following:

- ❑ Items recorded in the cash at bank account are not (yet) shown in the bank statement.
- ❑ Items in the bank statement that have not been recorded in the cash at bank account.
- ❑ Errors by the bank (these are quite rare but do happen).
- ❑ Errors in the cash book.

Each of these will be considered in turn.

Items recorded in the cash at bank account that have not (yet) shown in the bank statement

Some transactions might have been recorded in the cash at bank account in the general ledger, but have not yet been recorded by the bank.

Cheques received from customers, recorded in the cash book and paid into the bank and may not have been processed yet by the bank. Processing payments through the banking system might take two or three days, perhaps even longer. These are known as outstanding lodgements.

Cheques paid to suppliers are recorded as payments in accounting system of the business (the general ledger) but they may not yet have been presented to the bank for payment (i.e. paid into the bank by the business's supplier). These are known as unpresented cheques.

Even if the cheques have been presented for payment by supplier the bank may not have processed the deduction form the business's account yet.

These are timing differences. The transactions will eventually be processed by the bank. There are no errors or omissions in the cash book, and no further action is needed.

Items in the bank statement that have not been recorded in the cash at bank account.

A business might not know about some items until they receive a bank statement.

Examples include:

- bank charges;
- bank interest on an overdrawn balance;
- bank interest received on a deposit account and withholding tax thereon;
- a payment from a customer that has been rejected by the bank (for example, the customer's cheque has been dishonoured).
- a bank transfer where a payment has been made directly into the business's account;
- a bank might make a mistake either crediting or debiting an incorrect amount into an account (these are rare but they do happen).

The general ledger cash at bank account should be amended to include these transactions.

When a cheque is dishonoured the business must reverse the entries that were made originally when the business thought that an amount had been received.

Illustration: Double entry for dishonoured cheque

Write back of receivable	Debit	Credit
General ledger:		
Receivables	X	
Cash at bank		X
Receivables ledger:		
Individual customer accounts	X	

The business should also consider whether the receivable should be written off as a bad debt or whether an allowance should be recognised for a doubtful debt.

Errors by the bank

The bank might sometimes make an error. If so, it should be notified and asked to correct its mistake. No further action is then needed as the bank immediately corrects the customer balance.

Errors in the cash book

Possibly, an error has been made in the cash book. This should be identified during the reconciliation of the bank statement with the cash at bank account balance. Any such errors must be corrected when discovered.

1.3 Possible cause of confusion

The bank statement presents information as recorded in the accounting system of the bank. It always shows the banks view of things.

When a business has a positive cash balance that is an asset and as far as the business is concerned it is a debit balance. From the bank's point of view they owe the business money. Therefore they show the business as having a credit balance on the bank statement.

Similarly a bank account is overdrawn, the business owes money to the bank and shows this as a liability (a credit balance) in its financial statements. However, from the bank's point of view they have an asset and show this as a debit balance on the bank statements. Following is useful to learn:

Bank balance and its nature	As per cash book	As per bank statement
Positive	Dr	Cr
Negative/Overdrawn	Cr	Dr

1.4 Format of a bank reconciliation statement

The purpose of a bank reconciliation is to show that the cash at bank account balance in the general ledger agrees with the bank statement balance after taking account of timing differences and making adjustments for any omissions or errors.

There is no single correct format for a bank reconciliation.

A useful approach is to correct the cash at bank balance for any omissions or errors and then adjust the balance per the bank statements for uncredited lodgements and unpresented cheques. The resultant balances should be the same.

Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank account:	X
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	X^1
Balance per bank statement	X
Items in general ledger not in bank statement	
Add: Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	X^1

The balances (X^1) should now agree

Alternative presentations are possible.

Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of Rs. 4,500.

Cheques for Rs. 2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling Rs. 6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged Rs. 700 in bank charges.

A cheque for Rs. 300 from a customer, customer X, has been dishonoured.

The balance in the account according to the bank statement is Rs. 7,700.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	4,500
Items in bank statement not in cash book	
Bank charges	(700)
Dishonoured cheques	(300)
	(1,000)
Corrected cash at bank figure	3,500^1

Balance per bank statement	7,700
Items in general ledger not in bank statement	
Add: Outstanding lodgements	2,000
Deduct: Unpresented cheques	(6,200)
Corrected balance per bank statement	3,500

Alternative format

This approach corrects the general ledger cash at bank account and then shows the differences between that figure and the balance as per the bank statement.

Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank account:	X
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	X[1]
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(X)
Add: Unpresented cheques	X
Balance per bank statement	X[1]

Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of Rs. 4,500.

Cheques for Rs. 2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling Rs. 6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged Rs. 700 in bank charges.

A cheque for Rs. 300 from a customer, customer X, has been dishonoured.

The balance in the account according to the bank statement is Rs. 7,700.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	4,500
Items in bank statement not in cash book	
Bank charges	(700)
Dishonoured cheques	(300)
	(1,000)
Corrected cash at bank figure	3,500[1]
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(2,000)
Add: Unpresented cheques	6,200
Balance per bank statement	7,700

1.5 Bank reconciliations and overdrawn balances

For a company with a bank account, money in the bank is an asset and the cash balance in the cash book is a debit balance. If there is a bank overdraft, the cash book has a credit balance, indicating that money is owed to the bank.

For the bank, the situation is the opposite way round.

- Money held by the bank in a bank account for a customer is money that belongs to the customer. For the bank, deposits are therefore liabilities and an account is said to be in credit when there is money in it.
- If a bank allows an overdraft to a customer, the customer owes the bank. The amount of the overdraft is a form of receivable for the bank, and is an asset. To the bank, an overdraft balance on a customer's account is therefore a debit balance (= asset).

A bank statement might therefore indicate that a customer's account has a 'debit balance', such as ***Rs. 5,250 Dr***. This debit balance means 'overdraft' and for the customer it is a liability and credit balance item in their financial records.

Preparing a bank reconciliation with an overdraft balance

If you are given a question in which there is an overdraft balance in the bank statement, it is useful to make the negative balance clear by putting brackets around the balance.

Illustration: Bank reconciliation

The following assumes that the cash balance is negative (i.e, the business has a credit cash balance).

Balance per general ledger cash at bank account:	(X)
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	(X^1)
Balance per bank statement	(X)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	(X^1)

The balances (X^1 should now agree)

Example: Bank reconciliation

A company receives a bank statement showing an overdraft balance of Rs. 20,000. The balance recorded in the company's cash book is a credit balance of Rs. 12,100.

(1) Lodgements not yet cleared by the bank (i.e. payments into the account but not recorded in the bank statement) Rs. 24,300

(2) Cheques not yet presented (i.e. payments from the account recorded in the cash book but not yet processed through the bank) Rs. 18,900

(3) Bank charges of Rs. 1,300

(4) A dishonoured cheque from a customer Rs. 1,200.

Items (3), (4) and (5) have not yet been recorded in the cash book.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	(12,100)
Items in bank statement not in cash book	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	(2,500)
Corrected cash at bank figure	(14,600)

Balance per bank statement	(20,000)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	24,300
Deduct: Unpresented cheques	(18,900)
Corrected balance per bank statement	(14,600)

Example: Bank reconciliation

Alternatively, the bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	(12,100)
Items in bank statement not in cash book	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	(2,500)
Corrected cash at bank figure	(14,600)

Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(24,300)
Add: Unpresented cheques	18,900
Balance per bank statement	(20,000)

Example: Al-Murtaza

Following information has been collected from the books of Al-Murtaza Company, as at August 31, 2013:

		Rupees
(a)	Balance as per bank book	272,178
(b)	Cash balance on bank statement	227,522

(c) Cheques outstanding on August 31 were as follows:

Cheque No.	Rupees
670	13,353
679	14,152
690	17,108
996	3,535
997	14,430
999	23,629

(d) The company made the following payments into the bank in the last week in August but these had not yet appeared on the bank statement.

Rupees
83,250
144,641

(e) The following matters have been discovered.

- (i) Receipt of Rs. 15,000 was erroneously recorded on the credit side of the bank book.
- (ii) A payment of Rs. 12,480 was erroneously recorded on the debit side of the bank book.
- (iii) The credit side of the bank book has been over casted by Rs. 4,800.
- (iv) The bank statement showed an amount collected by the bank but not shown in the cash book in the amount of Rs. 87,188.

The bank reconciliation as at 31 August shall be as follows:

Bank reconciliation statement (correct) as at August 31, 2013

	Rupees
Balance as per bank statement	227,522
Add undeposited receipts (83,250 + 144,641)	227,891
Less unpresented cheques	(86,207)
Adjusted balance as per bank statement	369,206
Balance as per cash book	272,178
Errors in the cash book	
Receipt of Rs. 15,000 entered as payment	30,000
Payment of Rs. 12,480 entered on the receipt side	(24,960)
Error in casting on the credit side	4,800
	9,840
	282,018
Collection of bill receivable by the bank	87,188
Adjusted balance as per cash book	369,206

Example: ABC Textiles

While reconciling the bank statement with the cash/bank book of ABC Textiles for the year ended December 31, 2013, you noted the following:

		Rupees
(i)	Balance as per bank statement at December 31, 2013, overdrawn	806,436
(ii)	Cheques drawn but not presented till December 31, 2013	377,784
(iii)	Mark-up on overdraft charged by the bank on January 2, 2014 was recorded in the cash/bank book on December 31, 2013	118,686
(iv)	Collections made on December 30 and 31, 2013 were not lodged with the bank till January 3, 2014	250,600
(v)	A bill which was due on December 29, 2013 was sent to the bank for collection on December 28, 2013, and entered in the cash/bank book. However, the proceeds were credited by the bank on January 1, 2014	196,500
(vi)	Subscription for a magazine was paid by the bank, as per the auto-debit instructions, on December 1, 2013. This transaction has not been recorded in the cash/bank book so far	3,144
(vii)	A time-barred cheque was replaced with a new cheque on December 30, 2013 and entered in the cash/bank book without the previous cheque being cancelled / reversed. Both the cheques are included in (ii) above	5,000
(viii)	Discount allowed on prompt payment to customers has been included in the cash/bank book	10,500
(ix)	A cheque received on December 21 was erroneously recorded on the credit side of the cash/bank book	7,500
(x)	A cheque issued to a supplier was time-barred as of January 2, 2014	25,000
(xi)	A cheque for Rs. 125,000 drawn by the company to pay for a new item of plant had been mistakenly entered in the cash/bank book as	12,500
(xii)	A cheque issued by the company has been entered in the credit column of the bank statement	13,200

The bank reconciliation statement as at December 31, 2013 shall be as follows:

Bank reconciliation statement

As at 31st December 2013

Cash Book corrections - (Increase)/decrease in overdraft:

Bank balance as per cash book (overdraft) (before above adjustments/corrections)		(771,062)
Bank mark-up wrongly entered in cash book	118,686	
1st time-barred cheque reversed	5,000	
Discount allowed wrongly entered in cash column	(10,500)	
Error in recording of cheque (125,000 – 12,500)	(112,500)	
Subscription to magazines now entered	(3,144)	
Cheque received wrongly entered in bank book (7,500+7,500)	15,000	12,542
Adjusted balance per bank / cash book (overdraft) to be carried to statement of financial position		(758,520)
Balance overdrawn as per bank statement		(806,436)

(Increase)/decrease in over draft	
Cheques drawn not presented (377,784 – 5,000)	(372,784)
Cheque issued wrongly credited in bank statement (13,200 + 13,200)	(26,400)
Collection received not banked	250,600
Bill not credited	196,500
Bank statement balance as adjusted	(758,520)

The amount to be carried to the statement of financial position as "Cash at Bank" shall be Rs.(758,520)

Practice question **1**

On 30 June the cash account of Sohrab's business showed a balance at bank of Rs. 1,500,000.

The bank statements showed that cheques for Rs. 70,000, Rs.90,000 and Rs.100,000 had not been presented for payment and that lodgements totalling Rs.210,000 had not been cleared.

The balance on the bank statement at 30 June was Rs. 1,550,000.

Prepare a bank reconciliation.

Practice question **2**

The balance in Jabbar's cash account at 30 June showed an asset of Rs.1,660,000.

His bank statement showed an overdraft of Rs.450,000.

On reconciling the cash account he discovers the following.

a) The debit side of the cash account had been undercast by Rs.200,000.

b) A total on the receipts side of the cash account of Rs.2,475,000 had been brought forward as Rs.4,275,000.

c) A cheque received by Jovanovich for Rs.220,000 had bounced.

d) Bank charges of Rs.184,000 had been omitted from the cash account.

e) Unpresented cheques totalled Rs.520,000 and uncleared lodgements Rs.626,000.

Prepare a bank reconciliation.

Practice question **3**

A company receives a bank statement showing a credit balance of Rs.7,400,000. On investigation, its accountant discovers that the bank statement does not show cheques received from customers for Rs.16,200,000 and banked, or cheque payments to suppliers for Rs.18,500,000. The bank statement also shows bank charges of Rs.250,000, which have not yet been recorded in the ledger.

Required

What is the current balance on the cash book? (This is the balance on the Bank account in the main ledger.)

Practice question: Sandford **4**

A company receives a bank statement. The balance on its cash book (= bank account in the main ledger) is a debit balance of Rs.1,600,000. In reconciling the cash book balance with the bank statement balance, the accountant discovers that the bank statement does not show cheques received from customers for Rs.8,200,000 and banked, or cheque payments to suppliers for Rs.4,700,000. The bank statement also shows bank charges of Rs.150,000, a direct debit payment of Rs.400,000 and a dishonoured cheque for Rs.300,000. None of these three items which has yet been recorded in the ledger.

Required

What is the balance on the bank statement?

What entries should be made in the company's ledger accounts when the cash book and the bank statement balances have been reconciled?

Practice question: Mubarak & Company **5**

Mr. Mubarak is a sole trader and carries on business under the name "Mubarak & Company". The balance on his cash book at 31 December 2013 did not agree with the balance as per the bank statement which shows a credit balance of Rs. 367,500.

An examination of the cash book and bank statement disclosed the following:

(i) A deposit of Rs. 49,200 made on 29 December 2013 had been credited by the bank on 1 January 2014.

(ii) Bank charges of Rs. 1,700 have not been entered in the cash book.

(iii) A debit of Rs. 4,200 appeared on the bank statement for an unpaid cheque which has been returned marked "out of date". The cheque was re-dated by his customer and paid into the bank again on 3 January 2014.

(iv) A standing order for payment of an annual subscription amounting to Rs. 1,000 has not been entered in the cash book.

(v) On 26 December 2013, Mr. Mubarak had given the cashier a cheque for Rs. 10,000 to pay into his personal account at the bank. The cashier deposited it into the business account by mistake.

(vi) On 27 December 2013, a customer had made an online transfer of Rs. 49,900 in payment against goods supplied. The advice was received and recorded in the cash book on 2 January 2014.

(vii) On 30 September 2013, Mr. Mubarak entered into a hire purchase agreement and issued a standing order to the bank to pay a sum of Rs. 2,600 on the 10th day of each month, commencing from October 2013. No entries have been made in the cash book for these payments.

(viii) A cheque for Rs. 36,400 received from Mr. Bashir had been entered twice in the cash book.

(ix) Cheques issued amounting to Rs. 467,200 had not been presented to the bank for payment until after 31 December 2013.

(x) A customer who owed Rs. 20,000 and was entitled to a cash discount of 2½% paid a cheque for the net amount on 10 December 2013. The cashier erroneously recorded the gross amount in the bank column of the cash book.

(xi) Dividend collected by the bank amounting to Rs. 12,000 has not been recorded in the cash book.

(xii) A cheque of Rs. 243,000 received from Mr. Bilal was deposited in the bank but entered in the cash book as Rs. 234,000.

Required:

(a) Prepare a bank reconciliation statement as on 31 December 2013.

(b) Prepare necessary journal entries in the books of Mubarak & Company and determine the correct cash balance that should be reported in the statement of financial position. Also specify the situations in which no adjustment/entry is required.

Practice question: Unique Traders **6**

Following information has been extracted from the records of Unique Traders:

Bank book for the month of February 2018

Date	Receipts	Rupees	Date	Payments	Cheque	Rupees
01	Balance	133,500	03	Salaries	X09	225,000
05	Debtors	315,000	05	Utilities	X10	352,000
09	Sales	525,000	08	Purchases	X11	622,000
12	Rentals	615,000	15	Rental	X12	608,000
18	Security deposit	200,000	20	Purchases	X13	71,000
25	Advance from customers	182,000	28	Balance		441,500
26	Debtors	294,000				
28	Cash deposited in bank	55,000				
		2,319,500				2,319,500

Bank statement for the month of February 2018

Date	Description	Cheque	Withdrawals	Deposits	Balance
			Rupees	Rupees	Rupees
01	Balance				127,500
03	Cheque withdrawal	X09	225,000		(97,500)
05	Reversal of amount credited mistakenly		48,000		(145,500)
09	Cheque withdrawal	X05	63,000		(208,500)
14	Outward cheque clearing			315,000	106,500
20	Outward cheque clearing			525,000	631,500
22	Cheque withdrawal	X10	325,000		306,500
24	Payment against standing instructions		15,000		291,500
25	Outward cheque clearing			615,000	906,500
26	Outward cheque clearing			200,000	1,106,500
26	Transfer (from a debtor)			38,000	1,144,500
27	Cheque returned		200,000		944,500
28	Cheque withdrawal	X12	608,000		336,500
28	Cheque withdrawal	X13	71,000		265,500
28	Cash deposit			55,000	320,500
28	Bank charges		4,500		316,000
			1,559,500	**1,748,000**	

(All amounts appearing in the above bank statement are correct)

Bank reconciliation statement as on 31 January 2018

Description	Bank book	Bank statement
	——— Rupees ———	
Balance	(133,500)	127,500
Unpresented cheques:		
Cheque X05 dated 28 January 2018		(63,000)
Cheque X06 dated 31 January 2018		(150,000)
Amount mistakenly credited by bank		(48,000)
Corrected balance	(133,500)	(133,500)

Required:

Prepare bank reconciliation statement as on 28 February 2018, showing the correct balance as per bank book and bank statement.

Practice question: Comfort Travels **7**

The following bank reconciliation statement pertains to Comforts Travels for the month of February 2017:

	Rupees
Balance as per bank statement	3,258,000
Outstanding cheques	(869,200)
Cheques deposited and under clearance	456,350
Debit advices for bank charges received in March 2017	9,240
Un-reconciled difference	(9,000)
Balance as per bank book	2,845,390

Scrutiny of the bank book and bank statements revealed the following:

i. Outstanding cheques include:
  - a cheque of Rs. 37,250. The cheque was recorded in the bank book as Rs. 32,750.
  - a cheque amounting to Rs. 9,650 which is outstanding since 8 June 2016. Cheques outstanding for more than six months are not honoured by the bank.

ii. Cheques under clearance include a post-dated cheque of Rs. 35,000 received from a customer on 27 February 2017. The cheque was deposited in the bank on 28 February 2017. The date of the cheque was 1 March 2017.

iii. The bank charges include an amount of Rs. 2,500 which was subsequently reversed by the bank.

iv. A page total of payment side of the bank book amounting to Rs. 4,589,000 was carried forward to the next page as Rs. 4,598,000.

Required:

a) Post relevant transactions to the bank book to arrive at the correct balance as at 28 February 2017.

b) Prepare a revised bank reconciliation statement for the month of February 2017 using the corrected bank book balance.

Practice question: Eden Garments **8**

Following information has been extracted from the records of Eden Garments (EG), as at 30 June 2016:

	Rupees
Balance as per bank book (debit balance)	760,000
Balance as per bank statement (overdraft)	1,490,850

An examination of the bank book and the bank statement, revealed the following:

i. Outstanding cheques amount to Rs. 3,856,300 and include:

- ☐ a cheque of Rs. 50,000 issued to a supplier bearing an incorrect payee's name. The cheque was returned and recorded on 15 July 2016.
- ☐ a cheque issued to a supplier for Rs. 85,000 was recorded in bank book as Rs. 58,000.
- ☐ a cheque dated 20 December 2015 for Rs. 4,630 issued for repair of a car was misplaced. The repair charges were paid in cash and the misplacement of the cheque was not recorded.

ii. Un-cleared cheques amount to Rs. 6,460,000 and include:

- ☐ a cheque of Rs. 366,000 received from a customer was returned by the bank as amount in words was not in conformity with the amount in figures. The return was not recorded and the cheque was sent to the customer for replacement.
- ☐ a cheque of Rs. 76,000 received from a customer in settlement of an invoice availing payment discount of 5%. The collection was recorded by EG at gross amount of invoice.

iii. An unidentified credit of Rs. 354,000 was appearing in the bank statement. It was found that a customer had made an online transfer to avail 5% discount allowed on payments made by 30 June 2016.

iv. Following debit/credit advices dated 30 June 2016 were received from the bank on 5 July 2016:

- ☐ Bank charges amounting to Rs. 7,850. It has been noted that the bank had over charged EG by Rs. 1,250.
- ☐ Dividend collected by the bank amounting to Rs. 50,000.
- ☐ Payment on EG's standing instruction of an annual subscription for a magazine amounting to Rs. 12,000.

Required:

a) Post relevant transactions to bank book of EG to arrive at the correct bank balance as at 30 June 2016.

b) Prepare a bank reconciliation statement for the month of June 2016 to arrive at the adjusted bank balance as per EG's books.

Practice question: Galaxy Enterprises

9

Galaxy Enterprises (GE) maintains a bank account with Zee Bank Limited. Following information pertains to the bank account for the month of January 2016:

	Bank book	Bank statement
Balance as at 31 January 2016	(Dr.) Rs. 856,000	(Cr.) Rs. 1,182,500

Other information:

i. Following is the list of outstanding cheques as at 31 January 2016:

Cheque no.	Date	Rupees
111	14-Jul-2015	250,000
444	23-Nov-2015	79,000
666	15-Dec-2015	455,000
777	28-Jan-2016	500,000
Various	31-Jan-2016	1,350,000

Review of outstanding cheques revealed that incorrect payee's name was mentioned on cheque no. 666. Cheque no. 777 was issued to replace cheque no. 666. The difference of Rs. 45,000 represents payment against another invoice.

ii. Cheques outstanding for more than six months are not honoured by banks.

iii. Details of un-cleared cheques as at 31 January 2016 are as follows:

Date	Customer's name	Cheque no.	Rupees
8-Oct-2015	Zeta Enterprises	1XX	140,000
3-Dec-2015	XYZ Traders	2XX	70,000
26-Dec-2015	ABC & Co.	3XX	63,000
31-Jan-2016	Various customers	Various	1,780,000

❑ Cheque no. 1XX was dishonoured on 28 January 2016.

❑ Cheque no. 2XX was mistakenly credited by the bank to another party. GE's account was however credited on 8 February 2016.

iv. A debit of Rs. 135,000 is appearing in the bank statement of January 2016. It represents reversal of a credit given in December 2015 against a post-dated cheque of 1 March 2016 which was mistakenly deposited by GE.

v. A reconciling item of Rs. 9,000 is appearing in the bank reconciliation statement from December 2015. It represents the difference between a cheque of Rs. 54,000 received from a customer and recorded by GE at Rs. 45,000. The error could not be identified in December 2015.

vi. Following debit advices dated 29 January 2016 were received by GE in February 2016:

❑ Bank charges amounting to Rs. 8,500.

❑ Payments of Rs. 120,000 for annual subscriptions against standing instructions.

Required:

a) Compute corrected Bank book balance and prepare necessary journal entries to correct the errors in the Bank book.

b) Prepare a bank reconciliation statement for the month of January 2016.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Balance per general ledger cash at bank account:	1,500,000
Balance per bank statement	1,550,000
Items in general ledger not in bank statement	
Add: Outstanding lodgements	210,000
Deduct: Unpresented cheques	(260,000)
Corrected balance per bank statement	1,500,000

Alternative presentation:

Balance per general ledger cash at bank account:	1,500,000
Corrected cash at bank figure	
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(210,000)
Add: Unpresented cheques	260,000
Balance per bank statement	1,550,000

Solutions **2**

Balance per general ledger cash at bank account:	1,660,000
Items in bank statement not in cash book	
(a) Correction of undercast	200,000
(b) Correction of mistake	
(2,475,000 – 4,275,000)	(1,800,000)
(c) Dishonoured cheque	(220,000)
(d) Bank charges	(184,000)
	(2,004,000)
Corrected cash at bank figure	(344,000)
Balance per bank statement	(450,000)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	626,000
Deduct: Unpresented cheques	(520,000)
Corrected balance per bank statement	(344,000)

Alternative presentation:

Balance per general ledger cash at bank account:	1,660,000
Items in bank statement not in cash book	
(a) Correction of undercast	200,000
(b) Correction of mistake	
(2,475,000 – 4,275,000)	(1,800,000)
(c) Dishonoured cheque	(220,000)
(d) Bank charges	(184,000)
	(2,004,000)
Corrected cash at bank figure	(344,000)
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(626,000)
Add: Unpresented cheques	520,000
Balance per bank statement	(450,000)

Solutions **3**

	Rs.(000)
Bank balance in the bank statement	7,400
Items recorded in the cash book, but not yet in the bank statement	
Cheques received from customers and banked	16,200
Cheques paid but not yet presented for payment	(18,500)
	5,100
Items in the bank statement, not in the cash book	
Bank charges	250
Balance in the cash book	5,350

The bank charges should be recorded in the ledger:

Debit Bank charges account (expense), Credit Cash book (= Bank)

Solutions **4**

(a)

	Rs.(000)
Bank balance in the cash book	1,600
Items in the bank statement, not in the cash book	
Bank charges	(150)
Direct debit payment	(400)
Dishonoured cheque	(300)
	(850)
Adjusted balance in the cash book	750
Balance in the bank statement (= overdraft balance found as a balancing figure)	(2,750)
Items recorded in the cash book, but not yet in the bank statement	
Cheques received from customers and banked	(8,200)
Cheques paid but not yet presented for payment	4,700
	(3,500)
Bank statement balance as adjusted	750

Or

	Rs.(000)	Rs.(000)
Bank balance in the cash book		1,600
Items recorded in the cash book, but not yet in the bank statement		
Cheques received from customers and banked		(8,200)
Cheques paid but not yet presented for payment		4,700
		(1,900)

	Rs.(000)	Rs.(000)
Items in the bank statement, not in the cash book		
Bank charges	(150)	
Direct debit payment	(400)	
Dishonoured cheque	(300)	
		(850)
Balance in the bank statement (= overdraft balance)		(2,750)

	Debit	Credit
(b) The ledger accounts should be updated as follows:	Rs.(000)	Rs.(000)
Bank charges (expense account)	150	
Expense account to which the direct debit payment relates	400	
Receivables (dishonoured cheque) or bad debts expense	300	
Bank (cash book)		850

Solutions **5**

Bank Reconciliation Statement as at 31 December, 2013

Adjustment in cash book (Note: "Add" = increase bank overdraft and "less" = decrease bank overdraft)

Balance as per bank book – (OD) – **Balancing figure (Step 3)**			(79,800)
2	Add:	Bank charges	(1,700)
3	Add:	Cheque returned and re-deposited after re-dating	(4,200)
4	Annual subscription		(1,000)
5	Less:	Mr. Mubarak's cheque wrongly deposited	10,000
6	Less:	Debtor's A/c (direct deposits)	49,900
7	Add:	Hire purchase vendor	(7,800)
8	Add:	Mr. Bashir - Cheque entered twice now adjusted	(36,400)
10	Add:	Discount allowed	(500)
11	Less:	Dividend A/c	12,000
12	Less:	Error - cheque short booked	9,000
Adjusted balance as per bank statement – Overdraft **(Step 2)**			(50,500)

		Rs.
Balance as per bank statement - in favour of Mubarak & Company		367,500
9	Less : Cheques issued but not presented	(467,200)
1	Add: Amount deposited but not credited by bank	49,200
Adjusted balance as per bank statement – Overdraft **(Step 1)**		(50,500)

Journal entries		**Debit**	**CreditS**
2	Bank charges	1,700	
	Bank account		1,700
3	Debtor's A/c	4,200	
	Bank account		4,200
4	Subscription	1,000	
	Bank account		1,000
5	Bank account	10,000	
	Mr. Mubarak		10,000
6	Bank account	49,900	
	Debtor's A/c (direct deposits)		49,900
7	Hire purchase vendor	7,800	
	Bank account		7,800

		Debit	Credit
8	Mr. Bashir - Cheque entered twice	36,400	
	Bank account		36,400
10	Discount allowed	500	
	Bank account		500
11	Bank account	12,000	
	Dividend a/c		12,000
12	Bank Account	9,000	
	Debtors Account		9,000

Corrected cash book balance:

(79,800) + 29,300 (net favourable balance of above transactions)
Overdraft 50,500

Solutions **6**

Bank reconciliation statement as on 28 February 2018

Description		**Bank book**	**Bank statement**
		Rupees	
Balance as per bank book/bank statement		441,500	316,000
Error in opening balance at the bank book	(133,500×2)	(267,000)	
Cheque no. X10 wrongly recorded in the bank book (352,000-325,000)		27,000	
Direct transfer from a debtor		38,000	
Standing instructions		(15,000)	
Dishonoured cheque		(200,000)	
Bank charges not recorded in the bank book		(4,500)	
Deposits in transit:			
– Cheque of 25 February 2018			182,000
– Cheque of 26 February 2018			294,000
Unpresented cheques:			
– Cheque no. X06 dated 31 January 2018			(150,000)
– Cheque no. X11 dated 8 February 2018			(622,000)
Corrected balance		**20,000**	**20,000**

Solutions **7**

Comforts Travels

(a) Correct bank book balance as at 28 February 2017

Bank book

Date	Description	Rupees	Date	Description	Rupees
28-Feb	Balance b/d	2,845,390	(i)	Account payable (37,250–32,750)	4,500
(i)	Account payable	9,650	(ii)	Account receivable	35,000
(iv)	Suspense A/c - Correction of carry forward error - (4,598,000–4,589,000)	9,000	(iii)	Bank charges (9,240–2,500)	6,740
			28-Feb	Balance c/d	2,817,800
		2,864,040			**2,864,040**

(b) Bank reconciliation statement for the month of February 2017

		Rupees
Balance as per the bank statement		3,258,000
Outstanding cheques:		
	As per the previous reconciliation	(869,200)
(i)	Cheque issued for Rs. 37,250 is recorded as Rs. 32,750. (37,250–32,750)	(4,500)
(i)	Cheque dated 8 June 2016 included in the outstanding cheques is to be cancelled as outstanding for more than six months.	9,650
		(864,050)
Cheques deposited and under clearance:		
	As per the previous reconciliation	456,350
(ii)	Reversal of a post-dated cheque dated 1 March 2017 recorded in the month of February 2017	(35,000)
		421,350
(iii)	Bank charges subsequently reversed by the bank	2,500
Balance as per the bank book		**2,817,800**

Solutions **8**

(a)

Bank account

Date	Description	Rupees	Date	Description	Rupees
30-Jun	Balance b/d	760,000	(i)	Account payable	
(i)	Account payable	50,000		(85,000–58,000)	27,000
(i)	Repair charges	4,630	(ii)	Account receivable	366,000
(iii)	Account receivable	354,000	(ii)	Discount expense	
(iv)	Dividend income	50,000		(76,000÷0.95)–76,000	4,000
			(iv)	Bank charges	
				(7,850–1,250)	6,600
			(iv)	Subscription charges	12,000
			30-Jun	Balance c/f	803,030
		1,218,630			**1,218,630**

(b) Bank reconciliation statement for the month of 30 June 2016

	Rupees
Balance as per bank statement - **overdraft**	(1,490,850)
(i) **Cheques issued by EG but not yet paid by the bank:**	
– As given in question paper	(3,856,300)
– Cheque returned from the bank now recorded	50,000
– Misplaced cheque now reversed	4,630
	(3,801,670)
(ii) **Cheques deposited but not credited by the bank:**	
– As given in question paper	6,460,000
– Cheque deposited and returned by the bank now recorded	(366,000)
	6,094,000
(iv) Bank charges over charged	1,250
Unidentified difference **(balancing)**	300
Balance as per bank book	**803,030**

Solutions **9**

(a) Corrected bank book balance

		Rupees Dr./(Cr.)
Balance as per bank book		856,000
111	Reversal of cheque issued and time barred	250,000
666	Reversal of a cheque issued with an incorrect name	455,000
1XX	Reversal of a cheque deposited into the bank and dishonored	(140,000)
(iv)	Reversal of a post-dated cheque of 1 March 2016 mistakenly presented and credited by the bank in Dec. 2015	(135,000)
(v)	Correction of a customer's cheque of Rs. 54,000 mistakenly recorded as Rs. 45,000	9,000
(vi)	Bank debit advices of January 2016 received in February 2016	
	- Bank charges	(8,500)
	- Annual subscription	(120,000)
Corrected bank book balance		**1,166,500**

Correction Journal entries for the month of January 2016

Date	Description	Debit	Credit
		Rupees	
31-Jan-2016	Bank	250,000	
	Account payable		250,000
	(Reversal of time barred cheque # 111)		
31-Jan-2016	Bank	455,000	
	Account payable		455,000
	(Reversal of cheque # 666 issued with an incorrect name)		
31-Jan-2016	Account receivable	140,000	
	Bank		140,000
	(Reversal of dishonored cheque # 1XX)		
31-Jan-2016	Account receivable	135,000	
	Bank		135,000
	(Reversal of post-dated cheque of 1 March 2016 mistakenly presented to the bank in Dec. 2015)		
31-Jan-2016	Bank	9,000	
	Account receivable		9,000
	(Correction of a customer's cheque of Rs. 54,000 mistakenly recorded as Rs. 45,000)		
31-Jan-2016	Bank charges	8,500	
	Subscription charges	120,000	
	Bank		128,500
	(To record bank charges and annual subscriptions paid)		

(b) **Bank reconciliation statement for the month of January 2016**

		Rupees (Dr.)/Cr.
Bank balance as per bank statement		1,182,500
Less:	Cheques issued but not presented for payments:	
	444	(79,000)
	777	(500,000)
	Various	(1,350,000)
Add:	Cheques deposited into the bank but not yet cleared:	
	2XX	70,000
	3XX	63,000
	Various	1,780,000
Corrected bank book balance		**1,166,500**

2 OBJECTIVE BASED QUESTIONS

01. The following bank reconciliation statement has been prepared by a business.

Bank reconciliation statement as at April 30, 2018	Rs.
Balance as per bank statement (Cr)	45,200
Add: Outstanding cheques	11,500
Less: Uncleared lodgements	13,100
Balance as per cash book (Dr)	43,600

Assuming that all items other than balance as per cash book is correct; what is the correct balance as per cash book?

(a) Rs.43,600 Dr as per statement in question

(b) Rs.43,600 Cr

(c) Rs.46,800 Dr

(d) Rs.46,800 Cr

02. Debit balance of Rs.5,000 as per bank statement means:

(a) Rs.5,000 payable to business by the bank

(b) Rs.5,000 receivable from business by the bank

(c) Rs.5,000 deposited by the business during the month

(d) Rs.5,000 withdrawn from the bank by business during the year

03. The following bank reconciliation statement has been prepared by a trainee accountant:

	Rs.
Overdraft as per bank statement	6,980
Less: Outstanding cheques	10,460
	3,480
Add: Deposits credited after date	11,800
Cash at bank as per cash book	15,280

What should be the correct balance as per cash book?

(a) Rs.15,280 balance at bank as stated

(b) Rs.5,640 balance at bank

(c) Rs.15,280 overdrawn

(d) Rs.5,640 overdrawn

04. At the end of 31 March 2019, balance as per cash book of Imtiaz is Rs.10,200 (Dr) which did not agree with the balance as per the bank statement. On investigation following information was identified;

A standing order of Rs.350 was paid by the bank did not appear in the cash book.

Dividend received directly in the bank was Rs.30

Bank credited interest for the quarter Rs.350; it was included in cash book as Rs.530

A customer cheque deposited in the bank Rs.120 was dishonoured

What is the corrected balance as per cash book?

(a) Rs.10,170 Dr

(b) Rs.10,170 Cr

(c) 9,520 Dr

(d) 9,520 Cr

05. A business identified that there is a difference between balance of cash book and the balance as per bank statement at end of 28 February 2019. On investigation it was revealed that:

Bank debits account of business for bank charges Rs.30 and standing order Rs.150.

Bank erroneously debits bank account of business for a cheque of Rs.40.

Business has credited the bank account for quarterly interest income Rs.150.

What is the total amount of adjustment to be made in cash book of business?

(a) Rs.180 Cr and Rs.150 Dr

(b) Rs.180 Cr and Rs.300 Dr

(c) Rs.220 Cr and Rs.300 Dr

(d) Rs.220 Dr and Rs.300 Cr

06. Balance of bank account as per cash book is Rs.35,000 (Dr) while balance as per bank statement is Rs.32,500 (Cr). Difference is explained as Uncleared lodgments of Rs.2,500 not included in the bank statement.

What is the amount of bank balance to be reported in Statement of financial Position?

(a) Rs.35,000 Cash at bank

(b) Rs.35,000 Overdraft

(c) Rs.32,500 Cash at bank

(d) Rs.32,500 Overdraft

07. A business is in process of reconciling its cash book with banks statement.

Which of the following item require entry in cash book?

(a) Bank service charges

(b) Deposits credited by the bank after the date of the bank statement

(c) Cheque of another account erroneously credited by bank

(d) Cheques presented by suppliers after the date of bank statement

08. A business is in process of preparing its bank reconciliation statement. The balance of cash book did not agree with the balance in bank statement. The following information is available:

- Balance as per cash book before comparing bank statement Rs. 11,000 (Dr)
- Outstanding Cheques Rs.1,550
- Outstanding lodgments Rs.1,200
- Bank charges Rs.50
- Bank interest income Rs.100

What is the balance as per bank statement?

(a) Rs.11,200 Dr

(b) Rs.11,400 Dr

(c) Rs.11,400 Cr

(d) Rs.11,200 Cr

09. A business received a bank statement showing a credit balance of Rs.7,400. On investigation its accountant discovered that the bank statement does not show cheques received from customers Rs.16,200 and banked and same for cheque payments to suppliers Rs.18,500. The bank statement also shows bank charges of Rs.250 which has not yet been recorded in ledger.

What is the current balance as per cash book?

(a) Rs.5,350 Cr

(b) Rs.5,350 Dr

(c) Rs.5,100 Dr

(d) Rs.5,100 Cr

10. Following information has been collected from the books of Murtaza as at 31 January 2019:

Balance as per cash book Rs.15,000 (Dr)

On scrutiny of bank statement it was found:

- Unpresented Cheques Rs.2,500
- Uncredited lodgements Rs.1,500
- Bank charges Rs.200
- Bank debits Muratza for bank interest Rs.120 instead of Rs.150. No amount was recorded in cash book of Murtaza

Further it was found that:

- Receipt of Rs.1,500 was recorded on credit side of cash book
- Payment of Rs.1,200 was recorded on debit side of cash book

What is the corrected cash book balance of Murtaza?

(a) Rs.15,370 Dr

(b) Rs.15,250 Dr

(c) Rs.15,250 Cr

(d) Rs.15,370 Cr

11. A bank statement shows a balance of Rs.4,000 in credit. On examining the bank statement, it was found that the cheques of Rs.600 deposited in bank as per the cash book not yet on the bank statement and cheques of Rs.1,000 issued out but not yet appeared on the bank statement.

Furthermore, the cash book shows deposit interest received of Rs.100 but this is not yet on the statement.

What is the balance as per cash book?

(a) Rs.3,700

(b) Rs.4,500

(c) Rs.5,000

(d) Rs.3,900

12. If it was found that the receipt side of the cash book has been under-casted, then in preparing bank reconciliation statement, it should be:

(a) Deducted from balance as per cash book

(b) Added in balance as per bank statement

(c) Added in balance as per cash book

(d) Deducted from balance as per bank statement

13. Which of the following statements is correct?

(a) Credit balance as per bank statement means a bank overdraft

(b) Debit balance as per bank statement means a bank overdraft

(c) Debit balance as per cash book means a bank overdraft

(d) Credit balance as per cash book means an asset

14. Which of the following require deduction from cash book balance while preparing bank reconciliation statement?

(a) Direct deposit by a customer into bank but entered in cash book

(b) Standing orders paid by the bank not yet entered in cash book

(c) Unpresented cheques not yet paid by bank

(d) Bank debits interest Rs. 2,500 instead of Rs. 5,200

15. The following information relates to bank reconciliation:

(i) The bank balance in the cash book before taking the items below into account was Rs.9,870 overdrawn

(ii) Bank charges of Rs.750 on the bank statement have not been entered in the cash book

(iii) The bank has credited the account in error with Rs.645 which belongs to another customer

(iv) Cheque payments totaling Rs.4,385 have been entered in the cash book but have not been presented by payment

(v) Cheques totaling Rs.6,500 have been correctly entered on the debit side of the cash book but have not been paid in at the bank

What was the balance as shown by the bank statement?

(a) Rs.10,970 overdrawn

(b) Rs.12,200 overdrawn

(c) Rs.12,090 overdrawn

(d) Rs.11,550 overdrawn

16. Balance as per bank statement of Asim was Rs.11,600 credit as on April 30, 2018 which was not in agreement with the balance as per cash book.

On investigation the following items were detected:

- Cheques issued and paid by the bank for Rs.5,500 but recorded in the cash book as Rs.500
- Bank service charges not entered in the cash book Rs.420
- Outstanding lodgements Rs.1,300
- Bank has erroneously debited a cheque of Rs.900 to Asim actually the cheque was issued by Asif.
- Unpresented cheques Rs.1,200

What should be the balance as per cash book before adjustments?

Rs. ___________

17. Following information is available regarding cash at bank of a business:

- Cash at bank as per bank column of the cash book Rs.4,910
- Unpresented cheques Rs.630
- Cheques received & paid into the bank, but not yet entered on the bank statement Rs.460
- Credit transfers entered on the bank statement but not entered in the cash book Rs.340

What is Cash at bank as per bank statement?

Rs. ___________

18. The bank column of a cash book showed a credit balance of Rs.8,000. There were unpresented cheques amounting to Rs.2,500.

The bank statement showed bank charges, Rs.900, which were not recorded in the cash book.

What is the balance on the bank statement?

Rs. ___________

19. When preparing a bank reconciliation statement the following information is available.

- Balance as per cash book Rs.25,000 (Dr)
- Outstanding cheques Rs.1,500
- uncleared lodgements 1,300
- Standing order shown on the bank statement (not appearing in a cash book) Rs.200
- Dividend directly deposited in the bank (not appearing in the cash book) Rs.25

What is the balance as per bank statement?

Rs. ___________

20. Balance as per bank statement was Rs.1,000 in debit. Comparison of bank statement with cash book revealed that cheques of Rs.3,200 paid in per the cash book but not yet on the bank statement and cheques of Rs.500 paid out but not yet appeared on the bank statement. In addition the bank statement shows direct deposit of Rs.800 by a customer but it is not recorded in cash book.

What is the balance as per cash book after adjustments?

Rs. ___________

21. The main purpose of preparing a bank reconciliation statement is?

(a) To know the bank balance

(b) To know the balance of bank statement

(c) To correct the cash book

(d) To identify causes of difference between cash book and bank statement

22. Bank Reconciliation Statement is prepared by

(a) Bank

(b) Accountant

(c) Customer

(d) Auditors

23. Bank reconciliation statement is

(a) Part of bank statement

(b) Part of the cash book

(c) A separate statement

(d) A sub-division of journal

24. Favorable balance means?

- **(a)** Credit balance in the cash book
- **(b)** Credit balance in Bank statement
- **(c)** Debit balance in cash book
- **(d)** Both b and c

25. Unfavorable balance means?

- **(a)** Credit balance in the cash book
- **(b)** Credit balance in Bank statement
- **(c)** Debit balance in cash book
- **(d)** Debit balance in petty cash book

26. When cheque is not paid by the bank, it is called?

- **(a)** Stale cheque
- **(b)** Dishonored cheque
- **(c)** Bearer cheque
- **(d)** None of the above

27. Which of the following would not affect bank reconciliation?

- **(a)** Dishonored cheque
- **(b)** Bank interest
- **(c)** Discount received
- **(d)** Unpresented cheque

28. An amount of Rs. 1,000 is debited twice in the bank statement. When overdraft as per the cash book is the starting point?

- **(a)** Rs. 1,000 will be added
- **(b)** Rs. 1,000 will be deducted
- **(c)** Rs. 2,000 will be deducted
- **(d)** Rs. 2,000 will be added

29. Bank sent debit advice of Rs. 50,000 to company being interest on overdraft. It was not entered in cash book.

Identify the correct adjustment in cash book?

- **(a)** Rs. 50,000 will be debited
- **(b)** Rs. 50,000 will be credited

(c) No adjustment

(d) Rs. 100,000 will be subtracted

30. A discount of Rs. 20,000 was given to a supplier on his prompt repayment of debt but the cashier entered the gross amount in cash book.

What should be the adjustment in cash to work out the correct balance of cash book?

(a) Rs. 20,000 will be debited in cash book

(b) Rs. 20,000 will be credited in cash book

(c) Rs. 40,000 will be debited in cash book

(d) Rs. 40,000 will be credited in the cash book

31. In the Bank reconciliation statement “Deposit in transit” is usually:

(a) Subtracted from bank balance

(b) Added to bank balance

(c) Added to Cash book balance

(d) Subtracted from cash book balance

32. Interest credited to bank account

(a) Add to cash book balance

(b) Deduct from cash book balance

(c) Add to bank balance

(d) Deduct from bank balance

33. Bank inadvertently charged your bank account for another company's bank fees

(a) Add to cash book balance

(b) Deduct from cash book balance

(c) Add to bank balance

(d) Deduct from bank balance

34. A company had a receipt of Rs.989,000 and correctly prepared its bank deposit slip for Rs.989,000. However, the company recorded the receipt in its Cash account as Rs.998,000.

How is the difference of Rs.9,000 handled on the bank reconciliation?

(a) Add to cash book balance

(b) Deduct from cash book balance

(c) Add to bank balance

(d) Deduct from bank balance

2 OBJECTIVE BASED ANSWERS

<table>
<tr><td>01.</td><td>(c)</td><td>Uncleared lodgments are added and outstanding cheques are deducted from balance as per bank statement.
Rs. 45,200 – 11,500 + 13,100 = Rs. 46,800 (Normal debit balance)</td></tr>
<tr><td>02.</td><td>(b)</td><td>Dr balance as per bank statement means credit balance as per cash book i.e. a liability of business and asset of bank.</td></tr>
<tr><td>03.</td><td>(d)</td><td>The balance in bank statement should be taken as negative.
= – Rs. 6,980 – 10,460+11,800= – Rs. 5,640 overdraft (negative balance)</td></tr>
<tr><td>04.</td><td>(c)</td><td>= Rs. 10,200 – 350+30 [– 530+350] – 120= Rs. 9,520 debit</td></tr>
<tr><td>05.</td><td>(b)</td><td>Rs. 180 Cr (bank charges and standing order payment) and Rs. 300 Dr (150 x 2) the interest should have been debited (not credited) in cash book</td></tr>
<tr><td>06.</td><td>(a)</td><td>Uncleared lodgments are reconciling item cash book balance is not adjusted for those. Balance to be reported in the statement of financial position is balance as per cash book.</td></tr>
<tr><td>07.</td><td>(a)</td><td>All other items belong to reconciliation statement</td></tr>
<tr><td>08.</td><td>(c)</td><td>
<table>
<tr><th></th><th>Dr
Rs.</th><th>Cr.
Rs.</th></tr>
<tr><td>Balance as per cash book adj.</td><td>11,050</td><td></td></tr>
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Cash book
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Rs.</th></tr>
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<tr><td>As per question</td><td>15,000</td><td>Bank interest</td><td>150</td></tr>
<tr><td>Wrongly recorded 1,500x2</td><td>3,000</td><td>Payment wrongly recorded 1,200 x 2</td><td>2,400</td></tr>
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Rs.</th></tr>
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<tr><td>12.</td><td>(c)</td><td>Errors in cash book are adjusted to the balance as per cash book and undercasting of error would have decreased balance of cash that needs to be increased now.</td></tr>
<tr><td>13.</td><td>(b)</td><td>Debit balance as per bank statement means business is a debtor of bank, hence, bank overdraft.</td></tr>
<tr><td>14.</td><td>(b)</td><td>Standing order and bank charges both are payments and would be deducted from cash book balance.</td></tr>
<tr><td>15.</td><td>(c)</td><td>
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Rs.</th></tr>
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Cash book

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Rs.</th></tr>
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<tr><td>As per question</td><td>25,000</td><td>Standing order</td><td>200</td></tr>
<tr><td>Dividend</td><td>25</td><td>c/d</td><td>24,820</td></tr>
<tr><td></td><td>25,025</td><td></td><td>25,025</td></tr>
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<td>20.</td>
<td>Rs. 1,700 Dr</td>
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<tr><th></th><th>Dr
Rs.</th><th>Cr.
Rs.</th></tr>
<tr><td>Balance as per bank statement</td><td>1,000</td><td></td></tr>
<tr><td>Uncredited lodgment</td><td></td><td>3,200</td></tr>
<tr><td>Unpresented cheques</td><td>500</td><td></td></tr>
<tr><td>Balance as per cash book adjusted</td><td>1,700</td><td></td></tr>
<tr><td></td><td>3,200</td><td>3,200</td></tr>
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21.	**(d)**	
22.	**(b)**	
23.	**(c)**	
24.	**(d)**	
25.	**(a)**	
26.	**(b)**	
27.	**(c)**	
28.	**(a)**	
29.	**(b)**	
30.	**(b)**	
31.	**(b)**	
32.	**(a)**	
33.	**(c)**	
34.	**(b)**	

Certificate in Accounting and Finance
Introduction to accounting

CHAPTER

9

Correction of errors

Contents

1 ERRORS

Section overview

- Errors in the double entry accounting system
- Errors highlighted by the extraction of a trial balance
- Errors not highlighted by the extraction of a trial balance

1.1 Errors in the double entry accounting system

The types of error that will appear in the accounting records can be classified into four broad categories:

- ☐ Errors of transposition
- ☐ Errors of omission
- ☐ Errors of commission
- ☐ Errors of principle

Errors of transposition (transposition errors)

This involves getting the digits in a number the wrong way round, for example recording Rs. 9,700 as Rs. 7,900.

Sometimes the error will be made in both the debit and the credit entries in the ledger. For example a purchase invoice might be recorded as Rs. 1,650 instead of Rs. 1,560 in both the purchases account and the payables ledger control account. The trial balance will not reveal this sort of error.

Sometimes the error of transposition will be made in one account but not the other. For example, a payment of Rs. 1,980 from a customer might be recorded correctly in the cash book but posted incorrectly as Rs. 1,890 in the receivables ledger control account.

Errors of omission

This is where a transaction or entry is missed out. Sometimes a transaction is missed out of the ledger entirely because the bookkeeper forgets about it or is not informed about it. A transaction may be omitted from one location only.

Errors of commission

This means putting an entry in the wrong account, for example recording a telephone expense in the electricity expenses account. Similarly, discounts received might be recorded incorrectly in the discounts allowed account.

Errors of principle

This is where an entry is recorded in the wrong type of account, e.g. recording capital expenditure as revenue expenditure.

For example the purchase of a machine might be entered in the machinery repairs and maintenance account. Unless corrected, this error will result in an incorrect computation of depreciation charges, running costs and profit for the period.

1.2 Errors highlighted by the extraction of a trial balance

As stated earlier, one way of finding some errors in the accounting records is to extract a trial balance from the general ledger. If the total of the debit balances does not equal the total of the credit balances on the general ledger accounts then an error or several errors have been made.

If the trial balance does not balance then this will be due to an error where the debits and credits are not the same, so that the error results in the debit entry in one account in the general ledger not being equal to the matching credit entry in another account.

Types of error which affect the balancing of the trial balance are as follows:

- A transaction might be recorded with a debit entry in one account, but the corresponding credit entry is omitted. Similarly, a transaction might be recorded with a credit entry in one account, but the corresponding debit entry is omitted. For example a payment might be recorded as a credit entry in the cash book but omitted from the payables ledger control account.
- There could be a transposition error in one account. For example, the debit entry might be Rs. 1,234 and the corresponding credit entry might be Rs. 1,324. One of the entries must be incorrect.
- A transaction might be recorded as a debit entry in two accounts, instead of as a debit entry in one account and a credit entry in the other account. For example, rental income might be recorded as a debit entry in the cash book and, in error, as a debit entry in the rental expense account.
- Similarly, a transaction might be recorded as a credit entry in two accounts, instead of being a debit entry in one account and a credit entry in the other. For example, discounts allowed might be recorded as a credit entry in the receivables ledger control account and, in error, as a credit entry in the discounts received account.
- There might be a mistake in casting one or another side of an account. This would lead to the extraction of an incorrect balance.

You need to be able to:

- identify errors in a double entry accounting system, and
- know how to correct them.

Corrections to errors in an accounting system are recorded as journal entries and then posted from the journal to the relevant accounts in the general ledger.

1.3 Errors not highlighted by the extrsaction of a trial balance

A trial balance is only useful in helping to identify errors where the debit and credit entries in the general ledger accounts do not match. It does not help with the identification of errors where there has not been a mismatch between debit and credit entries.

There are some types of error that do not result in a difference between total debit and total credit entries and therefore do not affect the balancing of the trial balance. For example:

- A transaction might have been omitted entirely from the general ledger, with no debit entry and no credit entry.
- The wrong figure might be double entered.
- Transactions might be recorded in the wrong account. For example, the cost of repairing a machine might be recorded incorrectly as a debit in the machinery at cost account instead of recording it as a debit in the machine repairs account. The amount of the debit entry is correct; the error is to post the transaction to the wrong account.
- There might be compensating errors. For example one error might result in debits exceeding credits by Rs. 2,000 but anther error might result in credits exceeding debits by Rs. 2,000. If this happens, the errors will 'cancel each other out' and will not be apparent from a check on the trial balance totals for debits and credits.

Practice question: Trial Balance **1**

A trial balance is merely a proof of arithmetical accuracy. Briefly explain the various types of errors which a trial balance fails to disclose.

2 CORRECTING ERRORS

Section overview

- An approach to correcting errors
- The effect of errors on profit

2.1 An approach to correcting errors

Errors should be corrected when they are found.

- Transactions that have been omitted from the general ledger entirely should be recorded in the accounts. The omitted item can be recorded in the journal, and posted from the journal to the relevant accounts in the general ledger and, if required, the receivables or payables ledger.
- Entries that have been made incorrectly in the accounts must be corrected by means of suitable debit and credit entries in the accounts. The correction of an error should be recorded in the journal and then posted from the journal to the relevant accounts.

In order to correct errors properly, you need to be able to:

- identify an error;
- recognise what the correct entry in the accounts should have been; and
- work out how to make the correction by means of double entry adjustments.

One approach to correcting errors is to compare the entry that has been processed to the entry that should have been processed. This allows you to see what adjustment is needed. Memorandum T accounts can be used to do this.

For each account affected by an error, you can prepare two sets of memorandum T accounts for:

(1) What accounting entries have been made in the accounts, and

(2) What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

Some examples will help to illustrate the approach.

Example:

The total from a sales day book was Rs. 1,800.

This has been posted incorrectly as Rs. 1,080.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded		**(2) What should have been recorded**	
Receivables		**Receivables**	
1,080		1,800	
Sales		**Sales**	
	1,080		1,800

The receivables control account has a debit entry of Rs. 1,080 for the transaction but it should have been Rs. 1,800.

To remove this error and increase the account balance to Rs.1,800 for the transaction, we need to debit the receivables control account with Rs. 920.

The sales account has a credit entry of Rs. 1,080 for the transaction but it should have been Rs. 1,800.

To remove this error and increase the account balance to Rs.1,800 for the transaction, we need to credit the sales account with Rs. 920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Sales		920

Or using ledger accounts:

Receivables control account

	Rs.		Rs.
Before adjustment	1,080		
Sales account	920		

Sales account

	Rs.		Rs.
	920	Before adjustment	1,080
		Receivables	920

Example:

A business has recorded a repair cost of Rs. 15,000 to a machine as a debit in the machinery at cost account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded

Machinery (at cost) account

15,000	

Machine repairs account

0	

(2) What should have been recorded

Machine (at cost) account

0	

Machine repairs account

15,000	

The machinery (at cost) account has a debit entry of Rs. 15,000 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to Rs. 0 for the transaction, we need to credit the machine (at cost) account with Rs. 15,000.

The machine repairs account has nothing recorded for the transaction, but there should be a debit balance of Rs. 15,000.

To correct his account, we need to debit the account with Rs. 15,000.

Therefore the correcting entry is:

	Dr	Cr
Machine repairs	15,000	
Machinery cost		15,000

Example:

A business has recorded rental income of Rs. 21,800 as a credit in the rental expense account.

(1) What has been recorded | **(2) What should have been recorded**

Rental expense		Rental expense	
	21,800		0

Rental income		Rental income	
	0		21,800

The rental expense account has a credit of Rs. 21,800 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to Rs. 0 for the transaction, we need to debit the rental expense account with Rs. 21,800.

The rental income account has nothing recorded for the transaction, but there should be a credit balance of Rs. 21,800.

To correct his account, we need to credit the account with Rs. 21,800.

Therefore the correcting entry is:

	Dr	Cr
Rental expense	21,800	
Rental income		21,800

Example:

A business has recorded discounts allowed of Rs. 20,600 as a debit in the discounts received account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded | **(2) What should have been recorded**

Discounts allowed account		Discounts allowed account	
0		20,600	

Discounts received account		Discounts received account	
20,600		0	

The discounts allowed account has nothing recorded for the transaction, but there should be a debit balance of Rs. 20,600. To correct this account, we need to debit the account with Rs. 20,600.

The discounts received account has a debit entry of Rs. 20,600 when there should be nothing in the account for the transaction. To remove this error and reduce the account balance to Rs. 0 for the transaction, we need to credit the discounts received account with Rs. 20,600.

To correct the error, the required double entry is:

	Dr	Cr
Discounts allowed	20,600	
Discounts received		20,600

Example: Sky Electronics

While reviewing the draft financial statements of Sky Electronics (SE) for the year ended 31 December 2017, following errors have been identified:

(i) Computers costing Rs. 240,000 purchased on 1 September 2017 for office use were debited to purchases account. SE depreciates computers at 20% per annum using straight line method.

(ii) Furniture costing Rs. 1,200,000 and having a book value of Rs. 670,000 as on 31 December 2017 had already been sold on 1 November 2017. The proceeds of Rs. 700,000 were credited to sales. SE depreciates furniture at 10% per annum using straight line method.

(iii) On 1 April 2017, SE rented-out one of its premises at an annual rent of Rs. 900,000 payable in advance. The rent received was credited to income.

(iv) Trade receivables include a balance of Rs. 180,000 which is irrecoverable but has not been written-off. Further, a recovery of Rs. 96,000 against receivables written off in prior years was credited to trade receivables. As per SE's policy, provision for doubtful receivables has already been made at 5% on year-end balance.

(v) A cheque of Rs. 192,000 was received after a discount of 4% from a customer. However, in the cash book, the amount received was entered in the discount allowed column and the amount of discount was entered in the bank column.

The rectification entries to correct the above errors shall be prepared as:

Accounting entries for correction of the errors

Date	Description	Debit	Credit
		Rupees	
(i)	Fixed assets (Computers)	240,000	
	Purchases		240,000
	Depreciation expense [240,000×0.2÷12×4]	16,000	
	Accumulated depreciation		16,000
(ii)	Accumulated depreciation (1,200,000×0.1×2÷12)	20,000	
	Depreciation expense		20,000
	Sales	700,000	
	Accumulated depreciation [(1,200,000-670,000)-20,000]	510,000	
	Fixed assets (Furniture) (1,200,000-700,000)		1,200,000
	Gain on disposal (Balancing figure)		10,000
(iii)	Rent income (900,000÷12×3)	225,000	
	Advance rent		225,000
(iv)	Bad debt expense	180,000	
	Trade receivables		180,000
	Trade receivable	96,000	
	Bad debt expense/Bad debt recovered		96,000
	Provision for doubtful debts (180,000-96,000)×5%	4,200	
	Bad debt expense		4,200
(v)	Bank 192,000-(192,000÷0.96×0.04)	184,000	
	Discount allowed		184,000

2.2 The effect of errors on profit

Unless they are corrected, accounting errors will have an effect on the reported profit for the period.

A question might ask you to quantify this effect for a given error. In a typical question of this sort, the error might involve recording a capital expenditure item as a revenue expenditure item, or a revenue expenditure item as capital expenditure.

Alternatively, a capital expenditure item might be recorded at an incorrect amount.

Example:

A bookkeeper in error recorded the purchase cost of a new item of equipment as Rs. 36,000 when it should have been Rs. 360,000.

A draft profit of Rs. 2,560,000 for the period was calculated before the discovery of the error. This included a depreciation charge of 10% (Rs. 3,600) for the equipment.

What is the correct figure for profit?

	Rs.
Draft profit	2,560,000
Add back: Depreciation incorrectly charged	3,600
	2,563,600
Deduct: Correct depreciation charge (10% × Rs. 360,000)	(36,000)
Adjusted figure for profit	2,527,600

Example:

A bookkeeper in error recorded the Rs. 60,000 purchase cost of a new machine as repairs and maintenance costs

A draft profit of Rs. 300,000 for the period was calculated before the discovery of the error.

Depreciation on machinery is charged at 20% on cost, with a full year's charge in the year of acquisition.

What is the correct figure for profit?

	Rs.
Draft profit	300,000
Add back: Repair costs incorrectly charged	60,000
	360,000
Deduct: Depreciation charge (20% × Rs. 60,000)	(12,000)
Adjusted figure for profit	348,000

Example: BA Enterprises

The accountant of BA Enterprises prepared a statement of comprehensive income for the year ended December 31, 2013 which showed gross profit of Rs. 1,050,000 and net profit of Rs. 650,000. The company sells goods at cost plus mark-up of 20%.

The following errors/omissions were found on a detailed review of the financial statements.

(a) Items not included in the statement of comprehensive income:

  (i) Free samples costing Rs. 25,000 were sent to potential and regular customers.

  (ii) Goods costing Rs. 10,000 were taken by the owner for personal use and goods having sales value of Rs. 2,500 were used for office repairs.

  (iii) Unpaid salaries and transportation (inward) expenses payable, amounting to Rs. 20,000 and Rs. 10,000 respectively.

(b) Old furniture items were sold for Rs. 3,000 and entered in the sales day book. The book value of these items was Rs. 2,000.

(c) Goods sent on sale or return basis and having a sales value of Rs. 18,000 were still held in inventory by the consignee. At the time of dispatch, these were recorded as sales.

(d) Rs. 24,500 were paid to a creditor as full and final settlement of an amount of Rs. 25,000 and debited to purchases.

(e) The sales day book was overcast by Rs. 30,000.

(f) An amount of Rs. 67,000 was carried forward in the purchase day book as Rs. 6,700.

The correct amount of gross and net profit for the year shall be ascertained as follows:

Statement for ascertaining correct gross and net profit

			Gross Profit	**Net Profit**
Profit as given			1,050,000	650,000
Add / (Less)				
(a)	(i)	Cost of Goods distributed as free samples	25,000	-
	(ii)	Goods taken by owner for personal use	10,000	10,000
		Goods used for office repair (2,500*100/120)	2,083	-
	(iii)	Outstanding expenses		
		Salaries	-	(20,000)
		Transportation-in	(10,000)	(10,000)
(b)	Sale of old furniture items posted as sale		(3,000)	(2,000)
(c)	Sale on return basis [18,000 - (18,000 ×100/120)]		(3,000)	(3,000)
(d)	Payment to creditor wrongly debited to purchases		24,500	24,500
	Purchase discount		500	500
(e)	Over-casting of sales day book		(30,000)	(30,000)
(f)	Error in Carrying forward of purchases (67,000 – 6,700)		(60,300)	(60,300)
Corrected figures			1,005,783	559,700

3 SUSPENSE ACCOUNTS

Section overview

- Trial balance: differences in total debits and total credits
- Opening a suspense account
- Correcting errors where a suspense account is opened
- Unknown entry

3.1 Trial balance: differences in total debits and total credits

The examples of correcting errors in the previous section involve errors where the amount of the debit entry and the amount of the credit entry were the same. These errors would not be identified by extracting a trial balance.

When errors are made where the amount of the debit entry differs from the amount of the credit entry, total debit balances and total credit balances in the general ledger accounts will differ. A trial balance will demonstrate the existence of such errors.

These errors must be discovered and corrected. Until they are discovered, the first step should be to open a suspense account.

☐ When errors have resulted in total debit entries and total credit entries being different, the errors are corrected using a suspense account.

☐ A suspense account is a short-term account that is required only until the errors have been identified and corrected.

3.2 Opening a suspense account

A suspense account is opened with either a debit balance or a credit balance.

The balance entered into the suspense account should be an amount that makes the total debit balances equal to total credit balances on all the general ledger accounts (including the balance on the suspense account).

Example:

A business has prepared a trial balance of the general ledger account balances.

This shows total debit balances of Rs. 456,000 and total credit balances of Rs. 488,000.

A suspense account must be opened.

The balance on the account to make total debit and total credit balance equal is a debit balance of Rs. 32,000 (Rs. 488,000 credits less Rs. 456,000 debits).

Suspense account

	Rs.		Rs.
Opening balance	**32,000**		

Opening the suspense account in effect completes the missing and incorrect double entries but to the wrong place (the suspense account). The errors should be investigated and corrected. This usually involves a double entry to the suspense account.

Once the errors have been fully corrected the balance on the suspense account will be reduced to zero.

3.3 Correcting errors where a suspense account is opened

When it is clear that an error has occurred, it is often helpful to decide the answer to two questions:

- Has the error resulted in different total amounts for debit and credit entries?
  - If the answer is yes, making the correction will involve the suspense account.
  - If the answer is no, the correction should be made, but will not involve the suspense account.
- If the error has resulted in different total amounts for debit and credit entries, think about the general ledger account or accounts containing the error, and decide what needs to be done to correct the balance on that account.

The same approach used in the previous section for correcting errors can be used. For each account affected by an error, you can prepare two sets of memorandum T accounts for:

(1) What accounting entries have been made in the accounts, and

(2) What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

However, when the error involves different total amounts of debits and credits, a debit or credit entry in the suspense account is needed as a 'balancing figure' to make the total debits and credits equal.

Example:

A debit entry in the rent expense account has been entered as Rs. 5,000 when it should have been Rs. 5,500, but the entry in the cash book (bank account) for the payment was entered correctly as Rs. 5,500.

The debit entry in the rent account is Rs. 500 too low, resulting in a difference between total debits and total credits. The first step is to open a suspense account and enter a balance to make total debits and total credits equal.

Suspense account

	Rs.		Rs.
Opening balance	500		

Note that this completes the entry by recognising the missing debit of 500 in the suspense account

We can now look at 'where we are' and 'where we want to be'

(1) What has been recorded

Rent expense account

5,000	

Suspense account

500	

(2) What should have been recorded

Rent expense account

5,500	

Suspense account

0	

The correcting double entry is:

	Dr	Cr
Rent account	20,600	
Suspense account		20,600

Or using ledger accounts:

Suspense account

	Rs.		Rs.
Opening balance	500	Rent account	500

Rent expense account

	Rs.		Rs.
Opening balance	5,000		
Suspense account	500		

Example:

The total from a sales day book was Rs. 1,800.

This has been posted correctly to the sales account but Rs. 1,080 has been posted in error to the receivables control account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded

Receivables

1,080	

Sales

	1,800

Suspense

720	

(2) What should have been recorded

Receivables

1,800	

Sales

	1,800

Suspense

0	

The sales account has the correct entry but the receivables control account has a debit entry of Rs. 1,080, which should be Rs. 1,800.

To remove this error and increase the account balance to Rs. 1,800 for the transaction, we need to debit receivables control account with Rs. 920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	720	
Suspense		720

Or using ledger accounts:

Receivables control account

	Rs.		Rs.
Before adjustment	1,080		
Suspense account	720		

Suspense account

	Rs.		Rs.
Before adjustment	720	Receivables	720

Example:

A discount allowed of Rs. 4,000 (expense) has been recorded as a credit entry in the discount received account (an income account) by mistake.

(1) What has been recorded

Discounts allowed account

0	

Discounts received account

	4,000

Suspense

8,000	

(2) What should have been recorded

Discounts allowed account

4,000	

Discounts received account

	0

Suspense

0	

As a result of this error, total credits are Rs. 4,000 higher than they should be, and total debits are Rs. 4,000 lower than they should be resulting an the total credits balances in the trial balance being 8,000 bigger than the total debits.

A suspense account with a debit balance of 8,000 would be opened.

Both the discounts allowed account and the discount received account must be corrected.

This error is corrected as follows, with an entry in the suspense account to match total debits with total credits:

	Dr	Cr
Discounts received	4,000	
Discounts allowed	4,000	
Suspense		8,000

Or using ledger accounts:

Suspense account

	Rs.		Rs.
Before adjustment	8,000	Discounts allowed/received	8,000

Discounts received account

	Rs.		Rs.
Suspense account	4,000		

Discounts allowed account

	Rs.		Rs.
Suspense account	4,000		

Example:

A payment to a supplier of Rs. 23,500 has been recorded in the cash book/bank account in the general ledger, but has not been recorded in the trade payables account.

As a result, total credits exceed total debits in the trial balance by Rs. 23,500 and a suspense account must be opened with a debit balance of Rs. 23,500.

(1) What has been recorded

Trade payables account

0	

Suspense account

23,500	

(2) What should have been recorded

Trade payables account

23,500	

Suspense account

0	

This error would be corrected as follows.

	Dr	Cr
Trade payables	23,500	
Suspense		23,500

Practice question **2**

A trial balance has been prepared, and total debits are Rs. 459,100 and total credits are Rs. 459,700.

On investigation, the following errors are found:

1 Sales returns of Rs. 800 were recorded correctly in the receivables account in the general ledger, but they have been recorded incorrectly as a credit entry in the purchases returns account.

2 In the sales day book, the column for total sales has been added up incorrectly. The total should be Rs. 26,420, but the total was undercast by Rs. 1,000. (The total was added up as Rs. 25,420).

The correct total amount receivable was entered in the receivables account in the general ledger.

Open a suspense account and record the book-keeping entries required to correct the errors.

3.4 Unknown entry

A suspense account is opened in order to make a trial balance have equal debits and credits until the errors have been discovered.

In some instances however a suspense account will be opened deliberately by the bookkeeper if the bookkeeper is uncertain of where to post one side of the double entry.

Example:

A bookkeeper has received a cheque for Rs. 1,000 but does not know who the cheque is from or what it relates to.

Rather than putting the cheque to one side until it is known what it is for the bookkeeper may decide to record the debit entry in the cash book/bank account and then, not knowing where the credit entry should go, to credit the suspense account instead.

This can then be cleared at a later date.

Example: Grant Company

The accountant of Grant Company has prepared a trial balance, but has found that the total of debit balances is Rs.864,600 and the total of credit balances is Rs.862,150.

On investigation, he discovers the following errors in the book-keeping:

(1) Total purchases in the period were recorded at Rs.100 below their correct value, although the total value of trade payables was correctly recorded.

(2) Total telephone expenses were recorded at Rs.1,000 above their correct amount, although the total value of the amounts payable was correctly recorded.

(3) Purchase returns of Rs.550 were recorded as a debit entry in the sales returns account, but the correct entry had been made in the trade payables control account.

(4) Equipment costing Rs.2,000 had been recorded as a debit entry in the repairs and maintenance account.

(5) Rental expenses of Rs.5,490 were entered incorrectly as Rs.5,940 in the expense account but were entered correctly in bank account in the ledger.

(6) Bank charges of Rs.200 have been omitted entirely from the ledger.

(Note: Individual debtors and creditors accounts are maintained in the general ledger)

a) The journal entries for the correction of the errors shall be prepared as follows:

Transaction		**Debit Rs.**	**Credit Rs.**
1	Purchases	100	
	Suspense account		100
Correction of error: purchases under-stated by Rs.100.			
2	Suspense account	1,000	
	Telephone expenses		1,000
Correction of error: telephone expenses over-stated by Rs.1,000.			
3	Suspense account	1,100	
	Purchase returns		550
	Sales returns		550
Correction of error. Purchase returns of Rs.550 incorrectly recorded as a debit entry in sales returns.			
4	Equipment	2,000	
	Repairs and maintenance		2,000
Correction of error. Equipment purchase costs incorrectly recorded as repairs and maintenance expenses			
5	Suspense account	450	
	Rent expenses		450
Correction of error: rent expenses over-stated by Rs.450.			
6	Interest expense	200	
	Bank account		200

b) The appropriate corrections in the suspense account shall be as follows:

Transaction omitted from the ledger.

Suspense account

	Rs.		Rs.
Telephone expenses	1,000	Opening balance	2,450
Purchase returns	550	(864,600 – 862,150)	
Sales returns	550	Purchases	100
Rent expenses	450		
	2,550		2,550

Tutorial notes

(1) In the trial balance, total debits exceed total credits by Rs.2,450. A suspense account is therefore opened with a credit balance of Rs.2,450, to make the total debits and credits equal.

(2) It helps to think about the ledger account that needs correcting first, and then make the suspense account entry as the matching debit or credit. For example, since purchases were under-stated in the purchases account, the correction must be to increase the debit side of the purchases account by Rs.100. The matching double entry is a credit in the suspense account.

(3) You also need to recognise that one of the errors and the omission can be corrected without using a suspense account, because the error/omission has not made the total debits and credits unequal.

Practice question: Eastern Products **3**

The trial balance of Eastern Products showed a short credit of Rs. 6,264 as at June 30, 2013. A suspense account was opened for the difference and the profit for the year was then calculated at Rs. 956,180.

The following errors and adjustments were discovered subsequently:

(i) An invoice of Rs. 3,700 was debited to purchases but the goods were received after year-end and were not included in the closing inventory.

(ii) Store equipment costing Rs. 8,100 and having a book value of Rs. 3,600 was sold for Rs. 2,500. Cash was debited and store equipment was credited. No other entries were made.

(iii) A cheque of Rs. 1,850 received from a customer was dishonoured on June 25, 2013 but no entry was made in the books. Cash there against was received after year-end.

(iv) Purchase of office equipment costing Rs. 15,200 was entered in the purchases account. Depreciation on office equipment is provided at the rate of 10%.

(v) A purchase invoice of Rs. 197 was debited to the supplier account as Rs. 917.

(vi) Purchase returns book was under-casted by Rs. 650.

(vii) The opening balance of furniture account was brought forward as Rs. 18,300 instead of Rs.13,800. Depreciation on furniture is provided at the rate of 10%.

(viii) A balance of Rs.730 in the sales ledger is to be offset against a balance of Rs. 880 in the purchase ledger.

(Note: Individual debtors and creditors accounts are maintained in the general ledger)

Required:

(a) Prepare journal entries to adjust the above items.

(b) Recalculate the net profit for the year.

Practice question: A.A. Enterprises

4

The trial balance prepared by A.A. Enterprise showed a difference of Rs. 47,090 which was put on the credit side of a suspense account. An investigation disclosed that:

(i) The total of purchase return day book amounting to Rs. 16,160 had not been posted to the ledger.

(ii) Discount received amounting to Rs. 11,320 had been debited to discount allowed account.

(iii) The sales account had been added short by Rs. 10,000.

(iv) An asset bought four years ago for Rs. 7,000 and depreciated to Rs. 1,200 had been sold for Rs. 1,500 at the beginning of the year. The receipt of cash has been posted in the bank book but corresponding entries have not been recorded.

(v) A credit sale of Rs. 1,470 had been credited to the customer's account as Rs. 1,740. A bad debt of Rs. 1,560 has to be written off. Allowance for doubtful debts is to be maintained at 10% of receivables. Receivables appearing in the trial balance are Rs. 23,390 and the allowance for bad debts account shows a credit balance of Rs. 2,320.

(vi) A sub-total of Rs. 29,830 on the list of closing inventory had been carried over as Rs. 29,380 and another sheet had been overcast by Rs. 1,000.

(Note: Individual debtors and creditors accounts are maintained in the general ledger)

Required:

Pass rectification/adjustment entries to correct the above errors. (Narrations are not required)

Practice question: Mr. Fawwad

5

Mr. Fawwad owns a factory and closes his books on June 30. The trial balance prepared by him, contained a difference which he kept in a suspense account. On scrutinising the records, the following errors were detected:

(i) A cheque of Rs. 10,800 was paid to a creditor who allowed 10% cash discount. The payment was correctly entered in the bank book but was posted to purchase account as Rs. 1,080 only. No other entry was made.

(ii) Sundry receivables include an amount of Rs. 15,000 which had proved irrecoverable but was not written off. According to a consistent policy, a reserve for bad debt was created @ 5% on closing receivables;

(iii) Commission of Rs. 3,500 was paid but was debited twice, once in the party's account and again in the commission account;

(iv) Purchases of Rs. 4,500 were entered as sales in the Sales Day Book.

(v) Rs. 600 collected from a party in respect of dues which had been written off as bad two years ago, was credited to the receivables control account.

(vi) Goods invoiced at Rs. 4,600 were returned by a debtor. These were entered in the purchase book and posted from there to debtor's account as Rs. 6,400.

(vii) The discount column in the sales day book was short casted by Rs. 1,500.

(viii) A cash sale of Rs. 7,300 to Mr. Anwar was correctly entered in the cash book but was posted to the credit of Mr. Anwar's account

(ix) An amount of Rs. 17,400 was received in full and final settlement from a customer after he was allowed a discount of Rs. 2,600. However, while writing the books, the amount received was entered in the discount allowed column of the bank book and the discount allowed was entered in the bank column.

(Note: Individual debtors and creditors accounts are maintained in the general ledger)

Required:

Pass rectification entries (without narration) to correct the above errors.

Practice question: Ayub Brothers **6**

The trial balance of Ayub Brothers did not agree as at 31 December 2013 and the difference was carried to a suspense account. On scrutinising the books of account, the following types of errors were detected:

(i) Receivables include Rs. 15,000 which are irrecoverable and need to be written off.

(ii) Goods invoiced at Rs. 4,600 were returned by a customer. It was entered in the purchase book and posted from there to a creditor's account as Rs. 6,400.

(iii) A cheque of Rs. 8,000 received from a customer was not posted to his ledger account. Moreover, the corresponding sales invoice for Rs. 12,000 was incorrectly passed through the sales day book as Rs. 2,000.

(iv) Sales include goods sold for cash amounting to Rs. 25,000 on behalf of Mr Yasir. Ayub Brothers were entitled to a commission of 10% on the sales plus selling expenses, for which no adjustment was made. The related selling expenses amounted to Rs. 1,500.

(v) An amount of Rs. 3,800 owed by Zahid & Company for goods supplied was to be adjusted against an amount of Rs. 8,500 owed to Zahid & Company. No entry has been made in this regard.

(vi) A purchase of Rs. 15,100 was entered in the purchase day book as Rs. 1,500 and posted to the supplier's account as Rs. 5,100.

(vii) Goods invoiced at Rs. 23,000 and returned by Hamid Khan, a debtor, were entered in the purchase day book and posted therefrom to Hammad Khan, a creditor, as Rs. 32,000.

(viii) A supplier's invoice for Rs. 12,300 had been entered in the purchase day book on 28 December 2013. However, the goods were received on 2 January 2014.

(ix) Ayub Brothers maintains a allowance of 5% of the gross amount of receivables.

Required:

Prepare journal entries to rectify the errors identified above.

(Narrations are not required.)

Practice question: Mr. Rehan **7**

While closing his books on 30 June 2013, Mr. Rehan identified a difference in the trial balance which he kept in a suspense account. He prepared his P & L account on the basis of this trial balance and arrived at a profit of Rs. 679,000. While trying to reconcile the trial balance he detected the following errors:

(i) A cheque of Rs. 25,000 received from the insurance company in respect of loss of inventory has been paid into the proprietor's personal bank account and has not been recorded in the books. No entry has been passed in respect of the loss.

(ii) Bill received from ABC Furnishings on 1 July 2013 for repairs to furniture Rs. 3,000 and for new furniture supplied Rs. 10,000 was entered in the purchase day book as Rs. 11,000. Depreciation on furniture is provided @ 10 % per annum.

(iii) Furniture which stood in the books at Rs. 5,000 was sold on 1 July 2013 for Rs. 2,750 in part exchange of new furniture costing Rs. 8,750 and the net invoice of Rs. 6,000 was passed through the purchase day book.

(iv) Sale of goods on approval amounting to Rs. 5,000 was included in sales account, cost of these goods being Rs. 4,200. Out of these, goods having invoice value of Rs. 3,000 were returned and taken into inventory at cost but no entry was made in the books.

(v) Goods worth Rs. 10,200 purchased from a creditor on 28 June 2013 had been entered in the Purchase Day Book and credited to him but were not delivered till 5 July 2013. However, the title of the goods had passed on 28 June 2013.

(vi) A computer bought originally for Rs. 70,000 four years ago and depreciated to Rs. 12,000 had been sold for Rs. 15,000 on the first day of the year. The amount deposited was entered in the bank book but no other entry was passed.

(vii) Goods valuing Rs. 13,000 were returned by Zahid. These were entered in the Purchase Day Book and posted to a supplier's account as Rs. 31,000.

(viii) Discount of Rs. 3,700 was allowed but posted to the credit of discount received a/c as Rs. 7,300.

(ix) A cheque of Rs. 10,800 was paid to a creditor who allowed 10% cash discount, but the payment was wrongly posted to purchase account as Rs. 1,080 only without any other entry.

(Note: Individual debtors and creditors accounts are maintained in the general ledger)

Required:

(a) Pass rectification entries (without narration) to correct the above errors.

(b) Recalculate the profits after taking into account the above corrections.

Practice question: Smetena Newsagents **8**

The bookkeeper has produced the following statement of financial position at 31 December for Smetena's Newsagents.

	Rs.	Rs.
Non-current assets		72,208
Current assets		
Inventory	18,826	
Trade receivables	26,216	
Drawings	8,260	
Suspense account	3,830	
Cash	700	
		57,832
		130,040
Capital account		50,224
Loan – L Franks 12%		20,000
Trade payables		26,782
Bank overdraft		14,634
Profit for year		18,400
		130,040

Jan Smetena, the proprietor, is unhappy with the statement of financial position and asks you to revise it. You discover the following.

(1) The suspense account balance represents the difference on the trial balance.

(2) The purchases day book total for October of Rs.4,130 was posted to the purchases account as Rs.4,310 although the correct entry was made to the payables ledger control account.

(3) Inventory sheets were overcast by Rs.2,000.

(4) Cash should be Rs.110.

(5) Fixtures and fittings account balance of Rs.4,600 has been omitted from the trial balance.

(6) Interest for a half year on the loan account has not been paid and no provision has been made for it.

Required:

(a) Show the journal entries to correct the above errors.

(b) Write up the suspense account.

(c) Draw up a revised statement of financial position at 31 December. Clearly show the adjustments to profit.

Practice question: CND **9**

The bookkeeper has prepared a preliminary trial balance of CND for the year ended 31 December as follows.

	Rs.	Rs.
Capital account		110,000
Accumulated profit at 1 January		50,000
Bank loan		30,458
Trade receivables and payables	77,240	60,260
Cash in hand and bank overdraft	1,000	5,036
Inventories at 1 January	108,000	
Non-current assets at cost and accumulated depreciation at 31 December	161,879	60,943
Depreciation for the year	15,000	
Purchases and revenues	300,297	402,000
Returns	4,370	4,630
Discounts allowed and received	9,760	6,740
Wages and salaries	22,000	
Rent, rates and insurance	18,036	
Postage, telephone and stationery	3,009	
Repairs and maintenance	2,124	
Advertising	4,876	
Packing materials	924	
Motor expenses	2,000	
Sundry expenses	1,000	
Loan interest	4,000	
Accrued expenses		6,478
Suspense account	1,030	
	736,545	736,545

When the bookkeeper discovered that the preliminary trial balance did not balance he made it do so by opening a suspense account and entering the required amount on the appropriate side. A subsequent investigation shows the following mistakes have been made.

(1) A loan to the business of Rs.10,000 from the owner's brother, X, has been added to capital.

(2) Accrued interest on the bank loan of Rs.458 has been credited to the bank loan account instead of being treated as a current liability.

(3) Bank charges of Rs.1,000 have been completely omitted from the books.

(4) In addition to allowing discount of Rs.240 and receiving discount of Rs.260, various customers' and suppliers' accounts amounting to Rs.10,000 were set off by contra. No entries whatever have been made in respect of these items.

(5) Trade receivables amounting to Rs.2,000 are bad and need to be written off.

(6) A debt of Rs.1,000 written off as bad in a previous year has been recovered in full. The amount has been credited to the personal account and deducted from the trade receivables ledger control account.

(7) Goods returned from a customer of Rs.630 have been correctly entered into the personal account, but by mistake were entered in the returns outwards journal.

(8) A payment for stationery of Rs.234 was correctly entered in the cash book but debited in the ledger as Rs.243.

(9) A payment of Rs.76 for packing materials has been correctly entered in the cash book, but no other entry has been made.

(10) A payment of Rs.124 for advertising has been debited to repairs and maintenance.

(11) A cheque payment of Rs.26 for insurance has been recorded in all accounts as Rs.62.

(12) A page in the purchase account correctly totalled Rs.125,124 was carried forward to the top of the next page as Rs.125,421.

All entries other than those given above are to be assumed to have been made correctly.

(Note: Individual debtors and creditors accounts are maintained in the general ledger)

Required:

(a) Show the correcting entries in journal form (i.e. showing accounts and amounts debited and credited but no supporting narrative is required) in respect of each of the mistakes mentioned above.

(b) Show the trial balance of the company at 31 December after these corrections have been made. A working showing how the suspense account is cleared should be included.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Errors not disclosed by the trial balance

(i) ***Errors of commission***

If a transaction is recorded on the correct side of a wrong account, it will not cause a disagreement in the trial balance.

(ii) ***Errors of omission***

If a particular transaction is omitted altogether from the books of original entry (or recorded twice), it will not disturb the agreement of the trial balance.

(iii) ***Errors of principle***

These errors arise because of an incorrect application of the principles of accounting; for instance, failure to differentiate between capital and revenue expenditure.

(iv) ***Compensating errors***

These errors are of a neutralizing nature, i.e. one error is compensated by another error(s) or by errors of an opposite nature.

(v) ***Recording wrong amount in the books of original entry***

If a transaction is wrongly recorded in the books of original entry and is subsequently posted through the ledgers, it will not cause disagreement in the trial balance.

Solutions **2**

The opening balance on the suspense account is a debit balance, since total credits are higher than total debits by Rs.600.

Error 1

(1) What has been recorded

Purchase returns

	800

Sales returns

(2) What should have been recorded

Purchase returns

Sales returns

800	

Error 2

(1) What has been recorded

Sales

	25,420

(2) What should have been recorded

Sales

	26,420

The correcting double entries are:

	Dr	Cr
Error 1		
Sales returns	800	
Suspense account		800
Purchases returns	800	
Suspense account		800
Error 2		
Suspense account	1,000	
Sales		1,000

Solutions **3**

(a)

		Debit	Credit
1	Supplier/Creditor account /goods in transit	3,700	
	Purchases		3,700
2	Accumulated Depreciation	4,500	
	Loss on sale of store equipment	1,100	
	Store equipment a/c		5,600
3	Customer / debtors a/c	1,850	
	Bank		1,850
4	Office Equipment	15,200	
	Purchases		15,200
	Depreciation expense	1,520	
	Accumulated depreciation – office equipment		1,520
5	Suspense a/c	1,114	
	Supplier a/c (197 + 917)		1,114
6	Suspense a/c	650	
	Purchase Returns		650
7	Suspense a/c	4,500	
	Furniture a/c		4,500
	Accumulated Depreciation	450	
	Depreciation expenses		450
8	Payables a/c	730	
	Debtors a/c		730

(b)	**Recalculation of net profit for the year**	
	Net profit as per question	956,180
	Add: Reversal of purchases / goods in transit / increase in closing inventory	3,700
	Equipment wrongly debited to purchases	15,200
	Purchase returns	650
	Reversal of depreciation on furniture	450
		976,180
	Less: loss on sale of store equipment	(1,100)
	Depreciation on office equipment	(1,520)
	Adjusted net-profit	973,560

Solutions **4**

AA Enterprises – General Journal

		Dr. **Rs.**	**Cr.** **Rs.**
i	Suspense A/c	16,160	
	Purchase returns		16,160
ii	Suspense A/c	22,640	
	Discount Allowed A/c		11,320
	Discount Received A/c		11,320
iii	Suspense A/c	10,000	
	Sales		10,000
iv	Accumulated depreciation – non-current assets	5,800	
	Suspense A/c	1,500	
	Non-current assets A/c		7,000
	Profit on Sale of non-current assets A/c		300
v	(a) Customer A/c (1,740+1,470)	3,210	
	Suspense A/c		3,210
	(b) Allowance for Doubtful Debts A/c	1,560	
	Sundry Debtors A/c		1,560
	(c) Profit and Loss A/c	1,744	
	Allowance for Doubtful Debts A/c **(W 1 & 2)**		1,744
vi	Trading Account	550	
	Closing inventory		550

Working 1:

Debtors A/c

Dr.	**Rs.**	**Cr.**	**Rs.**
Balance b/d	23,390	Allowance for doubtful debts A/c	1,560
Suspense A/c [see entry v(a)]	3,210	Balance c/d	25,040
	26,600		26,600

Working 2:

Allowance for Doubtful Debts A/c

Dr.	**Rs.**	**Cr.**	**Rs.**
Debtors A/c	1,560	Balance b/d	2,320
Balance c/d (10% of Rs.25,040)	2,504	Profit and loss – bad debts (balancing figure)	1,744
	4,064		4,064

Solutions **5**

Journal Entries

		Debit Rs.	Credit Rs.
1.	Creditor A/c (10,800+1,200)	12,000	
	Purchases A/c		1,080
	Suspense A/c		9,720
	Discount received		1,200
2.	Bad Debts expenses	15,000	
	Debtors A/c		15,000
	Allowance for doubtful debts A/c – B/S	750	
	Bad debt expense account		750
3.	Suspense A/c	3,500	
	Parties A/c		3,500
4.	Sales A/c	4,500	
	Debtors A/c		4,500
	Purchase A/c	4,500	
	Payables A/c		4,500
5.	Debtors (receivables control account)	600	
	Other income or bad debt expense A/c		600
6.	Sales return A/c	4,600	
	Purchase A/c		4,600
	Debtors A/c	1,800	
	Suspense A/c		1,800

		Debit Rs.	Credit Rs.
7.	Discount allowed	1,500	
	Suspense account		1,500
8.	Mr. Anwar	7,300	
	Cash sales		7,300
9.	Cash (17,400 – 2,600)	14,800	
	Discount allowed		14,800

Solutions **6**

		Dr.	Cr.
1.	Bad debts accounts	15,000	
	Debtors A/c		15,000
2.	Sales return A/c	4,600	
	Payables	6,400	
	Purchase A/c		4,600
	Suspense A/c		1,800
	Debtors A/c		4,600
3.	Suspense A/c	8,000	
	Debtor A/c		8,000
	Debtor A/c	10,000	
	Sales		10,000
4.	Sales	25,000	
	Commission income		2,500
	Selling expense		1,500
	Mr. Yasir		21,000
5.	Payables A/c – Zahid & Co.	3,800	
	Debtors A/c – Zahid & Co.		3,800
6.	Purchases A/c (15,100-1,500)	13,600	
	Payables A/c (15,100-5,100)		10,000
	Suspense A/c		3,600
7.	Returns Inwards/Sales returns	23,000	
	Payables A/c	32,000	
	Purchase A/c		23,000
	Debtors A/c		23,000
	Suspense A/c		9,000

		Dr.	Cr.
8.	Goods-in-transit A/c – B/S	12,300	
	Trading Account		12,300
9.	Allowance for doubtful debts - B/S	2,220	
	Bad Debt Expenses		2,220
	(-15,000-4,600+2,000-3,800-23,000)= -44,400 × 5%		

Solutions **7**

(a)	S. No.	Particulars	Debit (Rs.)	Credit (Rs.)
	(i)	Drawings A/c	25,000	
		Trading Account /Purchases		25,000
	(ii)	Repairs	3,000	
		Furniture and Fittings	10,000	
		Purchases		11,000
		ABC Furnishings		2,000
		Depreciation	1,000	
		Acc. dep. on furniture		1,000
	(iii)	Furniture	8,750	
		Loss on sale of furniture	2,250	
		Purchases		6,000
		Furniture		5,000
		Depreciation (8,750 – 5,000) × 10%	375	
		Acc. dep. on furniture		375
	(iv)	Sales	3,000	
		Debtors		3,000
		(Assuming that remaining goods on sale or approval are sold)		
	(v)	Goods-in-transit	10,200	
		Trading Account /Purchases		10,200
	(vi)	Suspense Account	15,000	
		Accumulated depreciation - computers	58,000	
		Non-current assets		70,000
		Gain on disposal of computers		3,000
		Accumulated depreciation - computers	7,000	
		Depreciation expense		7,000

S. No.	Particulars	Debit (Rs.)	Credit (Rs.)
(vii)	Returns Inward	13,000	
	Payables	31,000	
	Purchases		13,000
	Debtors		13,000
	Suspense Account		18,000
	(On the assumption that purchase is recorded as Rs. 13,000 and creditor as Rs. 31,000)		
(viii)	Discount Allowed	3,700	
	Discount Received	7,300	
	Suspense Account		11,000
(ix)	Creditor A/c	12,000	
	Purchases		1,080
	Discount received		1,200
	Suspense Account		9,720

Amount in Rupees

(b) **Recalculation of Profit and Loss**

(ii)	Repair exp	3,000		Unadjusted profit	679,000
(ii)	Dep. on furniture 10% of 10,000	1,000	(i)	Drawings a/c (receipt from ins co.)	25,000
(iii)	Loss on exchange of furniture	2,250	(ii)	Purchases	11,000
(iii)	Depreciation on furniture 10% of (8,750 – 5,000)		(iii)	Purchases	6,000
		375	(v)	Goods-in-transit	10,200
(iv)	Sales	3,000	(vi)	Gain on sale of asset	3,000
(vii)	Return inwards	13,000	(vi)	Depreciation expense	7,000
(viii)	Discount allowed/received	11,000	(vii)	Purchases	13,000
	Adjusted profit for the year	722,855	(ix)	Purchases	1,080
			(ix)	Discount received	1,200
		756,480			756,480

Solutions **8**

(a) **Journal entries**

		Dr Rs.	*Cr* Rs.
	Suspense a/c	180	
	Purchases a/c		180
(2)	Correction of amount posted to purchases a/c arising from transposition error		
	Income & expenditure a/c (closing inventory)	2,000	
	Inventory per statement of financial position		2,000
(3)	Correction of overcasting of inventory-sheets		
	Suspense a/c	590	
	Cash a/c		590
(4)	Correction of overstatement of cash in hand		
	Fixtures and fittings a/c	4,600	
	Suspense a/c		4,600
(5)	Correction of omission from the trial balance of fixtures and fittings		
	Interest a/c (I& E)	1,200	
	Accrued expenses a/c		1,200
(6)	Provision for interest due on loan not yet provided for		

(b) **Suspense a/c**

	Rs.		Rs.
Difference in TB	3,830	Fixtures and fittings omitted from TB (5)	4,600
Purchases (2)	180		
Cash in TB (4)	590		
	4,600		4,600

(c) **Statement of financial position at 31 December**

	Rs.	Rs.	Rs.
Non-current assets		76,808	
Current assets			
Inventory		16,826	
Trade receivables		26,216	
Cash		110	
			43,152
Total assets			119,960

	Rs.	Rs.	Rs.
Owners' Equity			57,344
Non-current liabilities			
Loan – L Franks			20,000
Current liabilities			
Bank overdraft		14,634	
Trade payables		26,782	
Accrued expenses		1,200	
			42,616
Total capital and liabilities			119,960
WORKING			
Opening capital			50,224
Add Net profit (W)			15,380
			65,604
Less Drawings			(8,260)
			57,344

Adjustment to profit

	+	–	
Profit per draft statement of financial position		18,400	
Less Overstated closing inventory (3)		2,000	
Interest on loan a/c (6)		1,200	
		3,200	
Add Overstated purchases (2)	180		
			(3,020)
			15,380

Solutions **9**

(a) **Correcting entries**

		Dr **Rs.**	***Cr*** **Rs.**
(1)	Capital a/c	10,000	
	Loan a/c X		10,000
(2)	Bank loan a/c	458	
	Accrued expenses a/c		458
(3)	Bank charges a/c	1,000	
	Bank overdraft a/c		1,000
(4)	Trade payables a/c	10,260	
	Discounts allowed a/c	240	
	Trade receivables a/c		10,240
	Discount received a/c		260

		Dr Rs.	*Cr* Rs.
(5)	Bad debts a/c	2,000	
	Trade receivables a/c		2,000
(6)	Trade receivables a/c	1,000	
	Bad debts recovered a/c		1,000
(7)	Sales returns a/c	630	
	Purchases returns a/c	630	
	Suspense a/c		1,260
(8)	Suspense a/c	9	
	Postage, telephone and stationery a/c		9
(9)	Packing materials a/c	76	
	Suspense a/c		76
(10)	Advertising a/c	124	
	Repairs and maintenance a/c		124
(11)	Bank overdraft a/c	36	
	Insurance a/c		36
(12)	Suspense a/c	297	
	Purchases a/c		297

(b) **Trial balance at 31 December**

	Dr Rs.	*Cr* Rs.
Capital account Rs.(110 – 10)	100,000	
Accumulated profits at 1 January		50,000
Bank loan Rs.(30,458 – 458)	30,000	
Loan account – X		10,000
Trade receivablesRs. (77,240 – 10,240 – 2,000 + 1,000)	66,000	
Trade payables Rs.(60,260 – 10,260)		50,000
Cash in hand	1,000	
Bank overdraft Rs.(5,036 + 1,000 – 36)		6,000
Inventories at 1 January	108,000	
Non-current assets at cost	161,879	
Accumulated depreciation at 31 December	60,943	
Depreciation for the year	15,000	
Purchases Rs.(300,297 – 297)	300,000	
Revenues		402,000
Returns	5,000	4,000

	Dr **Rs.**	***Cr*** **Rs.**
Discounts allowed Rs.(9,760 + 240)	10,000	
Discounts received Rs.(6,740 + 260)		7,000
Wages and salaries	22,000	
Rent, rates and insurance Rs.(18,036 – 36)	18,000	
Postage, telephone and stationery Rs.(3,009 – 9)	3,000	
Repairs and maintenance Rs.(2,124 – 124)	2,000	
Advertising Rs.(4,876 + 124)	5,000	
Packing materials Rs.(924 + 76)	1,000	
Motor expenses	2,000	
Sundry expenses	1,000	
Debenture interest	4,000	
Bank charges	1,000	
Bad debts	2,000	
Bad debts recovered		1,000
Accrued expenses Rs.(6,478 + 458)		6,936
	727,879	727,879

Working

Suspense a/c

	Rs.		Rs.
Original balance	1,030	(7) Goods returned misposting	1,260
(8) Stationery transposition error	9	(10) Materials payment omitted	76
(12) Purchases transposition error	297		
	1,336		1,336

4 OBJECTIVE BASED QUESTIONS

01. Amna wrongly credited return inwards of Rs. 3,500 to returns outward although Receivable Account was correctly credited.

What will be the difference in trial balance prepared at the year end?

(a) Total of trial balance on the debit side will be Rs. 3,500 more than total of credit side

(b) Total of trial balance on credit side will be Rs. 3,500 more than the total of debit side

(c) Total of trial balance on the debit side will be Rs. 7,000 more than total of credit side

(d) Total of trial balance on credit side will be Rs. 7,000 more than the total of debit side

02. For the year ended 31 December 2018 Ahmad showed a profit of Rs. 15,500.

It was further discovered; during the year he purchased a piece of equipment for Rs. 5,000. Transaction was recorded as Debit Repairs account and Credit Cash account. It is policy to depreciate equipment at 10% and charging full year's deprecation in the year of purchase.

What is the impact of correcting the error on statement of profit or loss for the year?

(a) Profit will be increased by Rs. 5,000

(b) Profit will be reduced by Rs. 5,000

(c) Profit will be increased by Rs. 4,500

(d) Profit will be decreased by Rs. 4,500

03. Which of the following errors will require creating a suspense account?

(a) Repairs expense was considered a purchase of asset

(b) Purchase of inventory was considered purchase of non–current asset

(c) An invoice of Rs. 2,500 was totally omitted from the books

(d) Petty cash expenses of Rs. 500 were only credited to bank account

04. Zahid granted an early settlement discount of Rs. 1,500 to one of its customers. The discount amount was correctly entered in the account receivable control account but it was wrongly credited to discount received account.

In order to balance the trial balance at year end, what should be the balance of suspense account in trial balance?

(a) Rs. 3,000 Cr

(b) Rs. 3,000 Dr

(c) Rs. 1,500 Dr

(d) Rs. 1,500 Cr

05. The suspense account shows a debit balance of Rs. 500.

Which of the following errors could be the cause of suspense?

- **(a)** Overstatement of salaries expense by Rs. 500
- **(b)** Overcasting sales account by Rs. 500
- **(c)** Undercasting of sales by Rs. 500
- **(d)** Payment to supplier Rs. 500 was wrongly omitted from records

06. Interest expense of Rs. 100 has been wrongly debited to stationery expense.

What entry is required to correct the error?

- **(a)** Dr Interest expense Rs. 100; Cr Suspense Account Rs. 100
- **(b)** Dr Interest expense Rs. 100; Cr Stationery expense Rs. 100
- **(c)** Dr Suspense Account Rs. 100; Dr Interest expense Rs. 100 Cr Stationery expense Rs. 200
- **(d)** Dr Suspense Account Rs. 100, Cr Stationery expense Rs. 100

07. Which of the following errors will not affect a trial balance?

- **(a)** Rs. 5,000 utility expenses were entirely omitted from recording
- **(b)** Rent paid Rs. 2,500 has been recorded as Rs. 1,500 in rent account.
- **(c)** Discount allowed Rs. 100 has been credited to Discount received and credited to Accounts payable
- **(d)** Cash paid Rs. 3,000 for repair of equipment was credited to repairs account

08. Which error will cause an entry in the suspense account?

- **(a)** a transposition error when transferring a ledger account balance to the trial balance
- **(b)** an error of commission where the wrong account is used for a transaction but it is the correct type of account
- **(c)** an error of omission
- **(d)** an error of principle

09. The correction of which error requires an entry in the suspense account?

- **(a)** A cheque, Rs. 2,000, paid to Asif had been debited to Arif's account.
- **(b)** A purchase of stationery, Rs. 80, had been debited to the purchases account.
- **(c)** Commission income, Rs. 120, had been debited to a loan interest account.
- **(d)** Salaries account had been undercast by Rs. 300 and the entertainment account had beenovercast by Rs. 300.

10. A trial balance was extracted from the books of Nizam. It was found that debit side exceeded credit side. Following errors were identified;

(i) Purchases account was over-cast by Rs. 120,000.

(ii) An amount paid to Sajjad was debited to the control account as Rs. 98,000 instead of Rs. 89,000.

(iii) Sales account was under-cast by Rs. 11,000.

What was the balance of suspense account before correction of errors?

(a) Rs. 140,000Cr

(b) Rs. 140,000 Dr

(c) 0

(d) Rs. 271,000

11. The credit side of a business trial balance is Rs. 2,000 more than the debit side.

Which one of the following could be the reason for that?

(a) Credit purchase of Rs. 6,000 was recorded in Purchase day book as Rs. 4,000

(b) Cash paid to supplier Rs. 2,000 was omitted from books

(c) Overpayment of Rs. 2,000 was received from a customer

(d) Credit sales of Rs. 7,000 was posted to account receivable control account as Rs. 5,000 while it was correctly entered in sales account

12. A suspense account was opened when a trial balance failed to agree. The following errors were discovered afterwards:

(i) An electric bill of Rs. 620 had been recorded in the electric charges account as 250

(ii) A discount allowed of Rs. 200 was wrongly credited to discount received account

(iii) Interest given by bank Rs. 450 was debited to bank account only

At what amount the suspense account should be shown in trial balance in order to make trail balance agree?

(a) Rs. 320 Dr

(b) Rs. 320 Cr

(c) Rs. 120 Dr

(d) Rs. 120 Cr

13. Trial balance of a business did not agree and a suspense account was created.

On investigation it was revealed that while posting insurance expense was posted as Rs. 254,000 instead of Rs. 245,000.

What entry is required to correct the error?

(a) Dr Suspense a/c Rs. 9,000 a/c Cr Insurance a/c Rs. 9,000

(b) Cr Suspense a/c Rs. 9,000 Dr Insurance a/c Rs. 9,000

(c) Dr Insurance a/c Rs. 245,000 Cr Cash a/c Rs. 245,000

(d) Cr Insurance Rs. 245,000 Dr Suspense Rs. 245,000

14. A sales return of Rs. 400 has been wrongly posted to the credit of the purchases return account, but has been correctly entered in the customer's account.

Which of the following will be the effects of the error?

(a) Profit for the year will be overstated by Rs. 400

(b) Profit for the year will be overstated by Rs. 800

(c) Credit side of the trial balance will be Rs. 400 more than debit side

(d) Debit side of the trial balance will be Rs. 800 more than credit side

15. A company's trial balance failed to agree, the total being:

Debit	Rs. 950,300
Credit	Rs. 955,300

Which one of the following is the reason of this difference?

(a) Utilities expense of Rs. 5,000 entirely omitted from recording

(b) Transportation in of Rs. 5,000 is recorded as transportation out

(c) Discount received Rs. 2,500 debited in error to the discount allowed account

(d) Discount allowed Rs. 2,500 was wrongly recorded as discount received

16. Following errors occurred in books of Majid & Co.

(1) Carriage inwards of Rs. 100 was debited to carriage outwards

(2) Purchase of inventory Rs. 5,000 was debited to repairs account

(3) Rent expense was Rs. 200 was credited to rent account.

What will be the balance of Suspense account?

Rs. ___________

17. A return inward of Rs. 180 has been wrongly recorded as carriage inwards.

What is the impact on profit of the correction of this error?

Rs. ___________

18. A suspense account was opened when a trial balance failed to agree. The following errors were discovered afterwards:

(i) A payment of Rs. 5,000 to a supplier was credited to control account

(ii) A return outwards of Rs. 400 was wrongly debited to return inwards account

(iii) Payment for establishment of petty cash fund by Rs. 1,000 was only credited to bank account

At what amount the suspense account should be shown in trial balance in order to make trial balance agree?

Rs. ___________

19. After extracting trial balance a business has identified following errors;

(i) Owner’s home rent paid Rs. 1,500 has been debited to business rent account

(ii) Purchase of stationery Rs. 500 has been debited to machinery account. Depreciation rate is 10%

(iii) Freight paid Rs. 150 for inventory has been debited to stationery account

Profit for the year before correction of these errors was Rs. 10,500.

What is the amount of corrected profit?

Rs. ___________

20. A cash refund of Rs. 20,000 due to customer A was correctly treated in the cash book and then credited to the accounts receivable ledger account of customer B.

At what amount the suspense account should be shown in trial balance in order to make trial balance agree?

Rs. ___________

21. “Treating a revenue expense as a capital expenditure" is an example of?

(a) Compensating errors

(b) Error of omission

(c) Error of commission

(d) Error of principle

22. If an effect of an error is cancelled by the effect of some other error, it is commonly known as

(a) Errors of principle

(b) Errors of omission

(c) Compensating errors

(d) Errors of commission

23. Goods of Rs.100,000 purchased from Abbas Traders were recorded in sales book, the rectification of this error will

(a) Increase the gross profit

(b) Reduce the gross profit

(c) Have no effect on gross profit

(d) None of the given options

24. What would be the total of the trial balance if a purchase return of Rs.84,000 has been wrongly posted to the debit of the sales return account, but had been correctly entered in the suppliers account?

(a) The credit side to be Rs.84,000 more than debit side

(b) The debit side to be Rs.84,000 more than credit side

(c) The credit side to be Rs.168,000 more than debit side

(d) The debit side to be Rs.168,000 more than credit side

25. When opening stock is overstated, net profit for the accounting period will be

(a) Overstated

(b) Understated

(c) No effect

(d) None of the above

26. Difference of totals of both debit and credit side of the trial balance is transferred to

(a) Difference account

(b) Trading account

(c) Miscellaneous account

(d) Suspense account

27. Goods purchased from supplier worth Rs.200,000, no entry made in purchases book is an example of

(a) Error of posting

(b) Error of omission

(c) Error of principle

(d) Compensating errors

28. Purchase of fuel for the car is capitalised to motor vehicles. It is a type of

(a) Error of posting

(b) Error of omission

(c) Error of principle

(d) Compensating errors

29. The Company incorrectly recorded a deposit of daily credit sales of Rs. 45,000 as Rs. 54,000. What is the appropriate entry, the company should follow regarding the error of Rs. 9,000?

- **(a)** Add Rs. 9,000 to its Cash account
- **(b)** Sales (Dr) and Account Receivable (Cr) with Rs. 9,000
- **(c)** Account Receivable (Dr) and Sales (Cr) with Rs. 9,000
- **(d)** None of the above

30. Which of the following account(s) will be affected, while rectifying the error of Carriage paid Rs. 50,000 for the newly purchased machinery mistakenly debited to carriage account?

- **(a)** Only machinery account
- **(b)** Only carriage account
- **(c)** Both carriage and machinery account
- **(d)** Only cash account

31. If a cash sale is made for Rs. 400,000 and posted as follows:

Account	***Debit***	***Credit***
Sales	400,000	
Cash		400,000

What would be the correcting entry?

- **(a)** Sales (debit) = Rs. 800,000 and Cash (credit) = Rs. 800,000
- **(b)** Cash (debit) = Rs. 400,000 and Sales (credit) = Rs. 400,000
- **(c)** Cash (debit) = Rs. 600,000 and Sales (credit) = Rs. 600,000
- **(d)** Cash (debit) = Rs. 800,000 and Sales (credit) = Rs. 800,000

32. Received cheque from debtor – Faraz worth Rs. 100,000 was treated as received from debtor-Sarfaraz. What would be correcting entry?

- **(a)** Sales (debit) = Rs. 100,000 and debtor - Faraz (credit) = Rs. 100,000
- **(b)** Debtor - Faraz (debit) = Rs. 100,000 and debtor – Sarfaraz (credit) = Rs. 100,000
- **(c)** Debtor - Sarfaraz (debit) = Rs. 100,000 and debtor –Faraz (credit) = Rs. 100,000
- **(d)** Sales (debit) = Rs. 100,000 and debtor – Sarfaraz (credit) = Rs. 100,000

4 OBJECTIVE BASED ANSWERS

01.	**(d)**	Instead of debiting returns inwards; returns outwards have been credited. Hence the effect of error is that credit side exceed by double amount = Rs. 3,500x2 = Rs. 7,000
02.	**(c)**	Profit will be increased by Rs. 5,000 as repairs expense will be reversed. Depreciation expense of Rs. 5,000x10%= Rs. 500 will be charged. So the total net impact is Rs. 4,500 increase in profit.
03.	**(d)**	Suspense account is created when debit and credit side of trial balance are not equal. This does not arise when en entry is posted to incorrect account or totally omitted.
04.	**(b)**	Since the amount to be debited in discount allowed account has been credited to discount received account; hence total of credit side exceeds debit side by double amount i.e. Rs. 3,000.
05.	**(b)**	Sales are credit and over casting it is excess credit side (debit side short by Rs. 500), so suspense account of Rs. 500 balance would be created.
06.	**(b)**	Interest expense was incorrectly not debited, it should be debited now. Stationery expense was incorrectly debited; it should be credited now to reverse the effect.
07.	**(a)**	There is no impact on (a) on trial balance since no double entry has been recorded
08.	**(a)**	Any error while transferring balance of ledger account to trial balance would affect one balance (and one side) only, and suspense account would be created.
09.	**(c)**	Commission income is credited but it was incorrectly debited to interest account, creating a difference by double amount.
10.	**(a)**	Debit120,000+ Debit (98,000 - 89,000)+ Debit 11,000=Rs. 140,000 credit balance In all three corrections, the suspense account was debited and it means, before correction it had balance on credit side.
11.	**(d)**	Debit and credit sides of the entry are not equal hence suspense arises.
12.	**(a)**	(i) Dr side short (Rs. 620-250) =Rs. 370 (ii) Dr side short 200 x 2 =Rs. 400 (iii) Credit side short = Rs. 450 Total = Rs. 370 + Rs. 400 - Rs. 450= Dr side short Rs. 320
13.	**(a)**	Insurance expense was overstated, and now to correct this, it is to credited with the difference of Rs. 9,000, and suspense account will be debited.
14.	**(b)**	Not recording sales return, increased the profit by Rs. 400 and Incorrect recording of purchase returns, further increased the profit by Rs. 400 hence profit increased by Rs. 800 in total.
15.	**(d)**	Difference = Rs. 955,300 – 950,300 = Rs. 5,000 Impact of recording discount allowed Rs. 2,500 as discount received Rs. 2,500 is that the debit side is short by Rs. 5,000

16.	**Rs. 400**	Suspense account is created when errors affect trial balance Error (1) and (2) do not affect trial balance Error (3) is single side error and affects trial balance with double amount as rent expense should have been debited and it was rather credited.
17.	**Rs. 0**	The recording of return inwards (sales return) would have reduced the profit by Rs. 180, the same was effect of recoding carriage inwards (an expense), there is no effect of correction of this error on profit.
18.	**Rs. 10,200**	(i) Double impact Rs. 10,000 Dr side short (ii) Double impact Rs. 800 Cr side short (iii) Rs. 1,000 Dr side short Net impact is = Rs. 10,000+1,000-800= 10,200
19.	**Rs. 11,550**	Owner's home rent is drawings not business expense. Debiting one expense instead of other does not affect profit Corrected profit = Rs. 10,500+1,500-(500x0.9) = Rs. 11,550
20.	**Rs. 40,000**	Effect on trial balance is double of the amount since amount has been posted on wrong side.
21.	**(d)**	
22.	**(c)**	
23.	**(b)**	
24.	**(d)**	
25.	**(b)**	
26.	**(d)**	
27.	**(b)**	
28.	**(c)**	
29.	**(b)**	
30.	**(c)**	
31.	**(d)**	
32.	**(c)**	

CHAPTER 10

Property, Plant and Equipment

Contents

1 INITIAL MEASUREMENT

Section overview

- Introduction
- Recognition
- Initial measurement
- Exchange transactions
- Subsequent expenditure
- Capital and Revenue items

1.1 Introduction

The assets of a business are classified as current assets or non-current assets.

IAS 1 (***Presentation of financial statements***) defines current assets and then states that all other assets should be classified as non-current assets.

Current assets include, cash, receivables, prepayments and inventory. They are all items that will be used or recovered in the short term (generally within a year).

A ***non-current asset*** is an asset which is used by the business over a number of years.

Non-current assets may be:

- ***Tangible non-current assets***. These are physical assets, such as land and buildings, plant and equipment and motor vehicles; or
- ***Intangible non-current assets***. These are assets that do not have a physical existence such as patent rights.

Property, plant and equipment (PP&E) is a company’s long term, tangible fixed asset that is vital to business operations and cannot be easily liquidated.

Definitions

Property, plant and equipment are tangible items that:

- **are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and**
- **are expected to be used during more than one period.**

1.2 Recognition

The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

a) it is probable that future economic benefits associated with the item will flow to the entity; and

b) the cost of the item can be measured reliably.

Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.

1.3 Initial measurement

Property, plant and equipment are initially recorded in the accounts of a business at their cost.

Definition

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

The cost of an item of property, plant and machinery consists of:

- its purchase price after any trade discounts and rebates have been deducted plus any import taxes or *non-refundable* sales tax; plus
- the directly attributable costs of 'bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management'. These directly attributable costs may include:
  - employee costs arising directly from the installation or construction of the asset
  - the cost of site preparation
  - initial delivery and handling costs ('carriage inwards is the shipping and handling costs incurred by a company that is receiving goods from suppliers.')
  - installation and assembly costs
  - testing costs
  - professional fees such as architect and surveyor fee.
- When the entity has an obligation to dismantle and remove the asset at the end of its life, its initial cost should also include an estimate of the costs of dismantling and removing the asset and restoring the site where it is located.

The cost of a non-current asset cannot include any administration costs or other general overhead costs.

Example: Cost

A company has purchased a large item of plant.

The following costs were incurred.

List price of the machine	**1,000,000**
Trade discount given	**50,000**
Delivery cost	**100,000**
Installation cost	**125,000**
Cost of site preparation	**200,000**
Architect's fees	**15,000**
Administration expense	**150,000**

Local government officials have granted the company a license to operate the asset on condition that the company will remove the asset and return the site to its former condition at the end of the asset's life.

The company has recognised a liability of Rs. 250,000 in respect of the expected clearance cost.

The cost of the asset is as follows:

Purchase price of the machine (1,000,000 – 50,000)	**950,000**
Delivery cost	**100,000**
Installation cost	**125,000**
Cost of site preparation	**200,000**
Architect's fees	**15,000**
Decommissioning cost	**250,000**
	1,640,000

When the land is acquired, certain costs are necessary and should be part of the cost of land. These costs include the cost of the land, title and legal fees, site preparation costs like grading and draining and survey costs etc. All of these costs may be considered necessary to get the land ready for its intended use. Some costs are **land improvements**. This asset category includes the cost of parking lots, sidewalks, landscaping, irrigation systems etc. Care must be taken to distinguish land and land improvement costs. Land is considered to have an indefinite life and is not depreciated. Whereas, land improvements do wear out and must be depreciated.

The costs of day-to-day servicing of an asset are not included in the carrying amount of the asset but expensed when incurred.

Costs are no longer recognised when the item is ready for use. This is when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Examples of costs that are not costs of an item of property, plant and equipment are:

a) costs of opening a new facility;

b) costs of introducing a new product or service (including costs of advertising and promotional activities);

c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

d) administration and other general overhead costs.

e) Interest paid to finance the purchase of property, plant and equipment is expensed. An exception is interest incurred on funds borrowed to finance *construction* of plant and equipment. Such interest related to the *period of time during which active construction is ongoing* is capitalized.

f) The acquisition of new machinery is accompanied by employee training. The normal rule is that training costs are expensed. The logic is that the training attaches to the employee not the machine and the employee is not owned by the company. However, on rare occasion, justification for capitalization of very specialized training costs (where the training is company specific and benefits many periods) is made, but this is the exception rather than the rule.

Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item is not included in the carrying amount of that item.

The following costs are not included in the carrying amount of an item of property, plant and equipment:

a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

b) initial operating losses; and

c) relocating cost.

Exception

If a company main business is selling machines then that machine does not classify as property, plant and equipment rather the machinery used to produce the machine for sales is PP&E. The machine manufactured for sale is classified as inventory. The same goes for real estate companies. Their offices are PP&E but the houses they sell are inventory.

1.4 Exchange transactions

An asset may be acquired in exchange for another asset. The cost of such an asset is measured at its fair value unless:

☐ the exchange transaction lacks commercial substance; or

☐ the fair value of neither the asset received nor the asset given up is reliably measurable.

If the new asset is measured at fair value, the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

If the new asset is not measured at fair value, its cost is measured at the carrying amount of the asset given in exchange for it. This would be the case when the exchange lacked commercial substance or when the fair value of either asset cannot be measured.

1.5 Subsequent expenditure

Subsequent expenditure relating to non-current assets, after their initial acquisition, should be capitalised if it meets the criteria for recognising an asset.

In practice, this means that expenditure is capitalised if it:

- ❑ improves the asset (for example, by enhancing its performance or extending its useful life); or
- ❑ is for a replacement part (provided that the part that it replaces is treated as an item that has been disposed off).

1.6 Capital and revenue items

The difference between capital and revenue items are given below:

Timing

Capital expenditures are charged to expense gradually via depreciation or amortisation and over a long period of time. Revenue expenditures are charged to expense in the current period.

Consumption

A capital expenditure is assumed to be consumed over the useful life of the related non-current asset. A revenue expenditure is assumed to be consumed within a very short period of time.

Size

A capital expenditures tend to involve larger monetary amounts than revenue expenditures. However, certain quite large expenditures can still be classified as revenue expenditures, as long they are directly associated with sale transactions or are period costs.

This is further explained below:

Improvements are capitalised

Expenditure on a non-current asset after acquisition is treated as capital expenditure when it represents an improvement. This is added to the cost of the original asset.

Repairs are expensed

Expenditure on a non-current asset after acquisition is treated as revenue expenditure when it is incurred to make a repair. This is recognised as an expense in the statement of comprehensive income.

Advance payments

This is recognised as a receivable known as an advance. It represents the right that the business has to receive an asset (or part of one) at some time in the future.

Illustration: Advance payments

	Debit	Credit
Receivable – Advance	X	
Cash (bank)		X

Advances are not depreciated. An advance will become part of the cost of an asset when it is purchased.

Illustration: Treatment of advance when asset is purchased

	Debit	Credit
Cost of the asset	X	
Receivable – Advance		X

2 DEPRECIATION AND CARRYING AMOUNT

Section overview

- Explanation of depreciation
- Accounting for depreciation
- The purpose of depreciation

2.1 Explanation of depreciation

A business invests in assets in order to generate profit. The accruals concept results in the recognition of revenue and the cost of earning that revenue in the statement of comprehensive income in the same accounting period.

Expenditure on non-current assets is also incurred to enable a business to generate a profit. A non-current asset will help a business generate profit over several accounting periods. The cost of the benefit received from the use of such an asset must be recognised in the statement of comprehensive income in the same period that the benefit is recognised. This cost is known as **"Depreciation"** Depreciation is an expense that matches the cost of a non-current asset to the benefit earned from its use.

Depreciation is calculated at the end of the accounting period as an end-of-year adjustment. This might be the case for small businesses but larger businesses will often use software that is able to recognise depreciation on a monthly basis.

Definitions (from IAS 16)

Depreciation: The systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount: The cost of an asset (or its revalued amount, in cases where a non-current asset is revalued during its life) less its residual value.

Residual value: The expected disposal value of the asset (after deducting disposal costs) at the end of its expected useful life.

Useful life: The period over which the asset is expected to be used by the business entity.

Note that the revaluation of non-current assets and the disposal (sale) of non-current assets are not in this syllabus.

Depreciation is a method of spreading the cost of a non-current asset over its expected useful life (economic life), so that an appropriate portion of the cost is charged in each accounting period. Depreciation of a new asset commences from the date that an asset is available for use.

Depreciation does not cease when the asset becomes idle or is retired from active use. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

Example: Depreciation

An item of equipment cost Rs. 300,000 and has a residual value of Rs. 50,000 at the end of its expected useful life of four years.

Depreciation is a way of allocating the depreciable amount of Rs. 250,000 (= Rs. 300,000 - Rs. 50,000) over the four years of the asset's expected life.

2.2 Accounting for depreciation

The double entry for depreciation is as follows:

Illustration: Depreciation double entry

	Debit	Credit
Depreciation expense	X	
Accumulated depreciation		X

The balance on the depreciation expense account is taken to the statement of comprehensive income as an expense for the period.

The accumulated depreciation account contains all of the depreciation recognised to date. When the final statement of financial position is prepared it is deducted from the cost of the assets. The non-current asset figure in the statement of financial position is made up of two figures, the cost less accumulated depreciation.

The balance on the accumulated depreciation account is carried forward as a (credit) balance at the end of the period and appears in the statement of financial position as a deduction from the cost of the non-current assets. The figure that appears in the statement of financial position is known as the ***carrying amount*** (or ***net book value***).

Illustration: Carrying amount of a non-current asset

	Rs.	
Non-current asset at cost	X	
Less accumulated depreciation	(X)	
Carrying amount (net book value)	X	**This figure appears on the face of the statement of financial position**

Accounts in the ledger for non-current assets and accumulated depreciation

There are separate accounts in the general ledger for each category of non-current assets (for example, an account for land and buildings, an account for plant and machinery, an account for office equipment, an account for motor vehicles, and so on) and the accumulated depreciation for each of these categories of non-current assets.

This means that each category of non-current assets can be shown separately in the financial statements.

Example: Accounting for depreciation

A company purchases a non-current asset in Year 1 for Rs. 90,000.

In Year 1, the depreciation charge is Rs. 15,000.

These transactions should be recorded as follows:

Asset account

Year 1	**Rs.**		**Rs.**
Cash/creditors	**90,000**	**Balance c/f**	**90,000**
	90,000		**90,000**
Year 2			
Balance b/f	**90,000**		

Example: Accounting for depreciation (continued)

Accumulated depreciation account

Year 1	Rs.		Rs.
Balance c/f	15,000	**Depreciation account**	**15,000**
	15,000		15,000
Year 2			
		Balance b/f	15,000

Depreciation account

Year 1	Rs.		Rs.
Accumulated depreciation	**15,000**	Statement of comprehensive income	15,000
	15,000		15,000

At the end of Year 1, the carrying amount of the asset in the statement of financial position is:

	Rs.
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	(15,000)
Carrying amount	75,000

Example continued:

The depreciation charge In Year 2 is also Rs. 15,000.

The ledger accounts in Year 2 will be as follows:

Asset account

Year 2	Rs.		Rs.
Balance b/f	90,000	Balance c/f	90,000
	90,000		90,000
Year 3			
Balance b/f	90,000		

Accumulated depreciation account

Year 2	Rs.		Rs.
		Balance b/f	15,000
Balance c/f	30,000	**Depreciation account**	**15,000**
	30,000		30,000
Year 3			
		Balance b/f	30,000

Depreciation account

Year 2	Rs.		Rs.
Accumulated depreciation	**15,000**	Statement of comprehensive income	15,000

At the end of Year 2, the carrying amount of the asset in the statement of financial position is:

	Rs.
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	(30,000)
Carrying amount	60,000

Practice question **1**

An item of equipment cost Rs. 40,000 at the beginning of Year 1. It has an expected life of 5 years.

The annual depreciation charge is Rs. 8,000.

Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.

a **equipment account**

b **accumulated depreciation of equipment account**

c **depreciation of equipment account**

2.3 The purpose of depreciation

It is important to understand the purpose of depreciation. Depreciation is an application of the accruals concept or matching concept.

When a non-current asset is purchased the cost is:

☐ taken to the non-current asset account at cost and

☐ shown in the statement of financial position.

The cost is capitalised. However this asset is used within the business in order to earn profits. Therefore some element of its original cost must be charged to the statement of comprehensive income (‘charged to profit and loss’) each period in order to match the ‘consumption’ of the cost or value of the assets with the income that the asset is generating.

Depreciation is the element of the cost of the non-current asset that is charged to the statement of comprehensive income each period.

There are several methods of calculating the depreciation charge for the year. These methods are discussed in detail in the next section.

3 METHODS OF CALCULATING DEPRECIATION

Section overview

- Straight-line method
- Reducing balance method
- Sum-of-the-digits method
- Depreciation by the number of units produced
- Reviews of the remaining useful life, expected residual value and depreciation method

3.1 Straight-line method

Definition: Straight line depreciation

Where the depreciable amount is charged in equal amounts to each reporting period over the expected useful life of the asset.

Formula: Straight-line depreciation

$$\text{Depreciation charge for the year} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected useful life (years)}}$$

With the straight-line method, the annual depreciation charge is the same for each full financial year over the life of the asset.

This is the most common method in practice and the easiest to calculate.

Example: Straight line depreciation

A machine cost Rs. 250,000. It has an expected economic life of five years and an expected residual value of Rs. 50,000 at the end of that time.

Annual depreciation is:

$$\text{Depreciation charge} = \frac{250{,}000 - 50{,}000}{5 \text{ years}} = \text{Rs. 40,000 per annum}$$

Depreciation period

Depreciation of an asset begins when it is available for use. And depreciation ceases at the earlier of the date that the asset is classified as held for sale and the date that the asset is derecognised. Therefore, depreciation is charged on the number of months basis in the year of purchase and in the year of disposal.

Example: Straight line depreciation – mid-year acquisition

A machine cost Rs. 250,000. It has an expected economic life of five years.

It is expected that the machine will have a zero scrap value at the end of its useful life.

The machine was bought on the 1st September and the company has a 31st December year end.

The depreciation charge in the first year of ownership is:

$$\text{Depreciation charge} = \frac{250{,}000}{5 \text{ years}} \times \frac{4}{12} = \text{Rs. 16,667}$$

However, an exam question might state that a full year's depreciation is charged in the year of acquisition and no depreciation is charged in the year of disposal. This would mean that a full annual charge would be recognised even if the asset was only bought in the last few months of the year and no charge would be made if asset was sold during the year.

Depreciation as a percentage of cost

Another way of stating straight-line depreciation is to express the annual depreciation charge as a percentage of the cost of the asset. For example, suppose that an asset has an expected life of 10 years and zero residual value. If straight-line depreciation is used, the annual depreciation charge will be 10% of the cost of the asset.

Similarly, if an non-current asset has an expected life of six years and a residual value equal to 10% of its cost, straight-line depreciation would be 15% of cost each year (= (100% – 10%)/6 years).

Example: Sundry Depreciation Problem - 1

(a) The financial year of a company is 1st January to 31st December. A non-current asset was purchased on 1st May for Rs.60,000. Its expected useful life is five years and its expected residual value is zero. It is depreciated by the straight-line method.

The charge for depreciation in the year of acquisition, if a proportion of a full year's depreciation is charged, according to the period for which the asset has been held shall be as follows:

Annual depreciation = Rs.(60,000 – 0)/5 years = Rs.12,000.

Depreciation charge in the year of acquisition = Rs.12,000 x (8 months/12 months)

= Rs.8,000.

(b) An office property cost Rs.5 million, of which the land value is Rs.2 million and the cost of the building is Rs.3 million. The building has an estimated life of 50 years.

The annual depreciation charge on the property, using the straight-line method shall be as follows:

Annual depreciation = Rs.(3,000,000 – 0)/50 years = Rs.60,000.

(c) A lathe was purchased on 1 January 2009 for Rs. 150,000. The plant had an estimated useful life of twelve years, residual value of nil. Depreciation is charged on the straight line basis. On 1 January 2015, when the asset's net book value is Rs. 75,000, the directors decide that the asset's total useful life is only ten years.

The effects of these changes on the depreciation for the year to 31 December 2015 shall be as follows:

Lathe

The lathe was purchased in 2009 and was originally being depreciated over an estimated useful life of twelve years. As at 1 January 2015 six of the years have elapsed with a further six years remaining. It was decided that the machine will now only be usable for a further four years.

IAS 16 Property, plant and equipment requires that where the original estimate of useful life is revised, adjustments should be made in current and future periods (not in prior periods). The unamortised cost of the asset should be charged to revenue over the remaining useful life of the asset. The net book value of Rs.75,000 should therefore be charged over the remaining four years of useful life, giving an annual depreciation charge of Rs.18,750.

The revision is not a change in accounting policy, or a fundamental error but a change in accounting estimate. It is therefore not appropriate to deal with any excess depreciation by adjusting opening retained earnings.

Example: Maturin

Maturin bought a machine for Rs.10,000 on 1 January 2012. He estimates a useful life of 8 years and a residual value of Rs.800. Depreciation is to be calculated on a straight line basis.

(a) The activity in Machinery account, Accumulated depreciation account and Depreciation expense account in 2012 and 2013 shall be as follows:

Machinery a/c

		Rs.			Rs.
1.1.12	Cash (or creditor)	10,000	31.12.12	Balance c/d	10,000
		10,000			10,000
1.1.13	Balance b/d	10,000	31.12.13	Balance c/d	10,000
		10,000			10,000
1.1.14	Balance b/d	10,000			

Accumulated depreciation a/c

		Rs.			Rs.
31.12.12	Balance c/d	1,150	(W1)	Depreciation exp.	1,150
		1,150			1,150
			1.1.13	Balance b/d	1,150
31.12.13	Balance c/d	2,300	(W1)	Depreciation exp.	1,150
		2,300			2,300
			1.1.14	Balance b/d	2,300

Depreciation expense a/c

	Rs.			Rs.
Accumulated depreciation a/c	1,150	31.12 12	To P & L a/c	1,150
Accumulated depreciation a/c	1,150	31.12 13	To P & L a/c	1,150

Working

Rs.[10,000 – 800] ÷ 8 = Rs.1,150

(b) The machine would be presented in the statement of financial positions as at 31 December 2012 and 31 December 2013 as follows:

Statement of financial position Presentation

Balance	***Cost***	***Depreciation***	***Net book value (NBV)***
Sheet date	**Rs.**	**Rs.**	**Rs.**
31.12.12	10,000	(1,150)	8,850
31.12.13	10,000	(2,300)	7,700

Example: Diana

Diana leases out German sports cars. She started business on 1 January 2010 and has decided to depreciate the cars on a straight line basis at 25% per annum on cost at the year-end. During the years 2010 to 2013 the following purchases took place.

2010	Acquired 20 Porsche 924 Turbos at a cost of Rs.18,600,000 each
2011	Purchased 6 Porsches for a total cost of Rs.108,600,000.
2012	Purchased a further two cars costing Rs.19,800,000 each.
2013	Purchased 15 cars for Rs.21,000,000 each.

Diana prepares accounts to 31 December each year.

The vehicle account, an accumulated depreciation account and a depreciation account for the years 2010 to 2013 shall be as follows:

Vehicle a/c

2010	Rs.(000)	*2010*	Rs.(000)
Cash	372,000	Balance c/d	372,000
2011		*2011*	
Balance b/d	372,000		
Cash	108,600	Balance c/d	480,600
	480,600		480,600
2012		*2012*	
Balance b/d	480,600		
Cash	39,600	Balance c/d	520,200
	520,200		520,200
2013		*2013*	
Balance b/d	520,200		
Cash	315,000	Balance c/d	835,200
	835,200		835,200
2014			
Balance b/d	835,200		

Accumulated depreciation a/c

2010	Rs.(000)	*2010*	Rs.(000)
Balance c/d	93,000	Depreciation (25% × 372,000)	93,000
2011		*2011*	
		Balance b/d	93,000
Balance c/d	213,150	Depreciation a/c (25% × 480,600)	120,150
	213,150		213,150
2012		*2012*	
		Balance b/d	213,150
Balance c/d	343,200	Depreciation a/c (25% × 520,200)	130,050
	343,200		343,200
2013		*2013*	
		Balance b/d	343,200
Balance c/d	552,000	Depreciation a/c (25% ×835,200)	208,800
	552,000		552,000
		2014	
		Balance b/d	552,000

Depreciation a/c

2010	Rs.(000)	*2010*	Rs.(000)
Accumulated depreciation	93,000	P&L a/c	93,000
2011		*2011*	
Accumulated depreciation	120,150	P&L a/c	120,150
2012		*2012*	
Accumulated depreciation	130,050	P&L a/c	130,050
2013		*2013*	
Accumulated depreciation	208,800	P&L a/c	208,900

WORKING: ANNUAL DEPRECIATION CHARGES

Year	Asset	Cost Rs. 000	Calculation:	2010 Rs. 000	2011 Rs. 000	2012 Rs. 000	2013 Rs. 000
2010	Porsche 924	372,000	(372,000 x 25%)	93,000	93,000	93,000	93,000
2011	Porsches	108,600	(108,600 x 25%)		27,150	27,150	27,150
2012	Two Cars	39,600	(39,600 x 25%)			9,900	9,900
2013	15 Cars	315,000	(315,000 x 25%)				78,750
				93,000	120,150	130,050	208,800

3.2 Reducing balance method

Definition: Reducing balance method

Where the annual depreciation charge is a fixed percentage of the carrying amount of the asset at the start of the period.

Formula: Reducing balance depreciation

Depreciation charge for the year = Carrying amount at the start of the year × Fixed %

The annual depreciation charge is highest in the first year and lowest in the final year of the asset's economic life.

Example: Reducing balance method

A machine cost Rs. 100,000. It has an expected life of five years, and it is to be depreciated by the reducing balance method at the rate of 30% each year.

Annual depreciation and carrying amount over the life of the asset will be as follows.

Year	Carrying amount at start of year	Annual depreciation charge (at (30% of the reducing balance)	Carrying amount at end of year
	Rs.	Rs.	Rs.
1	100,000	30,000	70,000
2	70,000	21,000	49,000
3	49,000	14,700	34,300
4	34,300	10,290	24,010
5	24,010	7,203	16,807

Calculating the reducing balance

The reducing balance reduces the cost of an asset down to its expected residual value over its expected useful life.

The reducing balance percentage can be calculated using the following formula.

Formula: Calculation of reducing balance percentage

$$x = 1 - \sqrt[n]{\frac{\text{Residual value}}{\text{Cost}}}$$

Where:

x = The reducing balance percentage

n = Expected useful life.

Example: Reducing balance

An asset cost Rs. 10,000 and has an expected residual value of Rs. 2,000 at the end of its expected useful life which is 5 years.

The reducing balance percentage is calculated as follows.

$$x = 1 - \sqrt[\text{n}]{\frac{\text{Residual value}}{\text{Cost}}} = 1 - \sqrt[5]{\frac{2,000}{10,000}} = 0.275 \text{ or } 27.5\%$$

This percentage reduces Rs.10,000 to Rs. 2,000 over 5 years.

Year	Carrying amount at start of year	Annual depreciation charge (at (27.5% reducing balance)	Carrying amount at end of year
	Rs.	Rs.	Rs.
1	10,000	2,750	7,250
2	7,250	1,994	5,256
3	5,256	1,445	3,811
4	3,811	1,048	2,763
5	2,763	763	2,000

Note that the depreciation charge in year 5 contains a rounding difference of 3.

Example: Aubrey

Aubrey purchased a van for Rs.800 cash. He estimates that in four years it will have a scrap value of Rs.104.

The annual depreciation charge on the straight line method and the reducing balance method shall be as follows:

Straight line method

Depreciation charge per annum $= \dfrac{\text{Cost of asset - Scrap value}}{\text{Estimated useful life}}$

$= \dfrac{800 - 104}{4}$

= Rs.174

Reducing balance method

$$x = 1 - \sqrt[n]{\frac{\text{Residual value}}{\text{Cost}}} = 1 - \sqrt[4]{\frac{104}{800}} = 0.3995 \text{ or } 40.0\%$$

Depreciation charge is:

		Rs.
Year 1	Rs.800 × 40%	320
Year 2	Rs.(800 – 320) × 40%	192
Year 3	Rs.(800 – (320 + 192)) × 40%	115
Year 4	Rs.(800 – (320 + 192 + 115)) × 40%	69

Proof	Rs.
Cost	800
Less depreciation over 4 years	
320 + 192 + 115 + 69	(696)
Residual value	104

Example: Sophie

Since he commenced business on 1 January 2010 Sophie has purchased for cash the following three machines.

	Date of purchase	Cost Rs.	Rate of depreciation
Machine 1	20 January 2010	4,200	25%
Machine 2	17 April 2011	5,000	30%

Sophie's policy is to charge a full year's depreciation in the year of purchase irrespective of the date of purchase. The reducing balance method is used to calculate depreciation.

Accounts are prepared to 31 December each year.

(a) The machinery account and accumulated depreciation account showing the charge to the depreciation account for each year shall be prepared as followed:

(a)

Machinery a/c

2010		**Rs.**	***2010***		**Rs.**
20 Jan	Cash a/c	4,200	31 Dec	Balance c/d	4,200
2011			***2011***		
1 Jan	Balance b/d	4,200			
17 Apr	Cash a/c	5,000	31 Dec	Balance c/d	9,200
		9,200			9,200
2012			***2012***		
1 Jan	Balance b/d	9,200			
11 Jul	Cash a/c	3,500	31 Dec	Balance c/d	12,700
		12,700			12,700
2013					
1 Jan	Balance b/d	12,700			

Accumulated depreciation a/c

2010		**Rs.**	***2010***		**Rs.**
31 Dec	Balance c/d	1,050	31 Dec	Depreciation expense a/c (W1)	1,050
2011			***2011***		
			1 Jan	Balance b/d	1,050
31 Dec	Balance c/d	3,337	31 Dec	Depreciation expense a/c (W2)	2,287
		3,337			3,337
2012			***2012***		
			1 Jan	Balance b/d	3,337
31 Dec	Balance c/d	6,203	31 Dec	Depreciation expense a/c (W3)	2,866
		6,203			6,203
			2013		
			1 Jan	Balance b/d	6,203

(b) The relevant statement of financial position extracts for each year shall be prepared as followed:

Statement of financial position at 31 December (extract)

Tangible non-current assets

	Cost Rs.	*Dep'n* Rs.	*NBV* Rs.
2010 – Machinery	4,200	1,050	3,150
2011 – Machinery	9,200	3,337	5,863
2012 – Machinery	12,700	6,203	6,497

WORKING: ANNUAL DEPRECIATION CHARGES

		Cost		**2010**	**2011**	**2012**
Year	**Asset**	**Rs. 000**	**Calculation**	**Rs. 000**	**Rs. 000**	**Rs. 000**
2010	Machine 1	4,200	25% x 4,200	1,050		
			25% x (4,200 – 1,050)		787	
			25% x (4,200 – 1,050 – 787)			591
2011	Machine 2	5,000	30% x 5,000		1,500	
			30% x (5,000 – 1,500)			1,050
2012	Machine 3	3,500	35% x 3,500			1,225
				1,050	2,287	2,866

3.3 Sum-of-the-digits method

Definition

Where depreciation is calculated by multiplying the depreciable amount by a fraction where numerator is the remaining life of the asset at the start of the period and the denominator is the sum of all the years' useful life at the start of ownership.

This is another method of depreciation that charges the highest amount in the first year and the lowest amount in the final year.

Example: Sum of the digits

A machine cost Rs. 500,000 and was expected to have a useful life of 5 years.

Annual depreciation over the life of the asset will be as follows.

Step 1: Calculate the sum of the digits (the denominator in the fraction)

	Year
	1
	2
	3
	4
	5
Sum of the digits	115

Example: Sum of the digits (continued)

Step 2: Calculate the annual depreciation charge in each year

Year	Remaining useful life at the start of the year	Annual depreciation charge
1	5	$\frac{5}{15}\times500{,}000=166{,}667$
2	4	$\frac{4}{15}\times500{,}000=133{,}333$
3	3	$\frac{3}{15}\times500{,}000=100{,}000$
4	2	$\frac{2}{15}\times500{,}000=66{,}667$
5	1	$\frac{1}{15}\times500{,}000=33{,}333$

There following formula can be used to calculate the sum of the digits:

Formula: Sum of the digits

$$\text{Sum of the digits}=\frac{n(n+1)}{2}$$

Where:

n = the useful life at the start of ownership

Example: Sum of the digits by formula

5 year useful life

$$\text{Sum of the digits}=\frac{n(n+1)}{2}=\frac{5(5+1)}{2}=\frac{30}{2}=15$$

25 year useful life

$$\text{Sum of the digits}=\frac{n(n+1)}{2}=\frac{25(25+1)}{2}=\frac{650}{2}=325$$

3.4 Depreciation by the number of units produced

Definition

Where depreciation is calculated by expressing the useful life of an asset in terms of its expected total output and allocating the annual charge to depreciation based on actual output.

Formula: Depreciation by number of units produced

$$\text{Depreciation charge for the year} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected total output of asset over its life}} \times \text{Output this year}$$

Example: Number of units produced

A machine cost Rs. 500,000.

It is expected to produce 5,000,000 units over its useful life.

47,850 units were made in the first year of production.

The depreciation charge in the first year of ownership is:

$$= \frac{\text{Rs.}500{,}000}{5{,}000{,}000} \times 47{,}850 = \text{Rs. } 4{,}785$$

3.5 Reviews of the remaining useful life, expected residual value and depreciation method

Review of useful Life

IAS 16 requires useful lives and residual values to be reviewed at each year-end. Any change is a change in accounting estimate. The carrying amount (cost minus accumulated depreciation) of the asset at the date of change is written off over the (revised) remaining useful life of the asset.

Example: Chiniot Engineering

Chiniot Engineering owns a machine which originally cost Rs. 60,000 on 1 January 2014. The machine was being depreciated over its useful life of 10 years on a straight-line basis and has no residual value. On 31 December 2017 Chiniot Engineering revised the total useful life for the machine to eight years (down from the previous 10).

The depreciation charge for 2017 and subsequent years shall be calculated as follows:

The change in accounting estimate is made at the end of 2017 but may be applied to the financial statements from 2017 onwards.

	Rs.
Cost on 1 January 2014 60,000	
Depreciation for 2014 to 2016 (60,000 × 3/10)	(18,000)

Carrying amount at end of 2016	42,000

Remaining useful life at the end of 2016 = 8 – 3 years =	5 years.

Depreciation for 2017 and subsequent years = Rs. 42,000 ÷ 5 years = Rs. 8,400.

Review of residual value

The residual value of an item of property, plant and equipment must be reviewed at least at each financial year end and if expectations differ from previous estimates the depreciation rate for the current and future periods is adjusted.

A change in the asset's residual value is accounted for prospectively as an adjustment to future depreciation.

Example:

A machine was purchased three years ago on 1 January Year 2. It cost Rs.150,000 and its expected life was 10 years with an expected residual value of Rs.30,000.

Due to technological changes, the estimated life of the asset was re-assessed during Year 5. The total useful life of the asset is now expected to be 7 years and the machine is now considered to have no residual value.

The financial year of the entity ends on 31 December.

The depreciation charge for the year ending 31 December Year 5 shall be as follows:

Original depreciation=(150,000 – 30,000) /10 = Rs.12,000 per annum

Carrying amount at start of year 5 = 150,000 – (12,000 × 3) = Rs.114,000

If the total useful life is anticipated to be 7 years then there are four years remaining.

Depreciation charge for year 5 =Rs.114,000/4 = Rs.28,500

Review of depreciation method

The depreciation method applied to property, plant and equipment must be reviewed periodically and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method is changed to reflect the changed pattern.

Where there is a change in the depreciation method used, this is a change in accounting estimate. A change of accounting estimate is applied from the time of the change, and is not applied retrospectively. The carrying amount (cost minus accumulated depreciation) of the asset at the date of the change is written off over the remaining useful life of the asset.

Example: Marden Fabrics

Marden Fabrics owns a machine which originally cost Rs. 30,000 on 1 January 2014. It has no residual value.

It was being depreciated over its useful life of 10 years on a straight-line basis. At the end of 2017, when preparing the financial statements for 2017, Marden Fabrics decided to change the method of depreciation, from straight-line to the reducing balance method, using a rate of 25%.

The depreciation charge for 2017 shall be calculated as follows:

The change in accounting estimate is made at the end of 2017, but is applied to the financial statements from 1 January 2017. The reducing balance method of depreciation is applied to the 2017 statements.

	Rs.
Cost on 1 January 2014	30,000
Depreciation for 2014 to 2016 (30,000 × 3/10)	(9,000)
Carrying amount at end of 2016	21,000

Depreciation for 2017 will therefore be Rs. 21,000 × 25% = Rs. 5,250.

4 DERECOGNITION

Section overview

- Gain or loss on disposal of a non-current asset
- Accounting for the disposal of property, plant and equipment
- Working backward

4.1 Gain or loss on disposal of a non-current asset

Property, plant and equipment are eventually disposed of:

❑ by sale, or

❑ if they have no sale value, through disposal as scrap.

Disposal can occur at any time, and need not be at the end of the asset's expected useful life.

The effect of a disposal on the statement of financial position (or accounting equation) is that:

❑ the asset (at cost or valuation) is no longer in the statement of financial position, and

❑ the accumulated depreciation on the asset is also no longer in the statement of financial position.

The carrying amount of the asset is therefore removed from the accounting equation.

Gains on disposal should not be classified in the profit and loss account as revenue. Rather, it should be classified in other income.

There is a gain or loss on disposal of the asset, as follows:

Illustration: Gain or loss on disposal

		Rs.
Sale proceeds on disposal		X
Less Disposal costs		(X)
Net disposal value		X
Asset at cost	X	
Less: Accumulated depreciation	(X)	
Carrying amount at date of disposal		(X)
Gain /loss on disposal		X

Example:

A non-current asset originally cost Rs.75,000. Accumulated depreciation is Rs.51,000.

The asset is now sold for Rs.18,000. Disposal costs are Rs.500.

The gain or loss on disposal shall be as follows:

Gain or loss on disposal	Rs.	Rs.
Sale proceeds on disposal		18,000
Less Disposal costs		(500)
Net disposal value		17,500
Asset at cost	75,000	
Less: Accumulated depreciation	(51,000)	
Carrying amount at date of disposal		(24,000)
Loss on disposal		(6,500)

Practice question **2**

A non-current asset cost Rs.96,000 and was purchased on 1 June Year 1. Its expected useful life was five years and its expected residual value was Rs.16,000. The asset is depreciated by the straight-line method.

The asset was sold on 1 September Year 3 for Rs.68,000. There were no disposal costs.

It is the company policy to charge depreciation on a monthly basis.

The financial year runs from 1 January to 31 December.

What was the gain or loss on disposal?

Practice question **3**

A non-current asset was purchased on 1 June Year 1 for Rs.216,000. Its expected life was 8 years and its expected residual value was Rs.24,000. The asset is depreciated by the straight-line method. The financial year is from 1 January to 31 December.

The asset was sold on 1 September Year 4 for Rs.163,000. Disposal costs were Rs.1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

4.2 Accounting for the disposal of property, plant and equipment

In the general ledger the gain or loss on disposal of a non-current asset is recorded in a **disposal of asset account**. The double entry transactions required are as follows for an asset recorded at cost rather than at a revalued amount.

Step 1: Transfer the cost of the non-current asset from the asset account to the disposal account:

Step 2: Transfer the accumulated depreciation on the asset from the accumulated depreciation account to the disposal account:

Illustration:

	Debit	Credit
Disposal account	X	
Non-current asset account (cost of the asset)		X
Accumulated depreciation account (or Allowance for depreciation account)	X	
Disposal account		X

The carrying amount of the asset is now in the disposal account.

Step 3: Record the disposal costs in the disposal account.

Illustration:

	Debit	Credit
Disposal account (disposal expenses)	X	
Bank or Payables account		X

Step 4: Record the sale proceeds in the disposal account:

Illustration:

	Debit	Credit
Bank or Receivables account	X	
Disposal account (sale proceeds)		X

Step 5: The balance on the disposal account is the gain or loss on disposal. This is transferred to the statement of comprehensive income.

Example:

A non-current asset cost Rs.82,000 when purchased. It was sold for Rs.53,000 when the accumulated depreciation was Rs.42,000. Disposal costs were Rs.2,000.

The book-keeping entries to record the disposal shall be as follows:

Disposal of asset account

	Rs.		Rs.
Non-current asset account	82,000	Accumulated depreciation account	42,000
Disposal expenses (Bank)	2,000	Sales value (Receivables)	53,000
Gain on disposal (statement of comprehensive income)	11,000		
	95,000		95,000

Non-current asset account

	Rs.		Rs.
Opening balance	82,000	Disposal account	82,000

Accumulated depreciation account

	Rs.		Rs.
Disposal account	42,000	Opening balance	42,000

Receivables account

	Rs.		Rs.
Disposal account (sale value of disposal)	53,000		

Bank account

	Rs.		Rs.
		Disposal account (disposal expenses)	2,000

Statement of comprehensive income

	Rs.		Rs.
		Disposal account (gain on disposal)	11,000

Non-current asset accounts in the general ledger are usually maintained for a category of assets rather than for individual assets. This means that when a non-current asset is disposed of, there will be a closing balance to carry forward on the asset account and the accumulated depreciation account.

Example:

In the previous example, suppose that the balance on the non-current asset account before the disposal was Rs.500,000 and the balance of the accumulated depreciation account was Rs.180,000.

The accounting entries would be as follows:

Property, plant and equipment account

	Rs.		Rs.
Opening balance b/f	500,000	Disposal account	82,000
		Closing balance c/f	418,000
	500,000		500,000
Opening balance b/f	418,000		

Accumulated depreciation account

	Rs.		Rs.
Disposal account	42,000	Opening balance b/f	180,000
Closing balance c/f	138,000		
	180,000		180,000
		Opening balance b/f	138,000

4.3 Working Backwards

A question may require you to construct figures by working backwards from information provided. Such questions might provide information at the end of a period and ask you to construct the ledger accounts that resulted in the information. Alternatively, the question might reveal only one side of a double entry and require you to construct the other.

Solving such questions requires a strong understanding of the measurement rules for depreciation and of double entry principles.

Each question has different features. The following example illustrates some of these.

Example

Accumulated depreciation

	Rs.		Rs.
		1 January: Balance b/f	200,000
31 August: Disposal	30,667		
31 December Balance c/f	384,000	31 December Charge for the year	214,667
	414,667		414,667

Disposal

	Rs.		Rs.
		31 August: Cash	75,000
31 August: Cost	100,000	31 August: Disposal	30,667
Profit on disposal	5,667		
	105,667		105,667

Further information:

Assets are depreciated at 20% reducing balance.

The accumulated depreciation at the start of the year represents depreciation charged on assets owned from the beginning of the previous period.

The assets disposed of were all owned at the start of the year.

There were additions this year on 31 March.

Required: Construct the cost account for this category of non-current assets

Step 1: Draw the cost T account and fill in any easy detail (double entries that you know about from the other accounts, narrative for other entries etc.)

Cost

	Rs.		Rs.
1 January: Balance b/f			
31 March: Additions			
		31 August: Disposal	100,000
		31 December Balance c/f	

You should now try to calculate the missing figures in order of difficulty

Step 2: Calculate the opening balance.

The question tells us that the opening accumulated depreciation is that charged on assets owned from the beginning of the previous period.

If this statement is true, there cannot have been any additions or disposals last year.

Therefore the accumulated depreciation (Rs. 200,000) is 20% of the assets held at the start of last year and these were still held at the end of the year.

Grossing this up provides the cost of assets.

Rs. 200,000 × $^{100}/_{20}$ = Rs. 1,000,000.

Cost

	Rs.		Rs.
1 January: Balance b/f	1,000,000		
31 March: Additions			
		31 August: Disposal	100,000
		31 December Balance c/f	

Step 3: Calculate the depreciation on additions.

The question gives the depreciation charge for the year.

The total charge is the sum of depreciation on assets held for the whole year plus assets up to the date of disposal plus assets from the date of purchase.

The question gives the total and gives information which allows you to calculate the first two. Therefore the depreciation on assets from the date of purchase can be found as a balancing figure.

This can be grossed up to give the cost of the additions.

	Rs.
Depreciation on assets held for the whole year	
(1,000,000 – 100,000) × 80% × 20%	144,000
Depreciation on assets sold (1 January to 31 August)	
100,000 × 80% × 20% × $^8/_{12}$	10,667
Depreciation on assets purchased (31 March to 31 December) – a balancing figure	60,000
Total depreciation charge for the year	214,667

Step 4: Gross up the depreciation on additions to find the cost of additions

Rs. 60,000 is 20% × $^9/_{12}$ of the cost.

But 20% × $^9/_{12}$ = 15%

Therefore the cost = Rs.60,000 × $^{100}/_{15}$ = Rs. 400,000

Step 5: Complete the T account.

Cost

	Rs.		Rs.
1 January: Balance b/f	1,000,000		
31 March: Additions	400,000		
		31 August: Disposal	100,000
		31 December Balance c/f	1,300,000
	1,400,000		1,400,000

Example: Azfar and Company

The written down value of plant and machinery of Azfar and Company as at 30 June 2015 is Rs. 831,128.

Following additional information is also available:

(i) On 1 July 2011, second-hand machinery was purchased for Rs. 300,000. An amount of Rs. 200,000 was spent on its overhauling, before use.

(ii) On 1 January 2012 machinery costing Rs. 250,000 was purchased.

(iii) The machinery purchased on 1 July 2011 became obsolete and was sold for Rs. 100,000 on 1 January 2014. On the same date, new machinery was purchased at a cost of Rs. 600,000.

(iv) Machinery purchased on 1 January 2012 was sold on 30 June 2015 at its book value plus Rs. 50,000.

Azfar and Company provides depreciation on machinery @ 15% on written down value. Depreciation on addition / deletion is provided in proportion to the period of use.

(a) Machinery Account from 1 July 2013 to 30 June 2015 shall be as follows:

Machinery Account

		Rs.			Rs.
01.07.2013	Balance b/d	1,055,222	01.01.2014	Depreciation on disposal (W-1)	27,094
01.01.2014	Additions	600,000	01.01.2014	Disposal (W-1)	334,156
			30.06.2014	Depreciation (W-2)	104,096
			30.06.2014	Depreciation on additions (W-1)	45,000
			30.06.2014	Balance c/d	1,144,876
		1,655,222			1,655,222
01.07.2014	Balance b/d	1,144,876	30.06.2015	Depreciation (W-2)	146,670
			30.06.2015	Depreciation on disposal (W-1)	25,062
			30.06.2015	Disposal (W-1)	142,016
			30.06.2015	Balance c/d	831,128
		1,144,876			1,144,876

(b) Machinery Disposal Account for the years ended 30 June 2014 and 2015 shall be as follows:

Machinery Disposal Account

		Rs.			Rs.
01.01.2014	Machinery account	334,156	01.01.2014	Sales proceeds	100,000
				Profit and loss A/c	234,156
		334,156			334,156
30.06.2015	Machinery account	142,016	30.06.2015	Sales proceeds	192,016
30.06.2015	Profit and loss account	50,000			
		192,016			192,016

Working – 1

		Machine I	Machine II
01.07.2011	Cost (300+200)	500,000	
01.01.2012	Cost		250,000
30.06.2012	Dep. @ 15%	(75,000)	(18,750)
30.06.2012	W.D.V	425,000	231,250
30.06.2013	Dep. @ 15%	(63,750)	(34,688)
30.06.2013	W.D.V	361,250	196,562
01.01.2014	Dep. @ 15%	(27,094)	
01.01.2014	W.D.V	334,156	
30.06.2014	Dep. @ 15%		(29,484)
30.06.2014	W.D.V		167,078
30.06.2015	Dep. @ 15%		(25,062)
30.06.2015	W.D.V		142,016

Working – 2

Working for depreciation expense and other adjustments:

		2015	2014
Closing balance	**A**	831,128	1,144,876
Additions during the year	**B**	–	600,000
Disposed during the year (WDV)	**C (W1)**	142,016	334,156
Depreciation			
On additions during the year	**D = B × 15% ×$^1/_2$**	–	45,000
On closing balance excluding additions	**E =(A – B + D) × $^{15}/_{85}$**	146,670	104,096
On disposals during the year	**F (W1)**	25,062	27,094
Opening balance	**(A – B +C + D + E + F)**	1,144,876	1,055,221
Total depreciation		171,732	176,190

Illustration: Naveed Enterprises

Naveed Enterprises commenced business on 01 July 2012. Certain information about their vehicles, for the years ended 30 June 2014 and 2015 can be ascertained from the following ledger accounts:

Accumulated depreciation on vehicles All amount in Rupees

28-02-12	Vehicle disposal account	435,467	01-07-11	Balance b/d	1,360,000
30-06-12	Balance c/d	2,160,800	30-06-12	Dep. for the year	1,236,267
		2,596,267			2,596,267
30-04-13	Vehicle disposal account	560,000	01-07-12	Balance b/d	2,160,800
30-06-13	Balance c/d	3,025,040	30-06-13	Dep. for the year	1,424,240
		3,585,040			3,585,040

Vehicle disposal account All amount in Rupees

28-02-12	Cost at 01-07-2012	1,420,000	28-02-12	Accumulated Dep.	435,467
28-02-12	Profit on disposal	165,467	28-02-12	Cash received	1,150,000
		1,585,467			1,585,467
30-04-13	Cost at 01-07-2012	1,200,000	30-04-13	Accumulated Dep	. 560,000
			30-04-13	Cash received	500,000
			30-04-13	Loss on disposal	140,000
		1,200,000			1,200,000

Following further information is available in respect of the vehicles for the last three years

(01-07-2012 to 30-06-2015):

(i) Depreciation is being provided at the rate of 20% per annum on diminishing balance method.

(ii) Accumulated depreciation brought down on 1 July 2013 represents depreciation for the whole year on vehicles bought on 1 July 2012.

(iii) Two vehicles were purchased on 1 November 2013 and 1 September 2014.

Required:

Prepare Vehicles (Asset) Account for the years ended 30 June 2014 and 2015.

Answer

Vehicles at cost

01/07/11	Balance b/d **(W1)**	6,800,000	28/02/10	Vehicle disposal account	1,420,000
01/11/12	Additions **(W2)**	1,680,000	30/06/11	Balance c/d	7,060,000
		8,480,000			8,480,000
11/07/12	Balance b/d	7,060,000	30/04/12	Vehicle disposal account	1,200,000
01/09/12	Additions **(W2)**	2,820,000	30/06/12	Balance c/d	8,680,000
		9,880,000			9,880,000

W-1: Vehicles opening balance

Vehicle balance on 01/07/2013 (1,360,000 × 100/20)	6,800,000

W-2 : Cost of addition of Vehicles	**2014**	**2015**
Depreciation for the year	1,236,267	1,424,240
On deletions (1,420,000×0.8×0.2×8/12)	(151,467)	
On deletions (1,200,000×0.8×0.8×0.2×10/12)		(128,000)
On other b/f balances ((6,800,000-1,420,000)×0.8×0.2)	(860,800)	
On other b/f balances ((6,800,000-1,420,000-1,200,000)×0.8×0.8×0.2)		(535,040)
On additions during 2013 ((1,680,000-224,000) × 0.2)		(291,200)
Balance being dep. on additions during the year	224,000	470,000
Cost of vehicle purchased on 1/11/2013 (224,000 × 12/8/0.2)	1,680,000	
Cost of vehicle purchased on 1/9/2014 (470,000 × 12/10/0.2)		2,820,000

Practice questions **4**

1 An item of equipment cost Rs. 1,260,000. It has an expected useful life of six years and an expected residual value of Rs. 240,000. Using the straight-line method of depreciation:

What is the annual depreciation charge?

What will be the carrying amount of the asset after four years?

2 The financial year of a company is 1st January to 31st December. A non-current asset was purchased on 1st May for Rs. 60,000. Its expected useful life is five years and its expected residual value is zero. It is depreciated by the straight-line method.

What will be the charge for depreciation in the year of acquisition if a proportion of a full year's depreciation is charged, according to the period for which the asset has been held?

3 A non-current asset cost Rs. 64,000. It is depreciated by the reducing balance method, at the rate of 25% each year.

What is the annual depreciation charge in Year 1, Year 2 and Year 3?

4 A motor vehicle cost Rs.400,000. It has an expected residual value after 5 years of Rs.40,000.

What will be the annual charge for depreciation each year if the sum-of-the-digits method of depreciation is used?

What will be the carrying amount of the asset at the end of Year 2?

5 An office property cost Rs. 5 million, of which the land value is Rs. 2 million and the cost of the building is Rs. 3 million. The building has an estimated life of 50 years.

What is the annual depreciation charge on the property, using the straight-line method?

6 A non-current asset cost Rs.96,000 and was purchased on 1 June Year 1. Its expected useful life was five years and its expected residual value was Rs.16,000. The asset is depreciated by the straight-line method.

The asset was sold on 1 September Year 3 for Rs.68,000. There were no disposal costs.

It is the company policy to charge depreciation on a monthly basis.

The financial year runs from 1 January to 31 December.

What was the gain or loss on disposal?

7 A non-current asset was purchased on 1 June Year 1 for Rs.216,000. Its expected life was 8 years and its expected residual value was Rs.24,000. The asset is depreciated by the straight-line method. The financial year is from 1 January to 31 December.

The asset was sold on 1 September Year 4 for Rs.163,000. Disposal costs were Rs.1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

8 A motor vehicle cost Rs.80,000 two years ago. It has been depreciated by the reducing balance method at 25% each year. It has now been disposed of for Rs.41,000. Disposal costs were Rs.200.

The balance on the motor vehicles account before the disposal was Rs.720,000 and the balance on the accumulated depreciation of motor vehicles account was Rs.250,000.

Show the book-keeping entries to record the disposal.

Practice questions: Time Life Enterprises **5**

The draft statement of financial position of Time Life Enterprises (TLE) as on December 31, 2013, depicts the following:

	Rupees
Plant and Machinery – Cost	12,387,060
Less: Accumulated Depreciation	4,792,540
	7,594,520

On reviewing the accounts of the business, its auditor found that the records have been correctly maintained except for the following events:

i. On January 17, 2013 a contract was signed for the purchase of a machine from Makers Limited for Rs. 1,125,000 which is to be delivered on July 17, 2014. TLE paid an advance of Rs. 450,000 on the signing of the contract and the balance was to be paid on delivery of the machine. The advance was debited to plant and machinery account.

ii. Installation of a machine was completed on January 21, 2013. The cost of machine of Rs. 2,700,000 was debited to plant and machinery account. The cost of installation amounting to Rs. 300,000 had been debited to Repairs Account.

Depreciation is charged on a reducing balance method at 10% per annum. Depreciation on new assets commences in the month in which the asset is acquired.

The depreciation expense for the year 2013 have been correctly calculated and recorded except for the impact of errors discussed above.

Required:

Determine the correct balances as at December 31, 2013 by recording appropriate adjustments in the following accounts:

(a) Plant and machinery

(b) Accumulated depreciation - plant and machinery

Practice questions: Rose Enterprises **6**

Following information pertains to Rose Enterprises for the year ended 31 December 2017:

i. Acquisition of land and construction of a factory building:

	Rs. in '000
Cost of freehold land purchased with old building structure	25,000
Cost of demolition of the old building structure	1,500
Proceeds from sale of scrap of the old building	250
Fee paid to ABC Architects for site plan and drawings	800
Advance paid to Quality Construction (QC) for construction of the building	6,000
Further payment to QC	35,000

ii. Acquisition and installation of new plant:

	Rs. in '000
25% cost of the plant paid in advance	4,000
Transportation and import charges	1,250
Cost of installation	400

iii. Other information:

- Cost of freehold land includes property tax for 2017-18 and transfer fee of Rs. 120,000 and Rs. 850,000 respectively.
- Factory building was available for use from 1 July 2017. The final invoice of Rs. 19,000,000 is still unpaid.
- Transportation and import charges of the plant include annual fire insurance premium and insurance in-transit of Rs. 350,000 and Rs. 60,000 respectively.
- The plant started operations on 1 August 2017. Remaining amount was paid on 31 August 2017.
- Old plant was sold on 1 September 2017 at its written down value plus 20%. The plant was purchased on 1 April 2015 at a cost of Rs. 8,500,000.
- Building and plant are depreciated at the rate of 5% and 10% respectively on reducing balance method.

Required:

a) Pass journal entry to record disposal of the old plant.

b) Determine written down value of the fixed assets as at 31 December 2017.

Practice questions: Star Traders **7**

The following balances pertaining to fixed assets have been extracted from the trial balance of Star Traders for the year ended 31 December 2016:

	Rupees
Fixed assets – cost	25,000,000
Accumulated depreciation	6,250,000
Depreciation expense	1,250,000
Gain on disposal of fixed assets	58,000

Depreciation on fixed assets is charged from the month of addition to the month prior to disposal using reducing balance method at 20% per annum.

Depreciation expense for the current year has been correctly calculated and recorded except for the following:

i. Physical verification of fixed assets carried out on 31 December 2016, revealed the following matters:

- Two laptops purchased on 1 July 2015 at a cost of Rs. 245,000 were withdrawn by the proprietor on 1 May 2016 for his personal use.
- Equipment costing Rs. 800,000 purchased on 1 January 2014 was damaged in rain in December 2016 and was scrapped.

❑ A machine costing Rs. 75,000 is not in the list of fixed assets, but has been in the use of sales department since 1 March 2016. On investigation it was found that the machine was transferred from stock-in-trade but no adjustment was made in the books.

ii. Installation of an assembly plant was completed on 1 December 2016. Installation charges amounting to Rs. 240,000 have not yet been recorded in the books due to non-receipt of the invoice.

iii. An invoice of Rs. 683,000 for a machine purchased on 1 October 2016 was mistakenly accounted for as Rs. 863,000.

Required:

Prepare necessary adjusting and closing entries for the year ended 31 December 2016.

Practice questions: Sundry depreciation problem - 2

8

1 A company purchased some heavy machinery. The invoice for the machinery showed the following items:

	Rs.000
Cost of machinery	46,000
Cost of delivery	900
Cost of 12-month warranty on the machinery	1,600
Total amount payable	48,500

In addition, the company incurred Rs.3.4 million in making modifications to its factory so that the heavy machinery could be installed.

What should be the cost of the machinery in the company's machinery account in the ledger?

2 A business acquired new premises at a cost of Rs.400 million on 1 January 2015. In the period to the year end of 31 March 2015 the following further costs were incurred.

	Rs.000
Costs of initial adaptation of the building	12,000
Legal costs relating to the purchase	2,500
Monthly cleaning contract	3,400
Cost of air conditioning unit necessary for machinery to be used	2,800
Cost of machinery	12,300

What amount should appear as the cost of premises in the company's statement of financial position at 31 March 2015?

3 The plant and machinery account for a company for the year ended 30 June 2015 is as follows.

Plant and machinery account

2014		Rs.	2015		Rs.
1 July	Balance	960,000	31 March	Transfer to disposal account	80,000
31 Dec	Cash: purchase of machines	200,000	30 June	Balance	1,080,000
		1,160,000			1,160,000

The company's policy is to charge depreciation on plant and machinery at 25% each year on the straight-line basis, with proportionate charges in the year of acquisition and the year of disposal. None of the assets held at 1 July 2014 was more than three years old.

What is the charge for depreciation of plant and machinery for the year ended 30 June 2015?

Practice questions: Lahore Motors Limited **9**

Lahore Motors Limited leases second-hand German sports cars, generally a standard model. It started business on 1 January 2012 and has decided to depreciate the cars on a straight line basis at 25% per annum on cost at the year-end. During the years 2012 to 2015 the following purchases and sales of cars took place.

2012	Acquired 20 Porsche 924 Turbos at a cost of Rs.18.6 million each
2013	Purchased 6 Porsches for a total cost of Rs.108.6 million.
2014	Traded-in two of the cars acquired in 2012 and received an allowance of Rs.9 million each which was set against the purchase of a further two cars costing Rs.19.8 million each
2015	Replaced 15 cars purchased in 2012 with another 15, each of which cost Rs.21 million. A trade-in allowance totalling Rs.48 million was received

Lahore Motors Limited prepares accounts to 31 December each year.

Required:

Prepare a vehicle account, a provision for depreciation account, a depreciation account and a disposals account for the years 2012 to 2015.

Practice questions: Chiniot Trucking Limited **10**

Chiniot Trucking Limited is a haulage contractor. At 1 May 2014 the company had three lorries, details of which are as follows:

Lorry registration number	Date purchased	Cost
		Rs.000
BOW 1	1 July 2011	16,000
COW 2	1 February 2013	21,000
DOW 3	1 April 2014	31,000

During the year to 30 April 2015, the following lorry transactions took place:

(a) BOW 1 was sold on 31 July 2014 for Rs.3 million on cash terms. On 1 August 2014 Chiniot Trucking Limited replaced it with a new lorry, registration number FOW 4 for which he paid Rs.35 million in cash.

(b) On 1 December 2014, the new lorry (FOW 4) was involved in a major accident, and as a result was completely written off. The company was able to agree a claim with his insurance company, and on 31 December 2014 he received Rs.30 million from the insurance company. On 1 January 2015 he bought another lorry (registration number HOW5) for Rs.41 million.

(c) During March 2015, the company decided to replace the lorry bought on 1 April 2014 (registration number DOW 3) with a new lorry. It was delivered on 1 April 2015 (registration number JOW 6). The company agreed a purchase price of Rs.26 million for the new lorry, the terms of which were Rs.20 million in part-exchange for the old lorry and the balance to be paid immediately in cash.

Notes:

(1) Chiniot Trucking Limited uses the straight-line method of depreciation.

(2) The lorries are depreciated over a five-year period by which time they are assumed to have an exchange value of Rs.1 million each.

(3) A full year's depreciation is charged in the year of acquisition, but no depreciation is charged if a lorry is bought and sold or otherwise disposed of within the same financial year.

(4) Chiniot Trucking Limited does not keep separate ledger accounts for each individual lorry.

Required

(a) Write up the following accounts for the year to 30 April 2015:

- (i) lorries account
- (ii) lorries disposal account
- (iii) allowance for depreciation on lorries account.

(b) Show how the lorries account and the allowance for depreciation account would be presented in Chiniot Trucking Limited's statement of financial position as at 30 April 2015.

Practice questions: Aslam, Bashir & Company

11

The accountant of Aslam, Bashir & Company, a partnership concern, has finalised the draft financial statements for the year ended June 30, 2015. Mr Bashir is not satisfied with the non-current assets reported in the above financial statements and have asked you to review the same.

The details of non-current assets appearing in the financial statements are as follows:

	Useful life (years)	Cost (Rs.)		Accumulated depreciation (Rs.)	
		2015	2014	2015	2014
Land		5,000,000	5,000,000	-	-
Building	20	7,250,000	7,000,000	4,562,500	4,200,000
Plant & Machinery	15	11,910,000	10,000,000	3,994,000	3,200,000
Furniture & Fixtures	10	3,075,000	3,000,000	2,257,500	1,950,000

Depreciation is provided on straight line basis from the date of purchase to the date of sale.

An analysis of the working papers has revealed that the details of additions/deletions to non-current assets are as follows:

i. In January 2015, Rs. 200,000 were spent on the extension of the underground water tank and Rs. 50,000 were spent on fumigation of the entire building.

ii. On March 31, 2015 a generator which had completed five years of its life was replaced by another generator. The cost of new generator was Rs. 2,000,000 whereas the supplier allowed 10% of the cost of the old generator as trade-in-allowance. As a result, the company made a payment of Rs. 1,910,000 only.

iii. On July 1, 2014 fully depreciated furniture costing Rs. 400,000 was repaired at a cost of Rs. 75,000. It is expected that the repairs would allow the furniture to be used for the next five years.

Required:

Prepare necessary journal entries to record the required corrections.

Practice questions: MJ Enterprises **12**

The following information is available in respect of non-current assets of MJ Enterprises (MJE):

(i) The opening balances of cost and accumulated depreciation of non-current assets as on January 1, 2015 were Rs. 100,000 and Rs. 33,000 respectively.

(ii) Assets costing Rs. 20,000 were acquired on July 1, 2014. The remaining non-current assets were acquired when MJE commenced business on January 1, 2011. There were no disposals of non-current assets up to January 1, 2015.

(iii) MJE provides for depreciation on the cost of assets at the rate of 10% per annum using the straight line basis. Depreciation is calculated on a monthly basis.

(iv) Assets acquired on January 1, 2011 whose net book value on June 30, 2015 was Rs. 2,750 were sold for Rs. 1,500.

(v) On July 1, 2015, an asset which was acquired at a cost of Rs. 2,000 when MJE commenced business, was exchanged for a new asset. The balance of the purchase price was settled with a cheque for Rs. 800. The list price of the new asset was Rs. 1,200.

(vi) On October 1, 2015 MJE transferred to its factory an asset which had been included in its trading inventory and which bore a price label of Rs. 15,400 in the showroom. MJE makes a gross profit of 40% of cost, on sale of such assets.

Required:

Prepare the following ledger accounts for the year ended December 31, 2015:

(a) Non-current assets

(b) Accumulated depreciation

(c) Profit/loss on sale of non-current assets

Practice questions: Ziakot Steel Works **13**

Ziakot Steel Works, a sole proprietorship, provides depreciation on plant and machinery at 20% per annum on diminishing balance method.

On July 1, 2014 the balances in the plant and machinery and accumulated depreciation accounts were Rs. 712,000 and Rs. 240,000 respectively.

Depreciation is provided from the month of purchase till the month of disposal.

It was discovered during 2014-2015 that:

(a) Rs. 25,000 being ordinary repairs to machinery, incurred on October 1, 2012 had been capitalised incorrectly.

(b) A machine which was purchased on January 1, 2012 for Rs. 100,000 was traded-in, on March 31, 2014 for a new and more sophisticated machine. The disposal was not recorded and the new machine was capitalised at Rs. 120,000 being the net amount paid to the supplier. The trade-in allowance amounted to Rs. 50,000.

It was decided to correct the above mistakes while finalising the accounts for the year ended June 30, 2015.

Only one machine was purchased during the year ended June 30, 2015 costing Rs. 60,000. The machine was received in the factory on October 1, 2014 and was installed on January 1, 2015.

Required

Plant and machinery account and accumulated depreciation account for the year ended June 30, 2015. (Show all workings).

Practice questions: Kamran Enterprises **14**

Kamran Enterprises (KE) provides depreciation on plant and machines at 10% on written-down value. Depreciation is charged from the month the asset is available for use in operations up to the month prior to its disposal. Cost of its plant & machines and the accumulated depreciation as on 1 July 2015 were Rs. 75 million and Rs. 17 million respectively.

The following information is available in respect of its plant & machines, for the year ended 30 June 2016:

i. On 1 October 2015, a second-hand machine was acquired from a Chinese company for Rs. 15 million. The machine was renovated and overhauled at a cost of Rs. 3 million. 25% of this expenditure was in respect of purchase of consumables.

ii. On 1 November 2015, KE transferred a machine having a list price of Rs. 10 million from its stock-in-trade to its Engineering Department. KE sells such machines at cost plus 25%.

iii. On 1 January 2016, certain worn-out parts of a plant were replaced at a cost of Rs. 4 million. The replaced parts neither enhanced the useful life of the plant nor its operating efficiency. The old parts were sold for Rs. 0.75 million. The plant was purchased for Rs. 25 million on 1 January 2015.

On 1 May 2016, the plant was damaged and remained in-operative for one month. KE spent an amount of Rs. 3 million on repairs to restore the plant in working condition.

iv. On 1 April 2016, a machine which was purchased on 1 July 2012 for Rs. 12 million was completely damaged and was sold for Rs. 1.2 million.

Required:

Prepare accounting entries to record the above transactions in KE's books for the year ended 30 June 2016.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

a Equipment account

YEAR 1	Rs.		Rs.
Cash	40,000	Balance c/d	40,000
	40,000		40,000
YEAR 2			
Balance b/d	40,000	Balance c/d	40,000
	40,000		40,000
Balance b/d	40,000		

b Equipment – accumulated depreciation

YEAR 1	Rs.		Rs.
		Depreciation	8,000
Balance c/d	8,000		
	8,000		8,000
YEAR 2			
		Balance b/d	8,000
Balance b/d	16,000	Depreciation	8,000
	16,000		16,000
		Balance b/d	16,000

c Depreciation expense

YEAR 1	Rs.		Rs.
Acc. depreciation	8,000	Statement of comprehensive income	8.000
	8,000		8,000
YEAR 2			
Acc. depreciation	8,000	Statement of comprehensive income	8.000
	8,000		8,000

Carrying amounts at:	Year 1 (Rs.)	Year 1 (Rs.)
Cost	40,000	40,000
Accumulated depreciation	8,000	16,000
Carrying amount	32,000	24,000

Solution **2**

Annual depreciation = Rs.(96,000 – 16,000)/5 years = Rs.16,000.

Monthly depreciation = Rs. 16,000/12 = Rs. 1,333.33.

	Rs.	Rs.
Disposal value less disposal costs		68,000
Cost of the asset	96,000	
Accumulated depreciation at the time of disposal (= 27 months ×Rs. 1,333.33)	(36,000)	
Carrying amount at the date of disposal		60,000
Gain on disposal		8,000

Solution **3**

Annual depreciation = Rs.(216,000 – 24,000)/8 years = Rs.24,000.

	Rs.	Rs.
Disposal value		163,000
Less disposal costs		(1,000)
		162,000
Accumulated depreciation at the time of disposal		
Year to 31 December Year 1: (Rs.24,000 × 7/12)	14,000	
Years 2 and 3: (Rs.24,000 × 2 years)	48,000	
Year to 31 December Year 4: (Rs.24,000 × 8/12)	16,000	
	78,000	
Cost of the asset	216,000	
Carrying amount at the date of disposal		138,000
Gain on disposal		24,000

Solutions **4**

1 Annual depreciation = $^{\text{Rs.(1,260,000 – 240,000)}}/_{\text{6 years}}$ = Rs.170,000.

After 4 years:	Rs.
Asset at cost	1,260,000
Less accumulated depreciation: Rs. 170,000 x 4)	680,000
Net book value	580,000

2 Annual depreciation = $^{\text{Rs.(60,000 – 0)}}/_{\text{5 years}}$ = Rs.12,000.

Charge in the year of acquisition = Rs. 12,000 × $^{\text{8 months}}/_{\text{12 months}}$ =Rs. 8,000

3

	Rs.
Cost of the asset	64,000
Year 1 depreciation (25%)	(16,000)
Carrying amount at the end of year 1	48,000
Year 2 depreciation (25%)	(12,000)
Carrying amount at the end of year 2	36,000
Year 3 depreciation (25%)	(9,000)
Carrying amount at the end of year 3	27,000

4 Sum of the digits = 1 + 2 + 3 + 4 + 5 = 15

	Rs.
Cost of the asset	400,000
Year 1 depreciation ($^5/_{15}$ × Rs.(400,000 – 40,000)	(120,000)
Carrying amount at the end of year 1	280,000
Year 2 depreciation ($^4/_{15}$ × Rs.(400,000 – 40,000)	(96,000)
Carrying amount at the end of year 2	184,000

5 Annual depreciation = $^{\text{Rs.(3,000,000)}}/_{\text{50 years}}$ = Rs.60,000.

(Land is not depreciated (except in certain circumstances).

6 Annual depreciation = Rs.(96,000 – 16,000)/5 years = Rs.16,000.
Monthly depreciation = Rs. 16,000/12 = Rs. 1,333.33.

	Rs.	Rs.
Disposal value less disposal costs		68,000
Cost of the asset	96,000	
Accumulated depreciation at the time of disposal (= 27 months ×Rs. 1,333.33)	(36,000)	
Carrying amount at the date of disposal		60,000
Gain on disposal		8,000

7 Annual depreciation = Rs.(216,000 – 24,000)/8 years = Rs.24,000

	Rs.	Rs.
Disposal value		163,000
Less disposal costs		(1,000)
		162,000
Accumulated depreciation at the time of disposal		
Year to 31 December Year 1: (Rs.24,000 × 7/12)	14,000	
Years 2 and 3: (Rs.24,000 × 2 years)	48,000	
Year to 31 December Year 4: (Rs.24,000 × 8/12)	16,000	
	78,000	
Cost of the asset	216,000	
Carrying amount at the date of disposal		138,000
Gain on disposal		24,000

8

	Rs.	Rs.
Cost of the asset	80,000	
Year 1 depreciation (× 25%)	(20,000)	20,000
Carrying amount at end of Year 1	60,000	
Year 2 depreciation (× 25%)	(15,000)	15,000
Accumulated depreciation at date of disposal		35,000

Disposal account

	Rs.		Rs.
Motor vehicles account	80,000	Accumulated depreciation	35,000
Bank (disposal costs)	200	Receivables	41,000
		Statement of comprehensive income (loss on disposal)	4,200
	80,200		80,200

b **Motor vehicles**

	Rs.		Rs.
Opening balance b/d	720,000	Disposal of asset account	80,000
		Closing balance c/d	640,000
	720,000		720,000
Opening balance b/d	640,000		

c **Accumulated depreciation on motor vehicles**

	Rs.		Rs.
Disposal of asset account	35,000	Opening balance b/f	250,000
Closing balance c/d	215,000		
	250,000		250,000
		Opening balance b/d	215,000

Solutions **5**

Plant & Machinery

2013			2013		
	Balance before adjustment	**12,387,060**			
Jan. 21	Cost of installation	**300,000**	Jan. 17	Reversal of Advance against contract for future delivery of plant	**450,000**
				Balance c/d:	
				Plant & Machinery	12,237,060
		12,687,060			12,687,060

Accumulated Depreciation - Plant & Machinery

2013			**2013**		
			Jan. 1	Balance before adjustment	4,792,540
	Removal of depreciation wrongly charged on advance (450,000 @ 10%)	45,000		Extra depreciation on 300,000 @10%	30,000
	Balance c/d	4,777,540			
		4,822,540			4,822,540

Solutions **6**

Rose Enterprises

(a) Journal entry for disposal of old plant:

		Debit	**Credit**
		—— Rs. in '000 ——	
Bank/Cash/Receivable	**(8,500–1,896)×1.2**	7,925	
Accumulated depreciation	**(W-1)**	1,896	
Fixed assets (Plant)			8,500
Gain on disposal (Balancing figure) [7,925 – (8,500 – 1,896)]			1,321

W-1: Accumulated depreciation:		**Rs. in '000**
From 1 April to 31 December 2015	(8,500 × 0.1 × 9 ÷ 12)	638
For the year ended 31 December 2016	(8,500 – 638) × 0.1	786
From 1 January to 31 August 2017	(8,500 – 638 – 786) × 0.1 × 8 ÷ 12	472
		1,896

(b) WDV as at 31 December 2017

		Freehold land	Building	Plant
		Rs. in '000		
Costs				
Purchase price		25,000		
Property tax for the year 2017		(120)		
Transfer fee		-		
Demolition of old building		1,500		
Proceeds from sale of building scrap		(250)		
Architect fee paid to ABC consultant			800	
25% Advance paid to QC			6,000	
Further payment			35,000	
Final invoice under process for payment			19,000	
Advance paid for the plant				4,000
Transportation and import charges				1,250
Fire insurance premium				(350)
Insurance in transit				-
Installation charges				400
Remaining cost of plant	(4,000÷0.25-4,000)			12,000
Cost to be capitalised		**26,130**	**60,800**	**17,300**
Depreciation for 2017				
– Land		-		
– Building	**(60,800 × 0.05 × 6 ÷ 12)**		(1,520)	
– Plant	**(17,300 × 0.1 × 5 ÷ 12)**			(721)
WDV of fixed assets as at 31 December 2017		**26,130**	**59,280**	**16,579**

Solutions **7**

Star Traders

Adjusting and closing entries

Date	Particulars	Debit	Credit
		—— Rupees ——	
31-Dec-16	Accumulated depreciation (245,000×90%×20%×8/12)	29,400	
(i)	Depreciation expense		29,400
	(Reversal of depreciation on laptops in use of use of the proprietor)		
	Drawings (245,000–39,200)	205,800	
	Accumulated deprecation	39,200	
	(245,000×20%×6/12)+(245,000×90%×20%×4/12)		
	Fixed assets		245,000
	(Laptops withdrawn by proprietor for his personal use)		
31-Dec-16	Accumulated depreciation (800,000 × 12.8% × 1/12)	8,533	
(i)	Depreciation expense		8,533
	Accumulated depreciation (800,000×20%)+ (800,000×16%)+[(800,000×12.8%)×11/12]	381,867	
	Loss on scrapping of fixed assets (800,000–381,867)	418,133	
	Fixed assets		800,000
	(Equipment damaged in rain and scrapped now recorded)		
31-Dec-16	Fixed assets	75,000	
(i)	Depreciation expense (75,000×20%×10/12)	12,500	
	Accumulated depreciation		12,500
	Purchases/inventory		75,000
	(A machine issued from stock-in-trade for office use now accounted for)		
31-Dec-16	Fixed assets	240,000	
(ii)	Depreciation expense (240,000×20%/12)	4,000	
	Accumulated depreciation		4,000
	Installation charges payable		240,000
	(Accrual of installation charges and its effect on depreciation)		
31-Dec-16	Account payable (863,000–683,000)	180,000	
(iii)	Accumulated depreciation (863,000–683,000)×20%×3/12	9,000	
	Depreciation expense		9,000
	Fixed assets		180,000
	(Correction of transposition error and its effect on depreciation)		

Date	Particulars	Debit	Credit
		—— Rupees ——	
31-Dec-16	Statement of comprehensive income	1,579,700	-
	Depreciation expense (1,250,000–29,400 – 8,533 +12,500+4,000–9,000)		1,219,567
	Loss on disposal of fixed assets (418,133–58,000)		360,133
	(Revenue expenditure closed to statement of comprehensive income)		

Solutions **8**

1 The cost of the machinery should include the delivery cost and also the cost of preparation work or modification work carried out by the entity to enable the machinery to be installed and become operational. = Rs.50.3 million (46 + 0.9 + 3.4).

2

	Rs.000
Cost	400,000
Adaptation	12,000
Legal fees	2,500
	414,500

3

Depreciation charge	**Rs.**
On asset disposed of in the year: 25%× Rs.80,000 × 9/12	15,000
On other assets held at the beginning of the year: 25%× (Rs.960,000 - Rs.80,000)	220,000
On assets purchased in the year: 25%× Rs.200,000 × 6/12	25,000
Total depreciation charge	260,000

Solutions **9**

Vehicle a/c

2012	Rs.000	*2012*	Rs.000
Cash	372,000	Balance c/d	372,000
2013		*2013*	
Balance b/d	372,000		
Cash	108,600	Balance c/d	480,600
	480,600		480,600
2014		*2014*	
Balance b/d	480,600	Disposals	37,200
Disposals (allowance)	18,000		
Cash (βal fig)	21,600	Balance c/d	483,000
	520,200		520,200
2015		*2015*	
Balance b/d	483,000	Disposals	279,000
Disposals (allowance)	48,000		
Cash (βal fig)	267,000	Balance c/d	519,000
	798,000		798,000
2010			
Balance b/d	519,000		

Accumulated depreciation a/c

2012	Rs.000	*2012*	Rs.000
Balance c/d	93,000	Depreciation a/c	
		(25% × Rs.372,000,000)	93,000
2013		*2013*	
		Balance b/d	93,000
Balance c/d	213,150	Depreciation a/c	
		(25% × Rs. 480,600,000)	120,150
	213,150		213,150
2014		*2014*	
Disposals	18,600	Balance b/d	213,150
Balance c/d	315,300	Depreciation a/c	
		(25% × Rs.483,000,000)	120,750
	333,900		333,900
2015		*2015*	
Disposals	209,250	Balance b/d	315,300
Balance c/d	235,800	Depreciation a/c	
		(25% × Rs.519,000,000)	129,750
	445,050		445,050
		2010	
		Balance b/d	235,800

Depreciation a/c

2012	Rs.000	*2012*	Rs.000
Accumulated depreciation	93,000	P&L	93,000
2013		*2013*	
Accumulated depreciation	120,150	P&L	120,150
2014		*2014*	
Accumulated depreciation	120,750	P&L	120,750
2015		*2015*	
Accumulated depreciation	129,750	P&L	129,750

Disposals a/c

2014	Rs.000	*2014*	Rs.000
Vehicle a/c	37,200	Accumulated depreciation (W1)	18,600
		Vehicle a/c (allowance against car)	18,000
		Loss on disposal	600
	37,200		37,200
2015		*2015*	
Vehicle a/c	279,000	Accumulated depreciation (W2)	209,250
		Vehicle a/c (allowance)	48,000
		Loss on disposal	21,750
	279,000		279,000

WORKINGS

(1) **Depreciation on 2014 disposals**

2 years @ 25% × Rs.37.2 million = Rs.18.6 million

(2) **Depreciation on 2015 disposals**

3 years @ 25% × Rs.279 million = Rs.209.25 million

Note: Detail of dates is not given so depreciation has been charged on year basis.

Solutions **10**

(a) Lorries account entries

Lorries account

Date		Rs. 000	Date		Rs.000
1.5.2014	Balance b/d	68,000	31.7.2014	Disposal a/c (BOW1)	16,000
1.8.2014	Cash (FOW4)	35,000	15.12.2014	Disposal a/c (FOW4)	35,000
1.1.2015	Cash (HOW5)	41,000	1.4.2015	Disposal a/c (DOW3)	31,000
1.4.2015	Cash (JOW6)	6,000			
1.4.2015	Disposal account (part exchange)	20,000	30.4.2015	Balance c/d	88,000
		170,000			170,000
1.5.2015	Balance b/d	88,000			

Lorries disposal account

Date		Rs. 000	Date		Rs. 000
31.7.2014	Lorries a/c (BOW1)	16,000	31.7.2014	Allowance for depreciation a/c (BOW 1)	9,250
15.12.2014	Lorries a/c (FOW4)	35,000	31.7.2014	Cash (BOW1)	3,000
1.4.2015	Lorries a/c (DOW3)	31,000	1.12.2014	Allowance for depreciation a/c (BOW 1)	2,267
			31.12.2014	Cash (FOW4)	30,000
			1.4.2015	Allowance for depreciation a/c (DOW 3)	6,000
			1.4.2015	Lorries a/c – part exchange JOW 6 for DOW 3	20,000
			30.4.2015	P & L: loss on disposal	11,483
		82,000			82,000

Allowance for depreciation on lorries account

Date		Rs. 000	Date		Rs. 000
31.7.2014	Lorries disposal a/c (BOW 1) **(W)**	9,250	1.5.2014	Balance b/d	14,000
1.12.2014	Lorries disposal a/c (FOW 3) **(W)**	2,267			
1.4.2015	Lorries disposal a/c (DOW 3) **(W)**	6,000	30.4.2015	P & L: Charge for the year **(W)**	15,601
30.4.2015	Balance c/d	25,000			
		12,084			29,601
			1.5.2015	Balance b/d	12,084

(b) Statement of financial position (extract) at 30 April 2015

Non-current assets	Rs. 000
Lorries, at cost	88,000
Less: Accumulated depreciation	(12,084)
	75,916

(Note: The balance on the account at the end of the year represents the combined cost of lorries COW2, HOW5 and JOW6 = Rs.21 million + Rs.41 million + Rs.26 million).

Workings: Depreciation

	BOW 1	**COW 2**	**DOW 3**	**FOW 4**	**HOW 4**	**JOW 4**
Calculation	**Rs. 000**	**Rs. 000**	**Rs. 000**	**Rs. 000**	**Rs. 000**	**Rs. 000**
Cost	16,000	21,000	31,000	35,000	41,000	26,000
Residual value	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
Depreciable amount	15,000	20,000	30,000	34,000	40,000	25,000
Annual charge	3,000	4,000	6,000	6,800	8,000	5,000

	BOW 1	**COW 2**	**DOW 3**	**FOW 4**	**HOW 4**	**JOW 4**	
	Rs. 000	**Rs. 000**	**Rs. 000**	**Rs. 000**	**Rs. 000**	**Rs. 000**	
2012 depreciation							
3,000 × $^{10}/_{12}$	2,500						
2013 depreciation	3,000						
4,000 × $^{3}/_{12}$		1,000					
2014 depreciation	3,000	4,000					
6,000 × $^{1}/_{12}$			500				**Total**
At 30 April 2014	8,500	5,000	500				14,000
2015 depreciation		4,000					
3,000 × $^{3}/_{12}$	750						
6,000 × $^{11}/_{12}$			5,500				
6,800 × $^{4}/_{12}$				2,267			
8,000 × $^{4}/_{12}$					2,667		
5,000 × $^{1}/_{12}$						417	
Charge for the year	750	4,000	5,500	2,267	2,667	417	15,601
	9,250	9,000	6,000	2,267	2,667	417	
Disposal	(9,250)		(6,000)	(2,267)			
	–	9,000	–	–	2,667	417	12,084

Solutions **11**

		Dr. Rs.	Cr. Rs.
(i)	Repairs and maintenance - building	50,000	
	Building account		50,000
	(Fumigation cost previously capitalised now charged to revenue)		
	Accumulated depreciation – building (5,000 + 2,500)	7,500	
	Depreciation – building		7,500
	(Excess depreciation on Rs. 200,000 for six months reversed: Rs. 5,000 *Depreciation on Revenue item of Rs. 50,000 reversed; 50,000÷20: Rs. 2,500)*		
(ii)	Plant and machinery account	90,000	
	Loss on disposal of old generator	510,000	
	Accumulated depreciation – plant and machinery	300,000	
	Plant and machinery		900,000
	(To record disposal of old generator and the loss incurred thereby)		
	Depreciation – plant and machinery	1,500	
	Accumulated depreciation – plant and machinery		1,500
	(Adjustment of Depreciation on new generator short provided; Rs. 90,000 ÷ 15 ÷ 4)		
	Accumulated depreciation – plant and machinery	15,000	
	Depreciation – plant and machinery		15,000
	Depreciation on old generator provided for the whole year now adjusted for nine months; 900,000 ÷ 15 × 3 ÷ 12		
	Accumulated depreciation – plant and machinery	95,500	
	Depreciation – plant and machinery		95,500
	Depreciation on new generator provided for the whole year now adjusted for three months – 1,910,000 ÷ 15 × 9 ÷ 12		
(iii)	Accumulated depreciation – furniture and fixtures	32,500	
	Depreciation – furniture and fixtures		32,500
	*(Depreciation excess provided now reversed: **W1**)*		

W1		**Rs.**
	Cost of all furniture	3,075,000
	Items fully depreciated	400,000
	Depreciable assets	2,675,000
	Depreciation on major repair (75,000/5)	15,000
	Depreciation on remaining furniture and fixture ($^{2,675,000 - 75,000}/_{10}$)	260,000
		275,000
	Depreciation provided	307,500
	Amount to be reversed	32,500

Solutions **12**

Non-current assets Account

Debit	(Rs.)	Credit	(Rs.)
Balance b/d	100,000	Gain/Loss on asset disposal **W1**	5,000
Gain/Loss on asset disposal **W2**	400	Gain/Loss on asset disposal	2,000
Cash (New machine)	800		
Inventory A/c (15,400/1.4)	11,000	Balance c/d	105,200
	112,200		112,200

Accumulated Depreciation Account

Debit	(Rs.)	Credit	(Rs.)
Gain/Loss on asset disposal (5,000 – 2,750)	2,250	Balance b/d	33,000
Gain/Loss on asset disposal **W2**	900	Depreciation Expense **W3**	9,985
Balance c/d	39,835		
	42,985		42,985

Gain/Loss on asset disposal

Debit	(Rs.)	Credit	(Rs.)
		Non-current assets Account **W2**	400
		Accumulated Depreciation Account	
		Accumulated Depreciation Account	2,250
		Cash (Sale proceeds)	
		P& L A/c – loss on disposal	900
Non-current assets Account **W1**	5,000		1,500
Non-current assets Account	2,000		1,950
	7,000		7,000

W1:

The depreciation on asset up to June 30, 2015 is 45% i.e. 10% each year, therefore its NBV represents 55% of cost. Hence cost of asset = 2,750 ÷0.55 = Rs. 5,000

W2:	**Rupees**
Cost of asset	2,000
Depreciation 2011 – 2014 – (40%) + six months of 2015	(900)
Written down value at the date of exchange	1,100
Cost of new machine less amount paid (1,200 – 800)	400
Loss on exchange/disposal of asset	700

W3: Depreciation for the year

Depreciation on asset held throughout the year (100,000 – 5,000 – 2,000) *10%	9,300
Depreciation on asset sold (5,000 + 2,000) × 10% × $^{6}/_{12}$	350
Depreciation on new asset obtained in exchange (1,200*10%*$^{6}/_{12}$)	60
Depreciation on new asset (transferred from inventory) (11,000*10%*$^{3}/_{12}$)	275
Total depreciation for the year 2015	9,985

Solutions **13**

Plant and Machinery A/c

Balance b/d	712,000	Repairs wrongly capitalised	25,000
Trade in value (2014) now recorded	50,000	Machine traded-off	100,000
New machine purchased	60,000	Balance c/d	697,000
	822,000		822,000

Accumulated Depreciation A/c

Repairs wrongly capitalised	8,000	Balance b/d	240,000
Machine traded-off	42,400	Depreciation for the year	97,480
Balance c/d	287,080		
	337,480		337,480

Workings:

		Rs.
1.	Repair wrongly capitalised on 01.10.2012	25,000
	Less: Depreciation from 01.10.2012 to 30.06.2013	3,750
		21,250
	Less: Depreciation for 01.07.2013 to 30.06.2014	4,250
	WDV on 01.07.2014	17,000
2.	**Machine traded off in 2014**	
	Cost of machine (01.01.2012)	100,000
	Less: Depreciation for six months 01.01.2012 to 30.06.2013	10,000
		90,000
	Less: Depreciation 01.07.2012 to 30.06.2013	18,000
		72,000
	Less: Depreciation 01.07.2013 to 30.06.2014	14,400
		57,600
	Total depreciation provided up to 30.06.2014 (10,000 + 18,000 + 14,400)	42,400
3.	**Calculation of depreciation for 2014-2015**	**WDV**
	Opening balance	472,000
	Adjustment for prior year – repairs wrongly capitalised	(17,000)
	Disposal not recorded in 2014	(57,600)
	Short capitalised as trade-in value netted off against cost	47,500
		444,900
	Depreciation on Rs. 50,000 for the period 01.04.2014 to 30.06.2014	2,500
	Depreciation for full year on Rs.444,900 × 0.20	88,980
	Depreciation on machine purchase during the year (60,000 × 0.20 × 6/12)	6,000
		97,480

Solutions **14**

Date	Description	Debit	Credit
		—— Rupees ——	
1-10-2015	Machine B (15+3×75%)	17,250,000	
	Cost of sales/Repair and maintenance / Profit & loss a/c	750,000	
	Bank		18,000,000
1-11-2015	Machine a/c (10,000,000×100/125)	8,000,000	
	Stock-in-trade		8,000,000
1-1-2016	Plant and Machine	4,000,000	
	Bank		4,000,000
1-1-2016	Bank	750,000	
	Cost of sales/Other income		750,000
1-5-2016	Cost of sales/Repair and maintenance / Profit & loss a/c	3,000,000	
	Bank/payable		3,000,000
1-4-2016	Bank	1,200,000	
	Accumulated depreciation – Machine [12-(12×0.9×0.9×0.9×0.925)]	3,908,100	
	Loss on sale of machine (balancing)	6,891,900	
	Machine		12,000,000
30-1-2016	Depreciation expense (W-1)	7,608,383	
	Accumulated depreciation – Plant and machine		7,608,383

W-1:

	Written down value	Depreciation for the year
	——— Rupees ———	
Opening balance (75,000,000-17,000,000	58,000,000	
Less: Disposal [12,000,000×(0.9)^3]	(8,748,000)	
	49,252,000	4,925,200
Addition		
Addition on 01 October 2015 (17,250,000×10%×9/12)	17,250,000	1,293,750
Addition on 01 November 2015 (8,000,000×10%×8/12)	8,000,000	533,333
On 1 January 2015	4,000,000	200,000
Disposal		
Depreciation on machine sold during the year (8,748,000×0.1×9/12)		656,100
Total depreciation		7,608,383

5 OBJECTIVE BASED QUESTIONS

01. A building contractor decides to construct an office building to be occupied by his own staff.

Which TWO of the following expenses incurred by the building contractor cannot be included as a part of the cost of the office building?

(a) Interest incurred on a specific loan taken out to pay for the construction of the new offices

(b) A proportion of the contractor's general administration costs

(c) Hire of plant and machinery for use on the office building site

(d) Additional design work caused by initial design errors

02. The purpose of depreciation is to:

(a) Allocate the cost less residual value on a systematic basis over the asset's useful life

(b) Write the asset down to its realisable value each period

(c) Accumulate a fund for asset replacement

(d) Recognise that assets lose value over time

03. IAS 16 *Property, Plant and Equipment* requires an asset to be measured at cost on its original recognition in the financial statements.

Alpha Trading Limited (ATL) used its own staff, assisted by contractors when required, to construct a new warehouse for its own use.

Identify the costs listed below that cannot be capitalized.

(a) Clearance of the site prior to commencement of construction

(b) Professional surveyor fees for managing the construction work

(c) ATL's own staff wages for time spent working on construction

(d) A proportion of ATL's administration costs, based on staff time spent

04. Which TWO of the following items should be capitalised within the initial carrying amount of an item of plant?

(a) Cost of transporting the plant to the factory

(b) Cost of installing a new power supply required to operate the plant

(c) A deduction to reflect the estimated residual value

(d) Cost of a three-year maintenance agreement

05. Hunza Limited acquired a new office building on 1 October 2014. Its initial carrying amount consisted of:

	Rs. 000
Land	2,000
Building structure	10,000
Air conditioning system	4,000
	16,000

The estimated lives of the building structure and air conditioning system are 25 years and 10 years respectively.

When the air conditioning system is due for replacement, it is estimated that the old system will be dismantled and sold for Rs. 500,000.

Depreciation is time-apportioned where appropriate.

At what amount will the office building be shown in Hunza Limited's statement of financial position as at 31 March 2015?

(a) Rs. 15,625,000

(b) Rs. 15,250,000

(c) Rs. 15,585,000

(d) Rs. 15,600,000

06. Which of the following are items of property, plant and equipment?

(i) Standby generator expected to be used for seven years
(ii) A plot of land held for resale
(iii) A bus for pick-and-drop of staff members
(iv) A generator for rental to others

(a) (i) to (iv) all

(b) (i), (ii) and (iii) only

(c) (i), (iii) and (iv) only

(d) (ii), (iii) and (iv) only

07. An entity acquires a plant in exchange of old machinery which has carrying amount of Rs. 760,000 and fair value of Rs. 750,000 at the date of exchange. The list price of plant acquired is Rs. 850,000. The entity is also required to pay cash of Rs. 55,000 in this exchange transaction.

At which amount the acquired plant should be initially recognised?

(a) Rs. 850,000

(b) Rs. 760,000

(c) Rs. 815,000

(d) Rs. 805,000

08. A company purchased some heavy machinery. The invoice for the machinery showed the following items:

	Rs.000
Cost of machinery	46,000
Cost of delivery	900
Cost of 12-month warranty on the machinery	1,600
Total amount payable	48,500

In addition, the company incurred Rs.3.4 million in making modifications to its factory so that the heavy machinery could be installed.

What should be the cost of the machinery in the company's machinery account in the ledger?

(a) Rs. 48,500,000

(b) Rs. 46,900,000

(c) Rs. 46,000,000

(d) Rs. 50,300,000

09. A business acquired new premises at a cost of Rs.400 million on 1 January 2015. In the period to the year end of 31 March 2015 the following further costs were incurred.

	Rs.000
Costs of initial adaptation of the building	12,000
Legal costs relating to the purchase	2,500
Monthly cleaning contract	3,400
Air conditioning unit necessary for machinery to be used	2,800
Cost of machinery	12,300

What amount should appear as the cost of premises in the company’s statement of financial position at 31 March 2015?

(a) Rs. 414,500,000

(b) Rs. 412,000,000

(c) Rs. 425,800,000

(d) Rs. 417,800,000

10. An entity has built a new factory incurring the following costs:

	Rs. '000
Land	1,200
Materials	2,400
Labour	3,000
Architect's fees	25
Surveyor's fees	15
Site overheads	300
Apportioned administrative overheads	150
Testing of fire alarms	10
Business rates for first year	12
	7,112

What will be the total amount capitalised in respect of the factory?

(a) Rs. 6,112,000

(b) Rs. 6,950,000

(c) Rs. 7,112,000

(d) Rs. 7,100,000

11. A motor vehicle cost Rs.400,000. It has an expected residual value after 5 years of Rs.40,000.

If the sum of the digits method of depreciation is used, what will be the carrying amount of the asset at the end of Year 2?

(a) Rs. 96,000

(b) Rs. 120,000

(c) Rs. 280,000

(d) Rs. 184,000

12. On 1 March 2018 Mercury Limited (ML) acquired a machine from Plant under the following terms:

	Rs. 000
List price of machine	82,000
Import duty	1,500
Delivery fees	2,050
Electrical installation costs	9,500
Pre-production testing	4,900
Purchase of a five-year maintenance contract with Plant	7,000

In addition to the above information ML was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5% if payment for the machine was received within one month of purchase. ML paid for the plant on 25 March 2018.

On what amount, the plant should be initially measured on 1 March?

(a) Rs. 98,750,000

(b) Rs. 95,060,000

(c) Rs. 91,750,000

(d) Rs. 88,060,000

13. Construction of Venice Limited's new store began on 1 April 2019. The following costs were incurred on the construction:

	Rs. 000
Freehold land	4,500
Architect fees	620
Site preparation	1,650
Materials	7,800
Direct labour costs	11,200
Legal fees	2,400
General overheads	940

The store was completed on 1 January 2020.

Calculate the amount to be included as property, plant and equipment in respect of the new store

(a) Rs. 28,170,000

(b) Rs. 29,110,000

(c) Rs. 25,770,000

(d) Rs. 23,670,000

14. On 1 March 2010 Earth Limited (EL) purchased an upgrade package from Sun Limited at a cost of Rs. 18 million for the machine it originally purchased in 2008. The upgrade took a total of two days where new components were added to the machine. EL agreed to purchase the package as the new components would lead to a reduction in production time per unit of 15%. This will enable EL to increase production without the need to purchase a new machine.

What is appropriate accounting treatment?

(a) EL should expense this additional expenditure

(b) EL should capitalise this additional expenditure in the cost of existing plant

(c) EL should capitalise the 15% of Rs. 18 million in the cost of existing plant

(d) None of the above is appropriate treatment

15. An item of plant was purchased on 1 April 2008 for Rs. 2,000,000 and is being depreciated at 25% on a reducing balance basis. What would be its residual value after its useful life of 5 years?

- **(a)** Rs. 632,809
- **(b)** Rs. NIL
- **(c)** Rs. 474,609
- **(d)** Rs. 400,000

16. On 1 April 2010 Mars Limited (ML) held non-current assets that cost Rs. 312 million and had accumulated depreciation of Rs. 66 million at this date.

During the year ended 31 March 2011, ML disposed of non-current assets which had originally cost Rs. 28 million and had a carrying amount of Rs. 11.2 million.

ML's policy is to charge depreciation of 40% on the reducing balance basis, with no depreciation charged in the year of disposal

What is the depreciation charge to the statement of profit or loss for the year ended 31 March 2011?

Rs. ___________

17. Jupiter Limited (JL) purchased a machine on 1 July 2017 for Rs. 500,000. It is being depreciated on a straight line basis over its expected life of ten years. Residual value is estimated at Rs. 20,000. On 1 January 2018, following a change in legislation, JL fitted a safety guard to the machine. The safety guard cost Rs. 25,000 and has a useful life of five years with no residual value.

What amount will be charged to profit or loss for the year ended 31 March 2018 in respect of depreciation on this machine?

Rs. ___________

18. A non-current asset cost Rs.96,000 and was purchased on 1 June Year 1. Its expected useful life was five years and its expected residual value was Rs.16,000. The asset is depreciated by the straight-line method.

The asset was sold on 1 September Year 3 for Rs.68,000. There were no disposal costs. It is the company policy to charge depreciation on a monthly basis. The financial year runs from 1 January to 31 December.

What was the gain or loss on disposal?

Rs. ___________

19. A non-current asset was purchased on 1 June Year 1 for Rs.216,000. Its expected life was 8 years and its expected residual value was Rs.24,000. The asset is depreciated by the straight-line method. The financial year is from 1 January to 31 December.

The asset was sold on 1 September Year 4 for Rs.163,000. Disposal costs were Rs.1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

Rs. ___________

20. An asset was purchased on 1 July 2014 and it is being depreciated at 15% using reducing balance method. It has carrying amount of Rs. 654,321 on June 30, 2019.

Work back and calculate the cost of the asset when purchased on 1 July 2014.

Rs. ___________

21. Which of the following is not an asset that falls under the scope of IAS 16?

(a) Tangible assets
(b) Assets held for the production or supply of goods or services
(c) Assets held for sale in the normal course of business
(d) Assets expected to be used for more than one period

22. Depreciable amount means;

(a) Cost of an asset + Residual value
(b) Cost of an asset – Residual value
(c) Cost of an asset – Residual value / useful life
(d) Residual value – Cost of an asset

23. A machine price was Rs.1, 000,000 and was carried through a truck. The truck's fares were Rs. 20, 000. The engineers charged Rs. 45,000 for the installation.
The cost of the machine is?

(a) Rs.1,000,000
(b) Rs.1,020,000
(c) Rs.1,045,000
(d) Rs.1,065,000

24. Which of the following is not a component of cost of an asset?

(a) Purchase price
(b) Import duties
(c) Refundable sales tax
(d) Estimated dismantling costs

25. A company purchases land with an office building. The building has a useful life of 20 years. How should the land be depreciated?

(a) Depreciate over 20 years
(b) Depreciate over useful life of the land
(c) Don't depreciate the land
(d) None of these

26. If an asset is idle then?

(a) Depreciation is paused
(b) Depreciation for the entire period
(c) Depreciation is ignored
(d) Depreciation continues

27. Huge Ltd. purchases the machine for Rs.6 million. It has an estimated salvage value of Rs.1 million and a useful life of five years.

What is the depreciation charged for the year under the straight line method?

(a) Rs.1,200,000

(b) Rs.1,000,000

(c) Rs.800,000

(d) None of the above

28. Small Ltd. purchases the equipment for Rs.600,000. It has an estimated salvage value of Rs.100,000 and a useful life of five years.

What is the book value of equipment under the reducing balance method at the end of its useful life?

(a) Rs.163,840

(b) Rs.165,000

(c) Rs.120,000

(d) Rs.100,000

29. Medium Ltd. purchases the car for Rs. 2,200,000. It has an estimated salvage value of Rs. 200,000 and a useful life of five years.

What is the depreciation charge for the first year under the sum-of-the-year digit method?

(a) Rs. 400,000

(b) Rs. 555,555

(c) Rs. 666,667

(d) None of the above

30. A change in depreciation method is a?

(a) Change in accounting policy

(b) Change in accounting estimate

(c) Change in accounting method

(d) Change in accounting standard

31. Which of these cost is capitalised as cost of an asset?

(a) Professional fees

(b) General overheads

(c) Initial operating losses

(d) Administration expenses

32. When an asset is sold or disposed of, where is the gain or loss recognised?

(a) Asset disposal account

(b) Profit and loss

(c) Revaluation reserve

(d) Depreciation

33. What is the net amount an entity expects to obtain for an asset at the end of its useful life?

- **(a)** Residual value
- **(b)** Depreciated value
- **(c)** Present value
- **(d)** Fair value

34. How often should the useful life of an asset be reviewed?

- **(a)** Every six months
- **(b)** As and when the market value will significantly change
- **(c)** At least at each financial year end
- **(d)** Never

35. Which of the following is not allowable as a directly attributable cost of a machine?

- **(a)** Site preparation
- **(b)** Initial testing cost
- **(c)** Carriage inwards for fuel for the machinery
- **(d)** Estimated dismantling cost

5 OBJECTIVE BASED ANSWERS

<table>
<tr><td>01.</td><td>(b) & (d)</td><td>Direct costs relating to the acquisition of the asset can be included such as labour costs, interest on loans to acquire the asset and hire costs. The administration cost is not a direct cost. Also costs relating to errors or wastage cannot be capitalised.</td></tr>
<tr><td>02.</td><td>(a)</td><td>The depreciation is systematic allocation of depreciable amount of an asset over its useful life.</td></tr>
<tr><td>03.</td><td>(d)</td><td>Administration costs or share thereof cannot be capitalised.</td></tr>
<tr><td>04.</td><td>(a) & (b)</td><td>The maintenance costs should be expensed as incurred over three year. The residual value should be taken into account for the purposes of calculating depreciation, but not for the amount to be capitalised.</td></tr>
<tr><td>05.</td><td>(a)</td><td>Six months' depreciation is required on the building structure and air conditioning system.
<table>
<tr><td></td><td>Rs. 000</td></tr>
<tr><td>Land (not depreciated)</td><td>2,000</td></tr>
<tr><td>Building structure (10,000 – (10,000/25 × 6/12))</td><td>9,800</td></tr>
<tr><td>Air conditioning system (4,000 – (3,500/10 × 6/12))</td><td>3,825</td></tr>
<tr><td></td><td>15,625</td></tr>
</table></td></tr>
<tr><td>06.</td><td>(c)</td><td>Plot of land held for resale is inventory and not PPE.</td></tr>
<tr><td>07.</td><td>(d)</td><td>Fair value of asset given up + cash paid
= Rs. 750,000 + 55,000 = Rs. 805,000</td></tr>
<tr><td>08.</td><td>(d)</td><td>
<table>
<tr><td><i>Cost of machinery:</i></td><td>Rs. 000</td></tr>
<tr><td>Cost</td><td>46,000</td></tr>
<tr><td>Cost of delivery</td><td>900</td></tr>
<tr><td>Modification cost</td><td>3,400</td></tr>
<tr><td>Total</td><td>50,300</td></tr>
</table></td></tr>
<tr><td>09.</td><td>(a)</td><td>
<table>
<tr><td><i>Cost of premises:</i></td><td>Rs. 000</td></tr>
<tr><td>Cost</td><td>400,000</td></tr>
<tr><td>Adaptation</td><td>12,000</td></tr>
<tr><td>Legal fees</td><td>2,500</td></tr>
<tr><td>Total</td><td>414,500</td></tr>
</table></td></tr>
<tr><td>10.</td><td>(b)</td><td>
<table>
<tr><td></td><td>Rs. 000</td></tr>
<tr><td>Land</td><td>1,200</td></tr>
<tr><td>Materials</td><td>2,400</td></tr>
<tr><td>Labour</td><td>3,000</td></tr>
<tr><td>Architects fees</td><td>25</td></tr>
<tr><td>Surveyors fees</td><td>15</td></tr>
<tr><td>Site overheads</td><td>300</td></tr>
<tr><td>Testing fire alarms</td><td>10</td></tr>
<tr><td></td><td>6,950</td></tr>
</table></td></tr>
</table>

11.	**(d)**	***Sum of digits = 5 + 4 + 3 + 2 + 1 = 15***	**Rs.**
		Cost of asset	400,000
		Year 1 Depreciation (400,000 – 40,000) x 5/15	(120,000)
		Carrying amount at the end of year 1	280,000
		Year 2 Depreciation (400,000 – 40,000) x 4/15	(96,000)
		Carrying amount at the end of year 2	184,000
12.	**(c)**		**Rs. 000**
		List price of machine	82,000
		Less: trade discount 10%	(8,200)
		Import duty	1,500
		Delivery fees	2,050
		Electrical installation costs	9,500
		Pre-production testing	4,900
			91,750
13.	**(a)**		**Rs. 000**
		Freehold land	4,500
		Architect fees	620
		Site preparation	1,650
		Materials	7,800
		Direct labour costs	11,200
		Legal fees	2,400
			28,170
14.	**(b)**	The additional amount should be capitalised as it is probable that economic benefits would increase.	
15.	**(c)**	Rs. 2,000,000 x $(0.75)^5$ = 474,609	
16.	**Rs. 93.92 million**		**Rs. m**
		Carrying amount at 1 April 2010 (Rs. 312 – 66)	246
		Carrying amount of disposal	(11.2)
		Carrying amount at 31 March 2011	234.8
		Depreciation at 40%	93.92
17.	**Rs. 37,250**		Rs. '000
		Machine ((500,000 – 20,000) / 10 × 9/12)	36,000
		Safety guard ((25,000/5) × 3/12)	1,250
			37,250

<table>
<tr><td>18.</td><td>Rs. 8,000 gain</td><td>
<table>
<tr><td></td><td>Rs.</td></tr>
<tr><td>Sale proceeds on disposal (Cash received)</td><td>68,000</td></tr>
<tr><td>Less: Disposal costs and cash paid</td><td>0</td></tr>
<tr><td>Net disposal proceeds</td><td>68,000</td></tr>
<tr><td>Asset at cost</td><td>96,000</td></tr>
<tr><td>Less: Acc. depreciation 80,000/ 5 years x 2.25</td><td>(36,000)</td></tr>
<tr><td>Carrying amount at date of disposal</td><td>(60,000)</td></tr>
<tr><td><i>GAIN (LOSS) ON DISPOSAL</i></td><td>8,000</td></tr>
</table>
</td></tr>
<tr><td>19.</td><td>Rs. 24,000 gain</td><td>
<table>
<tr><td></td><td>Rs.</td></tr>
<tr><td>Sale proceeds on disposal (Cash received)</td><td>163,000</td></tr>
<tr><td>Less: Disposal costs and cash paid</td><td>(1,000)</td></tr>
<tr><td>Net disposal proceeds</td><td>162,000</td></tr>
<tr><td>Asset at cost</td><td>216,000</td></tr>
<tr><td>Less: Accumulated depreciation W1</td><td>(78,000)</td></tr>
<tr><td>Carrying amount at date of disposal</td><td>138,000</td></tr>
<tr><td><i>GAIN (LOSS) ON DISPOSAL</i></td><td>24,000</td></tr>
</table>
<table>
<tr><td><i>W1</i></td><td>Rs.</td></tr>
<tr><td>Depreciation year 1
(Rs. 216,000 – 24,000) / 8 years = 24,000 x 7/12</td><td>14,000</td></tr>
<tr><td>Depreciation year 2 ➔ Rs. 24,000 x 12/12</td><td>24,000</td></tr>
<tr><td>Depreciation year 3 ➔ Rs. 24,000 x 12/12</td><td>24,000</td></tr>
<tr><td>Depreciation year 4 ➔ Rs. 24,000 x 8/12</td><td>16,000</td></tr>
<tr><td></td><td>78,000</td></tr>
</table>
</td></tr>
<tr><td>20.</td><td>Rs.1,474,675</td><td>654,321 / $(0.85)^5$ = Rs. 1,474,675</td></tr>
<tr><td>21.</td><td>(c)</td><td>Assets held for sale in the normal course of business are inventories.</td></tr>
<tr><td>22.</td><td>(b)</td><td>Depreciable amount = Cost less residual value</td></tr>
<tr><td>23.</td><td>(d)</td><td>Rs. 1,000,000 + 20,000 + 45,000 = Rs. 1,065,000</td></tr>
<tr><td>24.</td><td>(c)</td><td>Refundable sales tax is not a cost as it would be received back.</td></tr>
<tr><td>25.</td><td>(c)</td><td>Land is not depreciated because it has indefinite life.</td></tr>
<tr><td>26.</td><td>(d)</td><td>Depreciation continues even if the asset is not in use.</td></tr>
</table>

27.	**(b)**	(Rs. 6m – 1m) / 5 years = Rs. 1 million
28.	**(d)**	The carrying amount of an asset is equal to its residual value at the end of useful life, under any depreciation method.
29.	**(c)**	(Rs. 2,200,000 – 200,000) x 5/15 = Rs. 666,667
30.	**(b)**	Change in depreciation method is change in accounting estimate.
31.	**(a)**	Professional fees are directly attributable expenditure. Other items are not.
32.	**(b)**	Gain or loss is recognised in profit or loss
33.	**(a)**	Residual value is amount expected at the end of useful life.
34.	**(c)**	Useful life is reviewed annually at each financial year end, at least.
35.	**(c)**	Carriage inwards for fuel for the machinery are revenue expenditure.

CHAPTER 11

Inventory

Contents

1 SCOPE AND EXPLANATION

Section overview

- Introduction
- Scope
- Definitions
- Explanation of defined terms
- Explain the situation when the cost of inventories may not be recoverable

1.1 Introduction

There are generally three reasons companies maintain inventories:

1. Meeting variation in production demand;
2. Economies of scale in procurement;
3. Guarding against price increases and stock outs

Inventory is a key component of calculating cost of goods sold (COGS) and is a key driver of profit and current assets. Because changes in materials prices affect the value of a company's inventory, it is important to understand how a company accounts for its inventory. Common inventory accounting methods include first in, first out (FIFO) and Weighted Average method.

Given the significant costs and benefits associated with inventory, companies spend considerable amounts of time calculating what the optimal level of inventory should be at any given time and changes in inventory levels can send mixed messages to investors.

Increases in inventory may signal that a company is not selling effectively, is anticipating increased sales in the near future or has an inefficient purchasing department. On the other hand, declining inventories may signal that the company is selling more than it expected, is experiencing a blockage in its supply chain, is expecting lower sales or is becoming more efficient in its purchasing activity.

1.2 Scope

It applies to all inventories except:

❑ work in progress on construction and service contracts (IFRS 15);

❑ financial instruments (IAS 32 and IFRS 9); and

❑ biological assets arising from agricultural activity (IAS 41).

1.3 Definitions

i. **Inventories** are assets that are:

❑ held for sale in the ordinary course of business;

❑ in the process of production for such sale; or

❑ in the form of materials or supplies to be consumed in the production process or in the rendering of services.

ii. **Net realisable value (NRV)** is the estimated selling price less the estimated costs of completion and the estimated costs necessary to make the sale.

iii. **Cost of inventories** is;

a) all costs incurred in bringing the inventories to their present location and condition excluding abnormal waste, storage costs, administrative overheads unrelated to production, selling costs, foreign exchange differences and interest cost when inventories are purchased with deferred settlement terms.

b) Costs of purchase of inventories comprise the purchase price (less trade discounts, rebates, duty drawbacks and similar items), irrecoverable taxes, freight inwards, handling and other costs directly attributable to their acquisition.

c) Costs of conversion in finished goods include costs directly related to the units of production, such as direct labour and systematically allocated fixed and variable production overheads incurred in producing finished goods.

iv. **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

1.4 Explanation of defined terms

a) Inventories are

i. held for sale in the ordinary course of business

Inventories are those assets (finished goods) of an entity which are sold in the normal course of business normally within one year from the balance sheet date. Assets which are held for sale but are not traded in the normal course of business cannot be classified as inventories.

ii. in the process of production for such sale;

The goods which have undergone some production process but are not in the intended selling condition are termed as work in process. Work in process is also part of the inventories.

iii. in the form of materials or supplies to be consumed in the production process or in the rendering of services (i-e raw material). The raw materials used for the production of goods are also classified as inventories.

Note

Goods that are in transit where risk and rewards is transferred to the buyer are also categorised as inventory (either finished goods or raw material)

b) Net realisable value (NRV)

Net realizable value is the expected selling price in the ordinary course of business minus any costs of completion, disposal and transportation.

To illustrate, let's assume that a company's cost of its inventory is Rs.55,000. However, at the end of the accounting year the inventory can be sold for only Rs.50,000 provided that the company spends an additional Rs.5,000 in packaging and shipping expense. Hence, the inventory's net realizable value is Rs.45,000 (50,000 - 5,000).

When the net realizable value of a company's inventory is less than its cost, the company's balance sheet should report the net realizable value. In our example, the inventory will be reported at Rs.45,000 and the income statement will report a Rs.5,000 loss on the write down of inventory.

Example:

Sage Pvt. Ltd (SPL) manufactures and sells 1300 CC. Motor Cars to its customers for Rs.1,500,000 per car. The stock of cars was included in the closing inventory as of 31 December 2019 at a cost of Rs.1,000,000 per car. The competitor launched the new 1300 CC hybrid cars on 31 December 2019 for Rs.1,800,000 per car.

During the final audit the auditors noted that the subsequent selling price for the Cars at 15th January 2020 was Rs.1,400,000 per car. Furthermore, inquiry reveals that during the physical stock take, a car is damaged. Accordingly, SPL in the following week, spent a total of Rs.500,000 for repairing.

Required:

Compute the amount of:

a) Net realizable value of the damaged cars

b) inventory write-down (loss) to the cars

Solution

a) Net realisable value = [Rs.1,400,000 (selling price) – Rs.500,000 (repair)]
= Rs.900,000

b) Inventory write-down = [Rs.1,000,000 (carrying amount) – Rs.900,000 (NRV)]
= Rs.100,000

Points to consider

- Sales tax on purchases (input tax) is eventually recovered from tax authorities in the form of adjustment to output tax, therefore it must not form part of the inventory cost.
- Storage costs of raw materials requiring further processing may be included in the cost of inventory. However, storage cost of finished goods is not included in the cost of inventory as it does not contribute to bringing the inventory to its present location and condition.
- Cost model should be used for inventory having similar nature and use to the entity. Difference in geographical location is not sufficient to justify using a different cost model.
- Fixed production overheads should be allocated to items of inventory on the basis of normal production capacity.
- Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost.
- The basic requirement for counting an item in inventory is economic control rather than physical possession (substance over form). Therefore, when a company purchases inventory, the item is included in the inventory even if the purchaser does not have physical possession of those items.

To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads.

Illustration:

Brad Shaw & Co. imports raw materials from China worth Rs.1 million. They paid Rs.80,000 as import duties and Rs.20,000 as import taxes (the import taxes were subsequently refunded by the local government). They paid Rs.50,000 for transportation of the materials from China and another Rs.10,000 as port handling charges for loading the materials at China.

Marketing expenses were Rs.10,000 and the general administrative overheads amounted to Rs.5,000. What will be the value of inventories as per IAS 2?

Solution	**Rs in thousands**
Materials	1,000
Non-refundable import duties	80
Transportation	50
Handling	10
Total	1,140

Marketing and selling costs, general overheads and refundable taxes are not permitted as a cost of inventory.

<u>Cost Formulas</u>

- For non-interchangeable items use Specification identification method
- For inter changeable items use either;
  – FIFO, or
  – Weighted Average Cost method.

Cost Measurement Techniques

1. **Standard Cost Method**

   This method takes into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and if necessary, revised in the light of current conditions.

2. **Retail Method**

   It is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin.

Recognition of Expenses

- **Carrying amount of inventories sold during the period to be shown as Cost of goods sold in the period in which the related revenue is recognised.**
- **Write down to NRV as expense in the period.**

1.5 Explain the situation when the cost of inventories may not be recoverable

The cost of inventories may not be recoverable if those inventories are either;

- damaged,
- wholly or partially obsolete,
- their selling prices have declined
- the estimated costs of completion or
- the estimated costs to be incurred to make the sale have increased.

The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use. Inventories are usually written down to net realisable value item by item.

2 END-OF-YEAR ADJUSTMENTS

Section overview

- Recording inventory
- Periodic inventory method (period-end method): accounting procedures
- Perpetual inventory method: accounting procedures

2.1 Recording inventory

In order to prepare a statement of comprehensive income it is necessary to be able to calculate gross profit. This is done by comparing the sale proceeds from the sale of items of inventory to the cost of those items. This is an application of the accruals concept (matching principle).

In order to calculate gross profit it is necessary to record opening inventory, purchases and closing inventory.

There are two main methods of recording inventory.

- ☐ Periodic inventory method (period end system)
- ☐ Perpetual inventory system

Each method uses a ledger account for inventory but these have different roles.

A question on year-end adjustments for inventories will normally require you to use the periodic inventory method but the perpetual inventory system is examinable in its own right.

2.2 Periodic inventory method (period-end method): accounting procedures

This system is based on the use of two ledger accounts:

- ☐ Purchases account which is used to record all purchases during the year; and
- ☐ Inventory account which is used to record the value of inventory at the beginning/end of the financial year.

Year 1

A business starts on 1 January Year 1. This business has no opening inventory. All inventory purchased in the year to 31 December is recorded in the purchases account.

Illustration: Purchases through the year

	Debit	Credit
Purchases	X	
Cash or liabilities		X

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year. This is transferred to cost of sales clearing the purchases account to zero.

Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales	X	
Purchases		X

At the end of the year cost of sales must be calculated. Purchases are not the same as cost of sales because the company still holds some of the items that it purchased.

The number of items of inventory still held is established through an inventory count. This involves the staff of the business counting every item of inventory and making a record of this. The inventory is then valued (usually at cost). This figure is the closing inventory.

It is recognised as an asset on the statement of financial position and as a credit entry on the statement of comprehensive income (where it reduces the cost of sales expense).

Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of comprehensive income)		X

The exact location of the credit entry might be to one of several accounts but ultimately it always achieves the same purpose, that is, to set reduce cost of sales. Thus it might be a credit to a statement of comprehensive income inventory account (which is later transferred to a cost of sales account or it might be a credit to the cost of sales account.

At the end of year 1 the purchases and the credit entry for closing inventory form part of the profit for the period. The debit entry for closing inventory is carried down into year 2 as an asset.

Year 2

The closing inventory in year 1 becomes the opening inventory in year 2

All inventory purchased in the year to 31 December Year 2 is recorded in the purchases account.

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year. Another of the balances is the opening inventory which has been there since the start of the year.

The purchases together with the opening inventory are what the business could have sold in the period. These are both transferred to the cost of sales.

Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales	X	
Purchases		X
Cost of sales	X	
Inventory (statement of financial position)		X

Note that this is the transfer of the opening inventory to cost of sales)

At the end of the financial year, the closing inventory is physically counted and valued. The closing inventory double entry is then processed.

Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of comprehensive income)		X

In summary

Opening inventory in the trial balance (a debit balance) and purchases (a debit balance) are both transferred to cost of sales.

This clears both accounts.

Closing inventory is recognised in the inventory account as an asset (a debit balance) and the other side of the entry is a credit to cost of sales.

Cost of sales comprises purchase in the period adjusted for movements in inventory level from the start to the end of the period.

Illustration: Cost of sales

	Year 1	Year 2
	Rs.	Rs.
Opening inventory (a debit)	–	X
Purchases (a debit)	X	X
	X	X
Closing inventory (a credit)	(X)	(X)
Cost of sales	X	X

Example:

Faisalabad Trading had opening inventory of Rs. 10,000.

Purchases during the year were Rs. 30,000.

Closing inventory at the end of Year was Rs. 12,000.

At the year end the following entries are necessary

Purchases account

	Rs.		Rs.
Balance b/d	30,000	**(1)** Cost of sales	30,000

Inventory account

	Rs.		Rs.
Balance b/d	10,000	**(2)** Cost of sales	10,000
		Removal of opening inventory	
(3) Cost of sales	12,000		
Recognition of closing inventory		Closing balance c/d	12,000
	22,000		22,000
Opening balance b/d	12,000		

Cost of sales

	Rs.		Rs.
(1) Purchases	30,000		
(2) Opening inventory	10,000		
		(3) Closing inventory	12,000
		Cost of sales c/f	28,000
	40,000		40,000
Cost of sales b/f	28,000		

The cost of sales total is then transferred to the statement of comprehensive income.

The cost of sales is part of the statement of comprehensive income and can be presented as follows:

	Rs.	Rs.
Sales		X
Opening inventory	10,000	
Purchases	30,000	
	40,000	
Closing inventory	(12,000)	
Cost of sales		(28,000)
Gross profit		X

Remember the following:

- In a period-end system of accounting for inventory, the double entries are between the inventory account and the statement of comprehensive income.
- The cost of opening inventory is included in the cost of sales. It is an expense, and expenses are a debit entry. So debit the statement of comprehensive income (and credit the inventory account) with the cost of the opening inventory.
- The cost of closing inventory is included in the statement of financial position as an asset, so there must be a debit balance for the closing inventory. So debit Inventory (and credit Statement of comprehensive income) with the valuation of the closing inventory.

Illustration: **1**

	Debit	Credit
	Rs. 000	Rs. 000
Salaries	10,500	
Drawings	3,000	
Lighting and heating	500	
Sales		30,000
Trade receivables	10,000	
Rent	2,000	
Office expenses	1,000	
Capital at 1 July 2012		27,500
Purchases	14,000	
Inventory at 1 July 2012	2,000	
Trade payables		4,000
Property, plant and machinery	17,500	
Cash	1,000	
	61,500	61,500

2.3 Perpetual inventory method: accounting procedures

A single account is used to record all inventory movements. The account is used to record purchases in the period and inventory is brought down on the account at each year-end. The account is also used to record all issues out of inventory. These issues constitute the cost of sales.

When the perpetual inventory method is used, a record is kept of all receipts of items into inventory (at cost) and all issues of inventory to cost of sales.

Each issue of inventory is given a cost, and the cost of the items issued is either the actual cost of the inventory (if it is practicable to establish the actual cost) or a cost obtained using a valuation method.

Each receipt and issue of inventory is recorded in the inventory account. This means that a purchases account becomes unnecessary, because all purchases are recorded in the inventory account.

All transactions involving the receipt or issue of inventory must be recorded, and at any time, the balance on the inventory account should be the value of inventory currently held.

Example:

Faisalabad Trading had opening inventory of Rs. 10,000.

Purchases during the year were Rs. 30,000.

Closing inventory at the end of Year 2 was Rs. 12,000.

The following entries are necessary during the period.

Inventory account

	Rs.		Rs.
Balance b/d	10,000	Cost of sales	28,000
Cash or creditors (purchases in the year)	30,000		
		Closing balance c/d	12,000
	40,000		40,000
Opening balance b/d	12,000		

Furthermore, all transactions involving any kind of adjustment to the cost of inventory must be recorded in the inventory account.

Example:

Gujrat Retail (GR) had opening inventory of Rs. 100,000.

Purchases during the year were Rs. 500,000. Inventory with a cost of Rs. 18,000 was returned to a supplier. One of the purchases in the above amount was subject to an express delivery fee which cost the company an extra Rs. 15,000 in addition to the above amount.

GR sold goods during the year which had cost Rs. 520,000. Goods which had cost Rs. 20,000 were returned to the company.

Just before the year end goods which had cost Rs. 5,000 were found to have been damaged whilst being handled by GR's staff.

The following entries are necessary during the period.

Inventory account

	Rs.		Rs.
Balance b/d	100,000		
Cash or creditors (purchases in the year)	500,000	Returns to supplier	18,000
Special freight charge	15,000		
Returns from customers	20,000	Cost of sales	500,000
		Normal loss	5,000
		Closing balance c/d	112,000
	635,000		635,000
Opening balance b/d	112,000		

3 OTHER ISSUES

Section overview

- Valuation of inventory
- Cost formulas

3.1 Valuation of inventory

Basic rule

The valuation of inventory can be extremely important for financial reporting, because the valuations affect both the cost of sales (and profit) and also total asset values in the statement of financial position. Inventory must be measured in the financial statements at the **lower** of:

- ☐ cost, or
- ☐ net realisable value (NRV).

Net realisable value is the amount that can be obtained from disposing of the inventory in the normal course of business, less any further costs that will be incurred in getting it ready for sale or disposal. This is simply the expected revenue from the sale of inventory after deducting any further costs that are necessary in order to sell the inventory. For example, if a company has raw material costing Rs.50 million, which will be sold as finished products for Rs.80 million after additional Rs.10 million of labour costs are incurred for completion, its NRV will be Rs.70 million (Rs.80 million – Rs.10 million).

Net realisable value is usually higher than cost. Inventory is therefore usually valued at cost. However, when inventory loses value, perhaps because it has been damaged or is now obsolete, net realisable value will be lower than cost.

The cost and net realisable value should be compared for each separately-identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Example:

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Rs.		
	Cost	**Sales price**	**Selling costs**
Inventory item A1	**8,000**	**7,800**	**500**
Inventory item A2	**14,000**	**18,000**	**200**
Inventory item B1	**16,000**	**17,000**	**200**
Inventory item C1	**6,000**	**7,500**	**150**

The value of closing inventory in the financial statements:

	Lower of:	**Rs.**
A1	**8,000 or (7,800 – 500)**	**7,300**
A2	**14,000 or (18,000 – 200)**	**14,000**
B1	**16,000 or (17,800 – 500)**	**16,000**
C1	**6,000 or (7,000 – 200)**	**6,000**
Inventory valuation		**43,300**

Example:

At 31 December 2013 Ales had the following items of inventory:

Product	Quantity	Total cost	Realisable value	Estimated cost of realisation
		Rs.	Rs.	Rs.
ABC	20	80	200	20
DEF	10	150	120	10
GHI	6	6	7	2
JKL	12	36	12	1

The value of inventory as it would appear in the statement of financial position of ales at 31 December 2013 shall be as follows:

All items must be valued at the lower of cost or net realisable value (NRV).

	Rs.
ABC (at cost)	80
DEF (at NRV)	110
GHI (at NRV)	5
JKL (at NRV)	11
Statement of financial position value at 31 December 2013	206

Example: HM

HM has following products in hand as at 31st December 2001, the relevant information is as follows:

Product	Cost	Estimated Selling Price (ESP)	Estimated Selling cost (ESC)	Estimated Cost to complete sale (ECCS)	Ratio of Credit sales based on past experience	Recovery cost	Bad debt expense
A	100,000	20% Markup	5% of ESP	15% of Cost	60%	1% of cost	5%
B	270,000	15% margin	3% of ESP	7% of Cost	40%	1% of cost	3%
C	830,000	25% Markup	6% of ESP	20% of Cost	20%	1% of cost	2%
D	690,000	30% Markup	8% of ESP	22% of Cost	0%	0%	0%
E	500,000	50% margin	10% of ESP	2% of Cost	100%	2% of cost	10%

Based on above information, the value of inventories to be shown in financial statements and NRV loss to be booked, if any, shall be calculated as follows:

		Net Realizable value					
Product	**Cost**	**Estimated Selling Price (ESP)**	**Estimated Selling cost (ESC)**	**Estimated Cost to complete sale (ECCS)**	**Net Realizable Value**	**Value to be shown in Financial Statements**	**NRV Loss**
A	100,000	120,000	6,000	15,000	99,000	99,000	1,000
B	270,000	317,647	9,529	18,900	289,218	270,000	-
C	830,000	1,037,500	62,250	166,000	809,250	809,250	20,750
D	690,000	897,000	71,760	151,800	673,440	673,440	16,560
E	500,000	1,000,000	100,000	10,000	890,000	500,000	-
			Total			2,351,690	38,310

Example: Chintu Co.

Chintu Co. deals in two products namely product A and Product, the details related to each product is as follows:

Product A

At 31 December 2001, Chintu Co. had 100,000 units with a carrying amount Rs.400 000 of this, 20 000 units had been set-aside for XYZ Limited in terms of a firm sales commitment at Rs.6 per unit. The current selling price per unit is Rs.4.50. Selling costs for the 20 000 unit is only Rs.1 000 whereas the normal estimated selling costs are Rs.1 per unit.

Product B

Product B has been placed in a warehouse with little infra structure, the factory manager informed the management on 15 January 2002 that the entire warehouse and all the inventory contained therein, with a carrying amount of Rs.900,000 – had been destroyed in a series of storms. The first storm hit the warehouse on 29 December 2001 destroying 70% of the inventory. He explained that the remaining inventory was quickly moved to higher ground but flood waters from a second storm on 5 January 2002 destroyed this too. He estimates that the entire inventory will be saleable as scrap for Rs.100,000. Costs to sell the entire inventory as scrap is estimated at Rs.1,000. The normal sales value for the entire inventory would have been Rs.1,500,000 and the selling costs would have been 10% thereof.

Net realizable value as at 31st December 2001 shall be calculated as follows:

Product A

	ESP	20 000 x Rs.6 + 80 000 x Rs.4.	440,000
less	ESC	1000+80000*1	(81,000)
	ECCS		-
			359,000

Product B			
	ESP	Rs.100 000 x 70% + Rs.1 500 000 x 30%	520,000
less	ESC	Rs.1 000 x 70% + 1 500 000 x 10% x 30%	(45,700)
	ECCS		-
			474,300
	Total Value to be shown in FS		833,300

Example: Kidz Party & Co.

Kidz Party & Co. (KPC) manufactures and sells toys. Following information is available regarding four of its inventory items as on 31 December 2017:

Items	Units	Cost per unit (Rs)	Normal selling price per unit (Rs)
Toy cars	10,000	1,250	1,200
Doll houses	5,000	1,800	2,700
Stuffed toys	1,850	1,200	1,900
Minion costumes	870	1,500	2,500

Following information is also available:

(i) A sales order for 3,000 toy cars @ Rs. 1,100 per unit is in hand. The remaining units can be sold at normal selling price after incurring selling cost of Rs. 150 per unit.

(ii) Doll houses include 1,000 defective units with no scrap value. 20% of the remaining doll houses are damaged and can be sold at 50% of cost.

(iii) Stuffed toys costing Rs. 420,000 were accidentally damaged and are beyond repair. KPC plans to sell these toys as scrap. Proceeds from such sale are estimated at Rs. 175,000 and the sale would require transportation cost of Rs. 6,300.

(iv) All minion costumes have manufacturing faults and can be sold in present condition at Rs. 1,350 per unit. However, 60% of the units can be rectified at a cost of Rs. 200 per unit after which they can be sold at Rs. 1,600 per unit.

The amount at which above inventory items should be carried as on 31 December 2017 in accordance with IAS 2 'Inventories' shall be calculated as follows:

Inventory valuation as on 31 December 2017

	Units	Cost per unit	Normal selling price per unit	Cost to sell per unit	NRV per unit	Inventory valuation at lower of cost and NRV	
	1	2	3	4	5=(3-4)	6	
	Rupees						
Toy cars	7,000	1,250	1,200	150	1,050	NRV	7,350,000
	3,000	1,250	1,100	-	1,100	NRV	3,300,000
	10,000						10,650,000

	Units	Cost per unit	Normal selling price per unit	Cost to sell per unit	NRV per unit	Inventory valuation at lower of cost and NRV	
	1	2	3	4	5=(3-4)	6	
	Rupees						
Doll houses	1,000	1,800	-		-	NRV	-
	800 (5,000-1,000)×20%	1,800	900 (1,800×50%)	-	900	NRV	720,000
	3,200	1,800	2,700	-	2,700	Cost	5,760,000
	5,000						6,480,000
Stuffed toys	350 (420,000÷1,200)	1,200	500 (175,000÷350)	18 (6,300÷350)	482	NRV	168,700
	1,500	1,200	1,900	-	1,900	Cost	1,800,000
	1,850						1,968,700
Minion costumes	522 (870×60%)	1,500	1,600	200	1,400	NRV	730,800
	348	1,500	1,350	-	1,350	NRV	469,800
	870						1,200,600
							20,299,300

Example: M/S Lasani Associates

M/S Lasani Associates have provided you with the following working papers regarding inventory on hand at 31 December 2002. The entity is a manufacturer of two product lines: Air coolers and Fans

	cost	NRV	Write Down
	Rs.	Rs.	
Raw Materials	200,000	150,000	50,000
-air cooler parts	80,000	50,000	-
-Fans parts	120,000	100,000	-
	-	-	-
Work In progress	160,000	170,000	-
-air cooler parts	60,000	50,000	-
-Fans parts	100,000	120,000	-
	-	-	-
Finished goods	320,000	330,000	-
-air cooler parts	160,000	110,000	-
-Fans parts	160,000	220,000	-
	-	-	-
	680,000	650,000	50,000

Due to the strengthening of the local currency, the parts used in the manufacture of both the aircoolers and fans became cheaper. As a direct result thereof, the net realisable value of both the finished aircoolers and fans also dropped.

Whether an analysis of the write down has been calculated correctly has been presented below.

The calculation of possible write-downs of inventory must not be done based on the classifications (raw materials, work-in-progress and finished goods) but should be assessed on an item-by-item basis.

Although both items of raw materials have net realisable values that are lower than cost, raw materials should not be written-down unless the reason for the drop in the NRV of the raw materials has also resulted in the NRV of the related finished product also dropping.

Since the NRV of the finished aircoolers has dropped below cost, aircoolers (raw materials) should be written-down to their net realisable value (the NRV in this case is usually the net replacement cost).

Despite the NRV of the finished fans having dropped, the NRV of the fans has not dropped below cost. The fans (raw materials) should therefore not be written-down.

Calculation of write down

	Cost	**NRV**	**NRV Loss**
	Rs.	**Rs.**	**Rs.**
Aircoolers			
Raw Materials	80,000	50,000	30,000
WIP	60,000	50,000	10,000
Finished goods	160,000	110,000	50,000
Fans			
Raw Materials	120,000	100,000	-
WIP	100,000	120,000	-
Finished goods	160,000	220,000	-
			90,000

Example: Cheesecake Limited

Part (a):

Goods purchased to be resold, cost of Rs.10,000 have been damaged. At the balance sheet date their replacement buying price is Rs.9,000. They can be sold in the normal course of business for Rs.14000, provided Rs.4500 is spent on rectifying the damage.

The stock should be valued as follows:

Part (a):

Cost	10,000
NRV	
Est.SP	14000
Est.SC	-4500
	9500
Value to be reported in FS	9500
NRV Loss	500

Part (b):

Cheesecake Limited produces cheese cakes for the local market. At its financial year ended 30 September 2005, it had raw materials of Rs. 320,000 on hand. It is expected that the cost to convert the raw materials into finished cheese cakes is Rs.80,000.

The net realisable value of the raw materials, assuming that, once converted into the finished cheese cakes, the total inventory of cheese cakes would have a, sales value of Rs. 480,000, where related selling costs would be Rs. 40,000 shall be as follows:

Part b (i):

	cost	**NRV**	**Value**
RM	320,000	300,000	320,000
Finished Goods (320000+80000)	400,000	440,000	400,000
		(480,000-40,000)	720,000

The net realisable value of the raw materials, assuming that, once converted into the finished cheese cakes, the total inventory of cheese cakes would have a, sales value of Rs. 400,000, where related selling costs would be Rs. 40,000 shall be as follows:

Part b (ii):

	cost	**NRV**	**Value**	**NRV Loss**
RM	320,000	300,000	300,000	20,000
Finished Goods (320000+80000)	400,000	360,000	360,000	40,000
	720,000	(400,000-40,000)	660,000	60,000

Entry to be made:

NRV loss	**60,000**
Inventory-RM	**20,000**
Inventory-FG	**40,000**

Example: Marfani & CO

Marfani&Co. has purchased goods costing Rs.100,000 at the start of 2001,however the goods remain unsold for 5 years and the estimated selling prices and cost of realization were as follows as at each year end:

	ESP	**ECR**
01-Jan-01	220,000	20,000
31-Dec-01	135,000	15,000
31-Dec-02	100,000	10,000
31-Dec-03	90,000	15,000
31-Dec-04	110,000	15,000
31-Dec-05	120,000	10,000

As at each year end, the value at which inventory should be reported in the financial statements of Marfani&Co. and NRV loss/reversal of any write down for each accounting year shall be as follows:

		Net Realizable Value				
	Cost	**ESP**	**ECR**	**NRV**	**Value to be shown in Financial Statements**	**NRV (Loss)/Reversal**
01-Jan-01	100,000	220,000	20,000	200,000	100,000	-
31-Dec-01	100,000	135,000	15,000	120,000	100,000	-
31-Dec-02	100,000	100,000	10,000	90,000	90,000	(10,000)
31-Dec-03	100,000	90,000	15,000	75,000	75,000	(15,000)
31-Dec-04	100,000	110,000	15,000	95,000	95,000	20,000
31-Dec-05	100,000	120,000	10,000	110,000	100,000	5,000

3.2 Cost formulas

With some inventory items, particularly large and expensive items, it might be possible to recognise the actual cost of each item.

In practice, however, this is unusual because the task of identifying the actual cost for all inventory items is impossible because of the large numbers of such items.

A system is therefore needed for measuring the cost of inventory.

The historical cost of inventory is usually measured by one of the following methods:

- First in, first out (FIFO)
- Weighted average cost (AVCO)

First-in, first-out method of measurement (FIFO)

With the first-in, first-out method of inventory measurement, it is assumed that inventory is consumed or sold in the strict order in which it was purchased or manufactured. The first items that are received into inventory are the first items that go out.

To establish the cost of inventory using FIFO, it is necessary to keep a record of:

- the date that units of inventory are received into inventory, the number of units received and their purchase price (or manufacturing cost)
- the date that units are issued from inventory and the number of units issued.

With this information, it is possible to put a cost to the inventory that is issued (sold or used) and to identify the cost of the items still remaining in inventory.

Since it is assumed that the first items received into inventory are the first units that are used, it follows that the value of inventory at any time should be the cost of the most recently-acquired units of inventory.

Example: Zippo Limited

Zippo Limited is in the business of buying and selling a specific type of machine. During the year, the Company bought four machines costing Rs.120,000, Rs.140,000, Rs.130,000 and Rs.100,000 respectively.

During the year, it sold only one machine for Rs.140,000 and follows the FIFO method of valuation.

The cost of inventory and cost of sales shall be the determined as follows:

As Zippo Limited uses the First On, First Out (FIFO) method of inventory valuation, the first machine, costing Rs.120,000 is the machine sold. Therefore, cost of sales is Rs.120,000. The remaining machines are valued using FIFO as Rs.140,000, Rs.130,000 and Rs.100,000 which is Rs.370,000.

Example

On 1 January a company had an opening inventory of 100 units which cost Rs.50 each.

During the month it made the following purchases:

5 April: 300 units at Rs. 60 each

14 July: 500 units at Rs. 70 each

22 October: 200 units at Rs. 80 each.

During the period it sold 800 units as follows:

9 May: 200 units

25 July: 200 units

23 November: 200 units

12 December: 200 units

This means that it has 300 units left (100 + 300 + 500 + 200 – (200 + 200 + 200 + 200 + 200)) but what did they cost?

There are various techniques that have been developed to answer this question.

The easiest of these is called FIFO (first in first out). This approach assumes that the first inventory sold is always the inventory that was bought on the earliest date. This means closing inventory is always assumed to be the most recent purchased.

In the above example a FIFO valuation would assume that the 300 items left were made up of the 200 bought on 22 October and 100 of those bought on 14 July giving a cost of Rs. 23,000 {(200 @ 80) + (100 @ 70)}

This can be shown on an inventory ledger card as follows.

Example: Inventory ledger card (FIFO)

	Receipts			Issues			Balance		
Date	**Qty**	**@**	**Rs.**	**Qty**	**@**	**Rs.**	**Qty**	**@**	**Rs.**
1 Jan b/f	100	50	5,000				100	50	5,000
5 Apr	300	60	18,000				300	60	18,000
							400	50/60	23,000
9 May				100	50	5,000	100	50	5,000
				100	60	6,000	100	60	6,000
				200	50/60	11,000	(200)	50/60	(11,000)
							200	60	12,000
14 Jul	500	70	35,000				500	70	35,000
							700	60/70	47,000
25 Jul				200	60	12,000	(200)	60	(12,000)
							500	70	35,000
22 Oct	200	80	16,000				200	80	16,000
							700	70/80	51,000
23 Nov				200	70	14,000	(200)	70	(14,000)
							500	70/80	37,000
12 Dec				200	70	14,000	(200)	70	(14,000)
	1,100		74,000	800		51,000	300	70/80	23,000

Note: 1,100 minus 800 equals 300

74,000 minus 51,000 equals 23,000

Weighted average cost (AVCO) method

With the weighted average cost (AVCO) method of inventory measurement it is assumed that all units are issued at the current weighted average cost per unit.

A new average cost is calculated whenever more items are purchased and received into store.

The weighted average cost is calculated as follows:

Formula: Calculation of new weighted average after each purchase

$$\text{weighted average rate} = \frac{Cost\ of\ inventory\ currently\ in\ store + Cost\ of\ new\ items\ received}{Number\ of\ units\ currently\ in\ store + Number\ of\ new\ units\ received}$$

Continuing with previous illustration:

$$\text{Weighted average rate} = \frac{(100x50)+(300x60)+(500x70)+(200x80)}{100+300+500+200} = 67.27$$

300 items were left of 67.27 each having total amount of Rs 20,182.

This can be shown on inventory ledger card as follows:

Example: Inventory ledger card (weighted average method)

	Receipts			Issues			Balance		
Date	**Qty**	**@**	**Rs.**	**Qty**	**@**	**Rs.**	**Qty**	**@**	**Rs.**
1 Jan b/f	100	50	5,000				100	50	5,000
5 Apr	300	60	18,000				300	60	18,000
							400	57.5	23,000
9 May				200	57.5	11,500	(200)	57.5	(11,500)
							200	57.5	11,500
14 Jul	500	70	35,000				500	70	35,000
							700	66.43	46,500
25 Jul				200	66.43	13,286	(200)	66.43	(13,286)
							500	66.43	33,214
22 Oct	200	80	16,000				200	80	16,000
							700	70.31	49,214
23 Nov				200	70.31	14,062	(200)	70.31	(14,062)
							500	70.31	35,152
12 Dec				200	70.31	14,062	(200)	70.31	(14,062)
	1,100		74,000	800		52,910	300	70.31	21,090

Note: 1,100 minus 800 equals 300

74,000 minus 52,910 equals 21,090

Example: Daska Retail

On 1 January 2014, a company held 300 units of an item of finished goods inventory. These were valued at Rs. 22 each. During January 2014 three batches of finished goods were received into store from the production department, as follows:

Date	Units	Production cost per unit
	Received	Rupees
10-Jan	400	Rs. 23
20-Jan	400	Rs. 25
25-Jan	400	Rs. 26

Goods sold out of the inventory during January 2014 were as follows:

Date	Units sold	Sale price per unit
		Rupees
14-Jan	500	Rs. 31
21-Jan	500	Rs. 33
28-Jan	100	Rs. 32

The cost of sales and inventory at 31 January 2014, shall be calculated under FIFO and Weighted Average Cost basis of inventory valuation as follows:

FIFO

Date	Cost of sales - issue			Cost of sales	Closing inventory
	Units	Unit cost	Total		
		Rupees			
14-Jan	300	22	6,600		
	200	23	4,600	11,200	
21-Jan	200	23	4,600		
	300	25	7,500	12,100	
28-Jan	100	25	2,500	2,500	
Closing inventory	400	26	10,400		10,400
				25,800	10,400

OR

Particulars	**Units**	**Per unit cost**	**Total**
Opening inventory	300	22	6,600
Purchases	1,200		29,600
Closing inventory (Rate of last purchases)	(400)	26	(10,400)
Cost of sales	1,100		25,800

Weighted average cost

Date	Particulars	Cost of sales - issue			Cost of sales	Closing inventory
		Units	Unit cost	Total		
			Rupees			
1-Jan	Opening inventory	300	22.000	6,600		
10-Jan	Purchases	400	23.000	9,200		
		700	22.571	15,800		
14-Jan	Sales	500	22.571	11,286	11,286	
		200	22.570	4,514		
20-Jan	Purchases	400	25.000	10,000		
	-	600	24.192	14,514		
21-Jan	Sales	500	24.192	12,096	12,096	
		100	24.190	2,418		
25-Jan	Purchases	400	26.000	10,400		
		500	25.638	12,818		
28-Jan	Sales	100	25.638	2,564	2,564	
31-Jan		400	25.638	10,254	25,946	10,255

Example: Quality Products

Quality Products (QP) deals in various goods. Following information pertains to one of its product for the month of January 2016:

Date	Description	Units	Purchase/sale price per unit (Rs.)
6-Jan-2016	Purchase	15,000	150
10-Jan-2016	Sale	(18,000)	210
16-Jan-2016	Purchase	13,000	160
18-Jan-2016	Purchase return	(1,000)	150
25-Jan-2016	Sale	(12,000)	215
28-Jan-2016	Drawing	(2,000)	-
29-Jan-2016	Purchase	10,000	140
31-Jan-2016	Shortage	(800)	-

Opening inventory consisted of 10,000 units costing Rs. 1,480,000. Closing inventory includes 1,200 units found damaged during stock taking. Net realisable values (NRVs) of the damaged and the good units are Rs. 120 and Rs. 200 per unit respectively. QP uses perpetual inventory method to record the inventory.

The value of closing inventory using, Weighted average cost and FIFO basis shall be computed as follows:

Valuation of closing inventory

Closing inventory at lower of cost or NRV, using - Weighted average cost

Date		Received		Issues				Balance		
		Qty.	Rate	Rs.	Qty.	Rate	Rs.	Qty.	Rate	Rs.
1-Jan-16	Balance							10,000	148.00	1,480,000
6-Jan-16	Purchases	15,000	150.00	2,250,000				25,000	149.20	3,730,000
10-Jan-16	Sales				(18,000)	149.20	(2,685,600)	7,000	149.20	1,044,400
16-Jan-16	Purchases	13,000	160.00	2,080,000				20,000	156.22	3,124,400
18-Jan-16	Purchase return	(1,000)	150.00	(150,000)				19,000	156.55	2,974,400
25-Jan-16	Sales				(12,000)	156.55	(1,878,600)	7,000	156.54	1,095,800
28-Jan-16	Drawings				(2,000)	156.54	(313,080)	5,000	156.54	782,720
29-Jan-16	Purchases	10,000	140.00	1,400,000				15,000	145.51	2,182,720
31-Jan-16	Shortages				(800)	145.51	(116,408)	14,200	145.51	2,066,312

		QTY	Cost per unit	NRV per unit	Closing inventory at lower of cost or NRV (Rs.)
Good units	(14,200-1,200)	13,000	145.51	200.00	1,891,630
Damaged units		1,200	145.51	120.00	144,000
		14,200			**2,035,630**

Closing inventory at lower of cost or NRV, using - FIFO

	QTY	Cost per unit	NVR per unit	Closing inventory at lower of cost or NRV (Rs.)
Good units	10,000	140.00	200.00	1,400,000
Good units	3,000	160.00	200.00	480,000
Damaged units	1,200	160.00	120.00	144,000
	14,200			**2,024,000**
	14,200			**2,048,000**

Example: M/S Mola Bakhsh

Following information relates to M/S Mola Bakhsh

Product A

		Units		Rate
01-Jan-16	Opening stock	40 units	@	400
02-Jan-16	Purchases	100units	@	500
03-Jan-16	sales	50units	@	1000
04-Jan-16	sales	10units	@	1500
05-Jan-16	Purchases	200units	@	300
06-Jan-16	Purchases	300units	@	700
07-Jan-16	sales	200units	@	5
08-Jan-16	sales return	100 units	@	5
09-Jan-16	purchases	200units	@	400

10-Jan-16 Purchase return were 100 units of purchases on 9 jan 2016

11-Jan-16 Shortage 10 units

12-Jan-16 Drawings 5 units

At the end of the month the estimated Selling price of the product A was Rs.300 and the cost of realization was Rs.150

The value of closing stock and cost of sales under Perpetual system and Periodic system using FIFO and Weighted average shall be as follows:

Product A

Perpetual System (Weighted Average)

Date	Purchases/Inflows			Cost of Sales/Outflows			Stock balance		
	Unit	Rate	Amount	Unit	Rate	Amount	Unit	Rate	Amount
01-Jan-16							40	400	16,000
02-Jan-16	100	500	50,000				140	471	66,000
03-Jan-16				50	471	23,571	90	471	42,429
04-Jan-16				10	471	4,714	80	471	37,714
05-Jan-16	200	300	60,000				280	349	97,714
06-Jan-16	300	700	210,000				580	531	307,714
07-Jan-16				200	531	106,108	380	531	201,606
08-Jan-16				(100)	531	(53,054)	480	531	254,660
09-Jan-16	200	400	80,000				680	492	334,660
10-Jan-16	(100)	400	(40,000)				580	508	294,660
11-Jan-16				10	508	5,080	570	508	289,580
12-Jan-16				5	508	2,540	565	508	287,040
						88,960			

Valuation of stock

cost	287,040	
NRV	84,750	(300-150)*565
Value	84,750	
NRV loss	202,290	

Perpetual System (FIFO)

Date	Purchases/Inflows			Cost of Sales/Outflows			Stock balance		
	Unit	Rate	Amount	Unit	Rate	Amount	Unit	Rate	Amount
01-Jan-16							40	400	16,000
02-Jan-16	100	500	50,000				100	500	50,000
03-Jan-16				40	400	16,000	90	500	45,000
				10	500	5,000			
04-Jan-16				10	500	5,000	80	500	40,000
05-Jan-16	200	300	60,000				200	300	60,000
06-Jan-16	300	700	210,000				300	700	210,000
07-Jan-16				80	500	40,000	80	300	24,000
				120	300	36,000	300	700	210,000
08-Jan-16				(80)	500	(40,000)	80	500	40,000
				(20)	300	(6,000)	20	300	6,000
							80	300	24,000
							300	700	210,000
09-Jan-16	200	400	80,000				200	400	80,000
10-Jan-16	(100)	400	(40,000)				(100)	400	(40,000)
11-Jan-16				10	400	4,000	70	500	35,000
							100	300	30,000
							300	700	210,000
							100	400	40,000
12-Jan-16				5	500	2,500	65	500	32,500
							100	300	30,000
							300	700	210,000
							100	400	40,000
						62,500	565		312,500

Valuation of stock

cost	312,500	
NRV	84,750	(300-150)*565
Value	84,750	
NRV loss	227,750	

4 JOURNAL ENTRIES

Section overview

- Introduction
- Inventory Purchases
- Return to supplier
- Sale Transaction
- Return from customer
- Lower of Cost or NRV
- Abnormal loss
- Summary of journal entries

4.1 Introduction

There are a number of inventory journal entries that can be used to document inventory transactions. In a modern, computerized inventory tracking system, the system generates most of these transactions. Nonetheless, you may find a need for some of the following entries from time to time, to be created as manual journal entries in the accounting system.

4.2 Inventory Purchased

This is the initial inventory purchase, which is routed through the accounts payable system. Under periodic system, the debit will be to purchase (expense) account. The entry is:

Inventory purchases entry (periodic system)

	Debit	Credit
Purchases (Statement of comprehensive income)	X	
Accounts payable (Statement of financial position)		X

Under perpetual system this is also routed through the accounts payable system. The debit will be to inventory account in the balance sheet. The entry is:

Inventory purchases entry (perpetual system)

	Debit	Credit
Inventory (Statement of financial position)	X	
Accounts payable (Statement of financial position)		X

4.3 Return to supplier

Inventory is returned when it is of low quality or shipment of wrong item or damaged. Therefore, a purchase return occurs when a buyer returns merchandise that it has purchased from a supplier.

Under the periodic inventory system, the cost of the merchandise that was returned is recorded as;

Purchase return entry (periodic system)

	Debit	Credit
Accounts payable (Statement of financial position)	X	
Purchase returns (Statement of comprehensive income)		X

Whereas, under the perpetual inventory system, returns reduce the buyer's debt to the seller (accounts payable) and decrease the cost of the goods purchased (inventory). The double entry would be as follows;

Purchase return entry (perpetual system)

	Debit	Credit
Accounts payable (Statement of financial position)	X	
Inventory (Statement of financial position)		X

4.4 Sale Transaction

When the sale of goods occur, account receivables and sales income both increase. The entry is:

Sales transaction (periodic system)

	Debit	Credit
Accounts receivable (Statement of financial position)	X	
Sales (Statement of comprehensive income)		X

Under perpetual inventory system, in addition to above entry for sale, another entry to charge the cost of sales to the cost of goods sold expense account, thereby transferring the cost of the inventory from the balance sheet (where it was an asset) to the income statement (where it is an expense). The entry is:

Sales transaction (perpetual system)

	Debit	Credit
Cost of goods sold (Statement of comprehensive income)	X	
Inventory (Statement of financial position)		X

There is also a separate entry for the sale transaction, in which you record a sale and an offsetting increase in accounts receivable or cash. A sale transaction should be recognized in the same reporting period as the related cost of goods sold

4.5 Return from customer

Inventory is returned when it is of low quality or shipment of wrong item or damaged item. Therefore, a sale return occurs when a customer returns goods that it has purchased from the company.

Under the periodic inventory system, the amount of the merchandise that was returned is recorded as;

Sales return entry (periodic system)

	Debit	Credit
Sales returns (Statement of comprehensive income)	X	
Accounts receivable (Statement of financial position)		X

Whereas, under the perpetual inventory system, returns reduce the customer's debt to the company (seller) (accounts receivable) and decrease the sales of the goods (sales return). The double entry would be as follows;

Sales return entry 1 (perpetual system)

	Debit	Credit
Sales returns (Statement of comprehensive income)	X	
Accounts receivable (Statement of financial position)		X

The company (seller) also needs to increase its inventory and reduces its corresponding cost of goods sold by passing the following entry;

Sales return entry 2 (perpetual system)

	Debit	Credit
Inventory (Statement of financial position)	X	
Cost of goods sold (Statement of comprehensive income)		X

4.6 Lower of Cost or NRV

If the NRV of any inventory item is lower than its cost then the carrying amount of the inventory item is reduced to its NRV and charge the loss / write down in the period. The associated entry is:

Lower of Cost or NRV (perpetual system)

	Debit	Credit
Write-off of inventory (Statement of comprehensive income)	X	
Inventory (Statement of financial position)		X

There is no need to pass double entry of NRV loss in periodic system as inventory is already recorded at lower of cost and NRV.

4.7 Abnormal loss

If inventory is damaged or lost, it is called abnormal loss. It is recorded as follows under periodic system.

Abnormal loss (periodic system)

	Debit	Credit
Abnormal loss (Statement of comprehensive income)	X	
Purchases (Statement of comprehensive income)		X

Under perpetual system, abnormal loss will credited in inventory as follows:

Abnormal loss (perpetual system)

	Debit	Credit
Abnormal loss (Statement of comprehensive income)	X	
Inventory (Statement of financial position)		X

4. 8 Summary of journal entries

Entry	Periodic inventory method	Perpetual inventory method
Opening inventory	Closing inventory as measured and recognised brought forward from last period	Closing balance on the inventory account as at the end of the previous period
Purchase of inventory	Dr Purchases Cr Payables/cash	Dr Inventory Cr Payables/cash
Freight paid	Dr Carriage inwards Cr Payables/cash	Dr Inventory Cr Payables/cash
Return of inventory to supplier	Dr Payables Cr Purchase returns	Dr Payables Cr Inventory
Sale of inventory	Dr Receivables Cr Sales	Dr Receivables Cr Sales **and** Dr Cost of goods sold Cr Inventory
Return of goods by a customer	Dr Sales returns Cr Receivables	Dr Sales returns Cr Receivables **and** Dr Inventory Cr Cost of goods sold
Normal loss	No double entry	Dr Cost of goods sold Cr Inventory
Abnormal loss	Dr Abnormal loss Cr Purchases	Dr Abnormal loss Cr Inventory
Closing inventory	Counted, valued and recognised by: Dr Inventory (statement of financial position) Cr Cost of sales (cost of goods sold)	Balance on the inventory account

Example: Max Savings

Max Savings sells goods at cost plus 30% and uses perpetual inventory method to record the inventory. The following transactions pertain to August 2017:

04-Aug	Purchased goods on cash for Rs. 568,000.
07-Aug	Sold goods on credit for Rs. 2,418,000.
10-Aug	Returned goods to a supplier costing Rs. 87,000.
13-Aug	Purchased goods on credit for Rs. 2,360,000.
13-Aug	Paid carriage inward of Rs. 48,000.
20-Aug	A customer returned goods which had been invoiced at Rs. 58,500.
24-Aug	Cash sales of Rs. 120,000 net of a special discount of Rs. 10,000.
31-Aug	Physical inventory count revealed that goods having list price of Rs. 26,000 have expired and had to be scrapped.

The journal entries to record the above transactions shall be as follows:

Max Savings

Journal entries to record transactions using perpetual inventory

Date	Description	Debit	Credit
		Rupees	
04-Aug-2017	Inventory	568,000	
	Cash		568,000
	(To record cash purchases)		
07-Aug-2017	Account receivables	2,418,000	
	Sales		2,418,000
	Cost of sales (2,418,000÷1.3)	1,860,000	
	Inventory		1,860,000
	(To record sales and cost of sales)		
10-Aug-2017	Account payables	87,000	
	Inventory		87,000
	(To record goods returned to a supplier)		
13-Aug-2017	Inventory	2,360,000	
	Account payables		2,360,000
	(To record purchase of inventory)		
13-Aug-2017	Inventory	48,000	
	Cash/bank		48,000
	(To record carriage-inward)		

Date	Description	Debit	Credit
		Rupees	
20-Aug-2017	Sales return/Return inward	58,500	
	Account receivables/Cash		58,500
	Inventory (58,500÷1.3)	45,000	
	Cost of sales		45,000
	(To record sales return)		
24-Aug-2017	Cash	120,000	
	Sales		120,000
	Cost of sales (120,000+10,000)÷1.3	100,000	
	Inventory		100,000
	(To record sales and cost of sales)		
31-Aug-2017	Cost of sales (26,000÷1.3)	20,000	
	Inventory		20,000
	(Inventory shortages charged to cost of sales)		

Example: Ogay

Ogay started business on 1 January 2012. At the end of his first year of trading he had closing inventory of Rs.5,000. During 2013 he traded continuously and at 31 December 2013 he had inventory amounting to Rs.7,500.

Sales for 2012 and 2013 were Rs.120,000 and Rs.155,000 respectively and purchases were Rs.75,000 and Rs.110,000 respectively.

a) The inventory account, purchases account and revenue account for the two years shall be as follows:

(a) **Inventory a/c**

2012		Rs.	*2012*		Rs.
31 Dec	Trading a/c	5,000	31 Dec	Balance c/d	5,000
2013			*2013*		
1 Jan	Balance b/d	5,000	31 Dec	Trading a/c	5,000
31 Dec	Trading a/c	7,500	31 Dec	Balance c/d	7,500
		12,500			12,500
2013					
1 Jan	Balance b/d	7,500			

Purchases a/c

2012		Rs.	*2012*		Rs.
	Cash/Payables	75,000	31 Dec	Trading a/c	75,000
2013			*2013*		
	Cash/Payables	110,000	31 Dec	Trading a/c	110,000

Revenue a/c

2012		Rs.	*2012*		Rs.
31 Dec	Trading a/c	120,000		Cash/receivables	120,000
2013			*2013*		
31 Dec	Trading a/c	155,000		Cash/receivables	155,000

b) The trading account for EACH of the two years shall be as follows:

Trading accounts for the year ended

	31 December 2012		***31 December 2013***	
	Rs.	**Rs.**	**Rs.**	**Rs.**
Revenue		120,000		155,000
Opening inventory	–		5,000	
Purchases	75,000		110,000	
	75,000		115,000	
Less: Closing inventory	(5,000)		(7,500)	
Cost of sales		70,000		107,500
		50,000		47,500

Example: Zamir Traders

The following information has been extracted from the books of Zamir Traders (ZT):

PRODUCT: VITA-PLUS			
Date	**Description**	**No. of units**	**Purchase/sales price per unit (Rs.)**
1-Feb-2017	Opening balance	4,500	120
3-Feb-2017	Purchases	2,700	125
8-Feb-2017	Sales	(2,800)	150
15-Feb-2017	Purchase return	(255)	120
18-Feb-2017	Purchases	2,650	130
20-Feb-2017	Drawings	(180)	125
23-Feb-2017	Sales return	300	150
25-Feb-2017	Sales	(3,200)	160
	Closing balance	3,715	

As per physical inventory carried out at month end, 315 units were found short and 400 units were found damaged. Out of damaged units, 300 units can be sold for Rs. 140 per unit after being repaired at a cost of Rs. 20 per unit. Remaining damaged units have no sales value.

ZT uses periodic inventory method and the inventory is valued at lower of cost determined on weighted average basis and net realisable value.

a) The value of closing inventory as would appear in ZT's financial statements for the month ended 28 February 2017 shall be as follows:

Inventory valuation at lower of cost & NRV:

Description		**No. of units**	**Weighted average cost per unit**	**NRV per unit**	**Inventory at lower of cost & NRV**
			Rupees		
Good units (3,715–315–400)		3,000	(W.1) 124.15	160.00	372,450
Inventory shortages		315	124.15	-	-
Damaged units:	having sales value	300	124.15	(140-20) 120.00	36,000
	having no sales value	100	124.15	-	-
		3,715			**408,450**

W-1: Weighted average cost per unit - Periodic inventory

Date	Description	No. of units	Cost per unit Rupees	Rupees
1-Feb-2017	Opening balance	4,500	120.00	540,000
3-Feb-2017	Purchases	2,700	125.00	337,500
15-Feb-2017	Purchase return	(255)	120.00	(30,600)
18-Feb-2017	Purchases	2,650	130.00	344,500
20-Feb-2017	Drawings	(180)	125.00	(22,500)
		9,415		**1,168,900**
Weighted average cost per unit			(1,168,900/9,415)	**124.15**

b) Necessary closing entries for the month of February 2017 shall be as follows:

Closing entries:

Date	Description		Debit	Credit
			—— Rupees ——	
28-Feb-2017	Closing inventory	**As above**	408,450	
	Purchase return		30,600	
	Sales	(2,800×150)+(3,200×160)	932,000	
	Opening inventory	(4,500×120)		540,000
	Purchases	(337,500+344,500–22,500)		659,500
	Sales return	(300×150)		45,000
	Statement of comprehensive income	**(Balancing)**		126,550

Example: Chenab Enterprises

Following balances have been extracted from trial balance of Chenab Enterprises (CE) for the year ended 30 June 2016:

	Rs. in ‘000
Opening inventory	15,000
Purchases	250,000
Sales	380,000

Other information:

i. A physical count of inventory for the year ended 30 June 2016 was carried out on 10 July 2016 and the cost of inventory was determined at Rs. 18,000,000. During physical count it was also noted that:

- no entry has been made in respect of goods costing Rs. 500,000 which were issued in June 2016 to the proprietor; and
- inventory includes damaged goods costing Rs. 350,000 which have no sales value.
- It was determined that damage had occurred prior to 1 July 2016.

ii. During the intervening period 1 July to 10 July 2016, following transactions took place:

	Rs. in '000
Sales (at cost plus 25%)	12,000
Goods returned by customers	800
Purchases	7,000

iii. CE uses periodic inventory method to record the inventory.

The adjusting and closing entries for the year ended 30 June 2016 shall be as follows:

Adjusting and closing entries

Date	**Description**		**Debit**	**Credit**
			— Rs. in '000' —	
30-Jun-2016	Drawings		500	
	Purchases			500
	(To record issue of goods to proprietor)			
	No accounting entry for normal inventory losses as CE uses periodic inventory method			
30-Jun-2016	Closing inventory	**(W-1)**	19,610	
	Cost of sales			19,610
	(To record closing inventory)			
30-Jun-2016	Sales		380,000	
	Opening inventory			15,000
	Purchases	(250,000–500)		249,500
	Statement of comprehensive income			115,500
	(Closing of accounts to statement of comprehensive income)			

W-1: Inventory as at 30 June 2016		**Rs. in '000'**
Physical inventory as at 10 July 2016		18,000
Adjustments for transactions of intervening period 1 July to 10 July 2016:		
Sales	(12,000 ÷ 1.25)	9,600
Sales return (Goods returned by customers)	(800 ÷ 1.25)	(640)
Purchases		(7,000)
		1,960
Damaged goods (damaged prior to 1 July 2016) – having no sales value		(350)
		19,610

5 INVENTORY COUNTS (STOCK TAKES)

Section overview

- Periodic inventory systems
- Perpetual inventory systems
- Timing of inventory counts

A stock take is a physical verification of the quantity of inventory that a business has.

Each item of inventory is counted and entered onto inventory sheets. The inventory counted can then be valued.

6.1 Periodic inventory systems

Inventory counts are vital for the operation of the periodic inventory system as it depends on the closing inventory at the end of each period being recognised in the system of accounts.

6.2 Perpetual inventory systems

Inventory counts are also important to the operation of perpetual inventory systems as the identify differences between the balance on the inventory account (the inventory that should be there) and the actual physical quantity of inventory.

The inventory account must be adjusted for any material difference.

Any difference should be investigated. Possible causes of difference between the balance on the inventory account and the physical inventory counted include the following.

- ☐ Theft of inventory.
- ☐ Damage to inventory with failure to record that damage.
- ☐ Mis-posting of inventory receipts or issues (for example posting component A as component B).
- ☐ Failure to record a receipt.
- ☐ Failure to record an issue.

6.3 Timing of inventory counts

Ideally the inventory count takes place on the last day of an accounting period (the reporting date). However, this is not always possible due to the day on which the last day of the accounting period falls or perhaps, not having enough employees to count the inventory at all sites at the same time.

If the inventory is counted at a date that differs from the reporting date the balance must be adjusted for transactions between the two dates.

Example: Timing of inventory counts

Sukkur Trading has a 31 December year end. It carried out an inventory count on 5th January 2014. The count was valued at Rs.2,800,000.

The following transactions took place between the 31 December and 5 January.

1. Sales of goods for Rs. 120,000. These goods cost Rs. 96,000.
2. Purchases of goods for Rs. 136,000.

The inventory at the reporting date is calculated as follows:

	Rs.
Inventory on 5 January	2,800,000
Add back cost of inventory sold since 31 December	96,000
Deduct purchase since 31 December	(136,000)
Inventory at 31 December	2,760,000

Example: Faisal

Faisal and partners carried out a physical count on 31 December 2012 and finds Rs.10,000 of inventory in its warehouse.

During the year ended 31 December 2013 the company makes Rs.70,000 of sales and buys Rs.58,000 of supplies.

The company carries out a physical count for the year ended 31 December 2013 on 7 January 2013 and finds Rs.15,000 worth of goods. In the six day intervening period there were sales of goods which had cost Rs.4,800 and deliveries inwards of goods costing Rs.8,000.

(a) The inventory shall be recorded in the relevant ledger accounts as follows:

Inventory a/c

		Rs.		Rs.
1.1.13	Balance b/d	10,000	To trading a/c	10,000
31.12.13	From trading a/c	11,800	31.12.13 Balance c/d (W)	11,800
		21,800		21,800
1.1.13	Balance b/d	11,800		

Trading (and income and expenditure) a/c

	Rs.		Rs.
Opening inventory	10,000	Sales	x
Purchases	x	Closing inventory	11,800

(b) The trading account for inclusion in the statement of comprehensive income for the year ended 31 December 2013 shall be prepared as follows:

Trading account for the year ended 31 December 2013

	Rs.	Rs.
Revenue		70,000
Cost of sales		
Opening inventory	10,000	
Purchases	58,000	
Closing inventory (W)	(11,800)	
		(56,200)
Gross profit		13,800

WORKING

	Rs.
Inventory at 7 January 2013	15,000
Less Deliveries	(8,000)
Add back Sales at cost	4,800
	11,800

Example: Salman Limited

Salman Limited (SL) closes its books on 30th June each year. Due to an administrative problem, SL carried out the stock-taking on 10 July 2016. The cost of stock as verified on 10 July 2016 was Rs. 812,500.

Details of transactions from 1 July to 10 July are given below:

(i) Total sales amounted to Rs. 326,000. The goods were sold in the normal course of business at cost plus 25% except the following:

- a sale of Rs. 25,000 was made at 40% of normal selling price.
- a sale of Rs. 60,000 was made at normal selling price but the goods were slightly damaged and an expenditure of Rs. 15,000 was incurred on these goods to bring them to saleable condition.

(ii) Purchases amounted to Rs. 246,000. All such purchases were included in stock as on 10 July 2016.

(iii) Sales returns and purchase returns amounted to Rs. 11,000 and Rs. 6,000 respectively.

(iv) Goods with customers on sale or return basis were Rs. 50,000 (at invoice value). The goods had been sent to the customers on 15 June 2016. The customers have the right to return the goods within four weeks. One of the customers informed SL on 29 June 2016 that goods worth Rs. 20,000 had been destroyed in fire.

The value of stock as at 30 June 2016 shall be calculated as follows:

	── Rupees ──	
Cost of stock on 10 July 2016		**812,500**
Less:		
Purchases from 01 July to 10 July 2016		**(246,000)**
Sales returns, at cost (Rs. 11,000 × 100/125)		**(8,800)**
		557,700
Add:		
Cost of stock sold for Rs. (326,000 – 25,000)/1.25	**240,800**	
Cost of good sold at 40% of invoice price (25,000/0.4)×100/125	**50,000**	
Goods on sale or return basis (50,000–20,000)× 100/125	**24,000**	
Purchase returns	**6,000**	
		320,800
Cost of stock on 30 June 2016 (A)		**878,500**
Less: NRV Adjustments		
Stock on which repair is done (60,000–15,000)	**45,000**	
Cost (60,000/1.25)	**48,000**	**(3,000)**
Stock sold at 40% of selling price		
Normal cost (25,000/0.4/1.25)	**50,000**	
Selling price	**25,000**	**(25,000)**
NRV of stock (B)		**850,500**
Value of stock as on 30 June 2016 [lower of cost (A) and NRV(B)]		**850,500**

****Goods destroyed in fire (Rs. 20,000) taken as sold***

6 DISCLOSURES

Section overview

- Disclosure requirements

6.1 Disclosure requirements

The financial statements are required to disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used;

(b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;

(c) the carrying amount of inventories carried at fair value less costs to sell;

(d) the amount of inventories recognised as an expense during the period; and

(e) the amount of any write-down of inventories recognised as an expense

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may be described as work in progress.

7 OBJECTIVE BASED QUESTIONS

01. In preparing its financial statements for the current year, a company's closing inventory was understated by Rs. 200,000.

What will be the effect of this error if it remains uncorrected?

- **(a)** The current year's profit will be overstated and next year's profit will be understated
- **(b)** The current year's profit will be understated and next year's profit will be overstated
- **(c)** The current year's profit will be understated but there will be no effect on next year's profit
- **(d)** The current year's profit will be overstated but there will be no effect on next year's profit

02. Which of the following cost should be deducted from Revenue to arrive at gross profit and what is accounting concept behind this?

- **(a)** Cost of goods purchased AND Prudence concept
- **(b)** Cost of goods produced AND Matching concept
- **(c)** Cost of goods sold AND Prudence concept
- **(d)** Cost of goods sold AND Matching concept

03. Which of the following is included in the cost of purchases?

- **(a)** Administrative Salaries
- **(b)** Abnormal loss
- **(c)** Freight in
- **(d)** Rent of store

04. At 01 December 2018 Nida had opening inventory of Rs. 20,000 and at 31 December 2018 Nida had closing inventory of Rs. 35,000.

Which of the following entries are required to account for opening and closing inventory when preparing financial statements of the business?

- **(a)** Dr Cost of sales Rs. 20,000 Cr Inventory Rs. 20,000 and Dr Inventory Rs. 35,000 Cr Cost of sales Rs. 35,000
- **(b)** Dr Cost of sales Rs. 35,000 Cr Inventory Rs. 35,000 and Dr Inventory Rs. 20,000 Cr Cost of sales Rs. 20,000
- **(c)** Dr Cost of sales Rs. 20,000 Dr Inventory Rs. 20,000 and Dr Inventory Rs. 35,000 Dr Cost of sales Rs. 35,000
- **(d)** Cr Cost of sales Rs. 35,000 Cr Inventory Rs. 35,000 and Cr Inventory Rs. 20,000 Cr Cost of sales Rs. 20,000

05. Maria had opening inventory of 900 units at Rs. 5 unit at 01 January 2019. During the month she made following purchases and sales transactions:

January 05	Purchased 1,000 units at Rs. 6 per unit
January 09	Sold 1,250 units
January 15	Purchased 600 units at Rs. 7 per unit
January 28	Sold 550 units

Maria uses periodic weighted average cost method for inventory valuation. What is value of closing inventory at 31 January 2019?

(a) Rs. 4,800
(b) Rs. 4,116
(c) Rs. 6,468
(d) None of the above

06. The accounting concept that requires valuation of Inventory at lower of cost and net realisable value is?

(a) Accrual
(b) Materiality
(c) Prudence
(d) Going concern

07. Which of the following costs are included in conversion costs?

(a) Commission of selling staff
(b) Carriage in
(c) Carriage outwards
(d) Supervisor's wages

08. What is impact on closing inventory if an item having cost of Rs. 2,500 and a net realizable value of Rs. 3,000 has been omitted from year - end inventory count?

(a) Understated by Rs. 2,500
(b) Understated by Rs. 3,000
(c) Overstated by Rs. 2,500
(d) Understated by Rs. 500

09. If closing inventory is accounted for as Rs.240,000 instead of Rs.180,000 then;

(a) Gross profit as well as net profit will be exaggerated
(b) Gross profit and net profit would both be understated
(c) Gross profit will be exaggerated, and net profit understated
(d) Gross profit will be exaggerated but net profit correctly reported

10. An organization had opening inventory of 35,000 units @Rs. 3.5 per unit. During the month it made purchases of 40,000 units @Rs. 5 per unit. Sales were 50,000 units.

What is value of cost of goods sold during the month if the company uses continuous weighted average method for inventory valuation?

(a) Rs. 107,500
(b) Rs. 215,000
(c) Rs. 197,500
(d) Rs. 75,000

11. After preparing draft accounts, Saima reviews her closing inventory. She discovers that some items included at cost of Rs. 2,600 can be sold for Rs. 2,550 after incurring selling costs of Rs. 65.

What effect will any required adjustment have on Saima's profits?

(a) Profit decreases by Rs. 65

(b) Profit decreases by Rs. 115

(c) No change to profit

(d) Profit decreases by Rs. 50

12. Ali had opening inventory of Rs. 1,500,000. Purchases made during the period were Rs. 2,550,000. Sales during the period were Rs. 4,500,000 and he had closing inventory of Rs. 1,000,000.

Gross profit for the period was?

(a) Rs. 1,950,000 Profit

(b) Rs. 450,000 Profit

(c) Rs. 1,450,000 Profit

(d) Rs. 550,000 Loss

13. What is correct entry for goods taken by owner for personal use?

(a) Cr Purchases account and Dr Drawings account with the cost price of the goods.

(b) Cr Opening Inventory account and Dr Drawings account with cost price of the goods.

(c) Cr Trading account and Dr Drawings account with the selling price of the goods.

(d) Cr Sales account and Dr Drawings account with the sale price of the goods.

14. Tasweeb Corporation sells three products – Alpha, Beta and Gamma. The following information was available at the year end:

	Alpha	**Beta**	**Gamma**
	Rs. per unit	**Rs. per unit**	**Rs. per unit**
Original cost	10	13	15
Estimated selling price	15	14	14
Selling and distribution costs	3	5	2
	Units	**Units**	**Units**
Inventory: units held	300	380	240

The value of inventory at the end of year should be?

(a) Rs. 8,300

(b) Rs. 5,700

(c) Rs. 9,300

(d) Rs. 6,150

15. The following information is related to a mobile dealer about his inventory at year end.

Mobile Set	**Cost value (Rs.)**	**Net realisable value (Rs.)**
A	5,000	3,300
B	13,000	13,500
C	14,200	13,900
D	14,900	15,000

What value of inventory should be shown in his Statement of Financial Position prepared at the year end?

(a) Rs. 39,800

(b) Rs. 45,900

(c) Rs. 40,000

(d) Rs. 45,100

16. On 1st July 2018, Imad had opening inventory of 50 units at a cost of Rs. 60 per unit. During July 2018 he has made following purchases and sales:

July 09	120 units purchased at a cost of Rs. 65 per unit
July 16	65 units sold
July 24	45 units purchased at a cost of Rs. 67 per unit
July 30	100 units sold

What is the value of inventory at 31 March using the FIFO method?

Rs. ___________

17. During August, Anum had sales of Rs. 158,000, which made a gross profit of Rs. 45,000. Purchases amounted to Rs. 101,000 and opening inventory was Rs. 34,000.

The value of closing inventory was?

Rs. ___________

18. The closing stock of Daniel amounts to Rs. 130,200. But later on it was discovered that some damaged items were included having cost of Rs. 25,000. Total repair cost is expected to be Rs. 3,500. After repair these could be sold for Rs. 18,000.

What is the correct value of Daniel inventory?

Rs. ___________

19. Following is the detail of inventory of Hamid at December 31, 2018:

Product	**Cost value (Rs.)**	**Net realisable value (Rs.)**
A	15,000	17,000
B	12,000	10,000
C	13,500	11,000
D	12,600	14,000
TOTAL	**53,100**	**52,000**

What value of inventory should be shown by the corporation in its Statement of Financial Position at year end?

Rs. ___________

20. Tahir and Taha are doing partnership business. The net profit earned by their business during the year ended Dec 31 2008 is Rs. 250,000. In subsequent year it was realized that the ending inventory of year 2007 was overstated by Rs. 10,000.

By what amount the profit for the year 2008 is understated?

Rs. ___________

21. Which of the following cost models is not permitted under IAS 2?

(a) First in, First out ('FIFO')

(b) Last in, Last out ('LIFO')

(c) Weighted Average

(d) Actual cost

22. Which of the following items are excluded from the scope of IAS 2 – Inventories?

(a) Inventories that are stated at Net Realisable Value

(b) Assets held for sale in the ordinary course of business

(c) Inventories whose fair value is more than the cost

(d) Agricultural produce at the point of harvest

23. Which of the following is not permitted as a cost of inventory?

(a) Non-recoverable taxes

(b) Storage costs

(c) Shipping

(d) Fixed manufacturing overheads

24. Which of the following items should be disclosed as per the requirements of IAS 2?

(a) Average holding period of inventories of the entity as at the end of the reporting period

(b) List of major customers to whom the inventories were sold during the reporting period

(c) Carrying amount of inventories pledged as security for liabilities

(d) Average lead time of procurement for major classes of inventories

25. A company sold goods of worth Rs.1 million, the manufacturing cost of the goods were Rs.600,000. The carriage outwards is Rs.50,000 and commission paid to agent were also Rs.50,000. What is the gross and net profit?

(a) Gross profit = 600,000 and net profit = 250,000

(b) Gross profit = 300,000 and net profit = 200,000

(c) Gross profit = 400,000 and net profit = 300,000

(d) Gross profit = 350,000 and net profit = 300,000

26. Bazuka Limited (BL) manufacturers and sells office equipment for workplaces. The stock of equipment was included in the closing inventory as of 31 December 2019 at a cost of Rs.50,000 per equipment.

During the final audit, the auditors noted that the subsequent selling price for the inventory at 15th January 2020 was Rs.40,000 per item. Furthermore, inquiry reveals that during the physical stock take, a water leakage has damaged the equipment. Accordingly, in the following week, BL spent a total of Rs.15,000 per equipment for repairing the equipment.

The net realizable value and inventory write-down (loss) amount to?

(a) Rs. 40,000 and Rs.10,000 respectively

(b) Rs. 25,000 and Rs. 25,000 respectively

(c) Rs. 35,000and Rs. 25,000 respectively

(d) Rs. 30,000 and Rs.15,000 respectively

27. Which of the following is allowed as a cost of inventory?

(a) Abnormal waste

(b) Storage costs

(c) Selling costs

(d) Variable manufacturing overheads

28. Spice Limited, imported raw materials from China worth Rs.10 million. They paid Rs.800,000 as import duties and Rs.200,000 as import taxes (the import taxes were subsequently refunded by the government). They paid Rs.150,000 million for transportation of the materials from China and another Rs.200,000 as port handling charges for loading the materials at China. Marketing expenses were Rs.100,000 and the general administrative overheads amounted to Rs.200,000.

What will be the value of inventories?

(a) Rs.11,600,000

(b) Rs.11,400,000

(c) Rs.11,150,000

(d) Rs.10,950,000

29. Any amount of write-down of inventories to net realisable value should?

(a) Treated as a deferred expense and written off based on the average inventory holding period

(b) Recognised as an expense in the period in which the write-down occurs

(c) Recognised as an expense in the subsequent period in which such write-down is warranted

(d) Recognized as a current liability in the statement of financial position

30. Phill Morris Limited (PML) is in the business of procuring a specific type of machine and sells them to international markets. During the year, PML bought four machines costing Rs.12million ,Rs.14 million, Rs.13 million and Rs.10 million respectively. During the year it sold only one machine for Rs.14 million and follows the FIFO method of valuation.

Which of the following statements is TRUE?

(a) The cost of Inventory is Rs.37 million and the cost of sales is Rs.10 million

(b) The cost of Inventory is Rs.39 million and the cost of sales is Rs.14 million

(c) The cost of Inventory is Rs.37million and the cost of sales is Rs.12 million

(d) The cost of Inventory is Rs.37 million and the cost of sales is Rs.13 million

31. The estimated selling price in the ordinary course of business less estimated cost of completion and estimated cost of sale is called

- **(a)** Market value
- **(b)** Fair value
- **(c)** Net realisable value
- **(d)** Current value

32. Which of the following costs must be expensed?

- **(a)** Costs of purchase that are paid to the suppliers of raw materials
- **(b)** Import duties on raw materials that are paid to the authorities
- **(c)** Variable production overheads that are allocated to each unit based on actual usage
- **(d)** Distribution cost

7 OBJECTIVE BASED ANSWERS

01.	**(b)**	Closing inventory is understated so current year's profit will be understated as well. However next year the effect will be opposite as it would become opening inventory.
02.	**(d)**	Due to matching concept, not all goods purchased are treated as expense and only cost of goods sold is matched against revenue by adjusting changes in inventory.
03.	**(c)**	Freight in is necessary to bring the inventory in its present condition and location. All other costs are period costs.
04.	**(a)**	Opening inventory is charged to cost of sales and closing inventory is credited in cost of sales.
05.	**(b)**	Closing inventory units = 900+1,000+600-1,250-550 = 700 Average cost per unit = ((900x5)+(1,000x6)+(600x7))/2,500 units = Rs. 5.88 Closing inventory = 700xRs. 5.88 = Rs. 4,116
06.	**(c)**	The prudence concept states that assets must not be overstated and measuring inventories at lower of cost and NRV ensures that.
07.	**(d)**	Conversion costs include direct labour and manufacturing overheads. Only supervisor's wages are part of overheads.
08.	**(a)**	Inventory is valued at lower of cost and NRV which is Rs. 2,500 in this case. Omission would understate the inventory.
09.	**(a)**	
10.	**(b)**	Cost per unit = [(35,0000x3.5)+(40,000x5)]/(35,000+40,000) =Rs. 4.3 Cost of goods sold = 50,000 x Rs. 4.3 = Rs. 215,000
11.	**(b)**	The cost is Rs. 2,600 and NRV is Rs. 2,485 (2,550 – 65) As NRV is lower, inventory will be written down by Rs. 115 (2,600 – 2,485). This would reduce the profit by Rs. 115 as well.
12.	**(c)**	Sales – costs of sales = gross profit Rs. 4,500,000 – (Rs. 1,500,000+2,550,000-1,000,000) = Rs. 1,450,000
13.	**(a)**	The correct entry for drawings is Debit sDrawings and Credit Purchases (or Cost of Sales). The cost price of goods is relevant, not selling price.
14.	**(c)**	See table below
15.	**(d)**	Rs. 3,300 + 13,000 + 13,900 + 14,900 = Rs. 45,100

	Alpha	**Beta**	**Gamma**
	Rs. per unit	**Rs. per unit**	**Rs. per unit**
Original cost	10	13	15
NRV	12	9	12
Inventory: units held	300	380	240
Valuation Rs.	3,000	3,420	2,880

Total valuation = 3,000 + 3,420 + 2,880 = Rs. 9,300

16.	**Rs. 3,340**	The closing inventory units 50+120+45 – 65 – 100 = 50 units 45 units @ Rs. 67 per unit and 5 units @ Rs. 65 per unit = Rs. 3,340
17.	**Rs. 22,000**	Gross profit = Sales – cost of goods sold; ***hence*** Cost of Goods sold = Sales – Gross profit Cost of Goods sold = Rs. 158,000 - Rs. 45,000 = Rs. 113,000 Cost of Goods sold = Opening inventory +Purchases – closing inventory Rs. 113,000 = Rs. 34,000 + Rs. 101,000 – Closing inventory Closing inventory = Rs. 22,000
18.	**Rs. 119,700**	Balance given= Rs. 130,200 Less: cost of damaged item already included= Rs. 25,000 Add: NRV of damaged item Rs. 18,000-Rs. 3,500 = Rs. 14,500 Correct value of inventory Rs. 119,700
19.	**Rs. 48,600**	Product A Rs. 15,000+ Product B Rs. 10,000+Product C Rs. 11,000+Product D Rs. 12,600 = Rs. 48,600 Cost and NRV comparison are to be made on item by item basis and not on the basis of totals.
20.	**Rs. 10,000**	Increase in opening inventory understates the profit for current year.
21.	**(b)**	
22.	**(d)**	
23.	**(b)**	
24.	**(c)**	
25.	**(c)**	
26.	**(b)**	
27.	**(d)**	
28.	**(c)**	
29.	**(b)**	
30.	**(c)**	
31.	**(c)**	
32.	**(d)**	

CHAPTER

12

Preparation of financial statements

Contents

1 FINANCIAL STATEMENTS

Section overview

- The process of preparing financial statements
- The components of financial statements
- Statement of financial position
- Statement of comprehensive income

1.1 The process of preparing financial statements

The basic financial reporting process is as follows:

i. transactions and events are recorded in the books of prime entry,
ii. totals from the books of prime entry are entered into the general ledger accounts,
iii. the control accounts are reconciled,
iv. the ledgers are balanced off,
v. unadjusted trial balance is produced,
vi. errors are corrected,
vii. year-end journals (adjusting entries) are made,
viii. Adjusted (final) trial balance is produced
ix. the financial statements are extracted from the final, extended trial balance.

1.2 The components of financial statements

A complete set of financial statements consists of:

❑ a statement of financial position as at the end of the period;

❑ a statement of comprehensive income for the period (made up of a statement of profit or loss and a statement of other comprehensive income);

❑ a statement of changes in equity for the period;

❑ a statement of cash flows statement of cash flows; and

❑ notes to these statements, consisting of a summary of significant accounting policies used by the entity and other explanatory notes.

Further requirements include:

❑ Financial statements should present fairly the financial position, financial performance and cash flows of the entity.

❑ Comparative information for the immediately preceding accounting period should be disclosed (you will not be asked to provide comparative information).

❑ Each component of the financial statements must be properly identified with the following information displayed prominently:

  - the name of the reporting entity
  - the date of the end of the reporting period or the period covered by the statement, whichever is appropriate
  - the currency in which the figures are reported
  - the level of rounding used in the figures (for example, whether the figures thousands of rupees or millions of rupees).

This syllabus examines only the preparation of statements of financial position and statements of comprehensive income. The other detail given above is for completeness.

Note: IAS 1 does not specify what the statements must be called and allows the use of other terminology. For example a statement of financial position is often called a balance sheet and a statement of profit or loss is often called an income statement.

1.3 Statement of financial position

The statement of financial position is a structured presentation of the assets and liabilities of the business. The difference between assets and liabilities is capital (equity).

Assets are resources controlled by the business as a result of past events and from which future economic benefits are expected to flow to the entity. Whereas, liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

In a statement of financial position, non-current assets and liabilities are shown separately from current assets and liabilities.

As a general rule, an amount is ‘current’ if it is expected to be recovered or settled no more than 12 months after the end of the reporting period.

Current assets

IAS 1 states that an asset should be classified as a current asset if it satisfies **any** of the following criteria:

- The entity expects to realise the asset, or sell or consume it, in its normal operating cycle.
- The asset is held for trading purposes.
- The entity expects to realise the asset within 12 months after the reporting period.
- It is cash or a cash equivalent unless the asset is restricted from being used for at least 12 months after the reporting date. (Note: An example of ‘cash’ is money in a current bank account. An example of a ‘cash equivalent’ is money held in a term deposit account with a bank.)

All other assets should be classified as non-current assets.

This definition allows inventory or trade receivables to qualify as current assets, even if they may not be realised into cash within 12 months, provided that they will be realised in the entity’s normal operating cycle or trading cycle.

The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. This is almost always the case.

Current liabilities

IAS 1 also states that a liability should be classified as a current liability if it satisfies **any** of the following criteria:

- The entity expects to settle the liability in its normal operating cycle.
- The liability is held primarily for the purpose of trading. This means that all trade payables are current liabilities, even if settlement is not due for over 12 months after the end of the reporting period.
- It is due to be settled within 12 months after the end of the reporting period.
- The entity does **not** have the unconditional **right** to defer settlement of the liability for at least 12 months after the end of the reporting period.

All other liabilities should be classified as non-current liabilities.

> **Illustration:**
>
> **If a company obtains a five-year bank loan, where none of the loan principal is repayable until the end of the loan period, the loan will be a non-current liability for the first four years and will then become a current liability in fifth year when it is repayable within 12 months.**

Accrued expenses (and deferred income) are current liabilities as these are monies due to a third party but not yet paid; for example, wages payable

Information to be presented on the face of the statement of financial position

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of financial position as a 'line item' (in other words, on a separate line in the statement):

Assets

(a) Property, plant and equipment

(b) Investment property

(c) Intangible assets

(d) Long-term financial assets, such as long-term holdings of shares in other companies, with the exception of item (e) below

(e) Investments accounted for using the equity method

(f) Biological assets

(g) Inventories

(h) Trade and other receivables

(i) Cash and cash equivalents.

Liabilities

(j) Trade and other payables

(k) Provisions

(l) Financial liabilities, excluding any items in (j) and (k) above: (for example, bank loans)

(m) Liabilities (but possibly assets) for current tax, as required by ***IAS 12: Income Taxes***

(n) Deferred tax liabilities (but possibly assets). These are always non-current.

Equity

(o) Issued capital and reserves attributable to the **owners** of the entity. (The term 'owners', refers to the **equity holders**.)

Additional line items should be included in the statement of financial position when presenting them separately and is 'relevant to an understanding of the entity's financial position.

Information to be shown on the face of the statement of financial position or in notes

Some of the line items in the statement of financial position should be sub-classified into different categories, giving details of how the total figure is made up. This sub-classification may be presented either:

☐ as additional lines on the face of the statement of financial position (adding up to the total amount for the item as a whole) or

☐ in notes to the financial statements.

For example:

☐ Tangible non-current assets should be divided into sub-categories, as required by ***IAS 16: Property, Plant and Equipment***.

☐ Receivables should be sub-classified into trade receivables, receivables from related parties, prepayments and other amounts.

☐ Inventories are sub-classified in accordance with ***IAS 2: Inventories*** into categories such as merchandise, materials, work-in-progress and finished goods.

Example: statement of financial position of an individual entity

IAS 1 does not specify what the exact format of the statement of financial position should be. However, it includes an illustrative statement of financial position in Guidance to implementing the Standard (which is an appendix to the Standard).

The example below is based on that example. Illustrative figures are included.

Statement of financial position of ABCD Entity as at 31 December 20XX

	Rs. m	Rs. m
Assets		
Non-current assets		
Property, plant and equipment	205.1	
Intangible assets	10.7	
Investments	6.8	
		222.6
Current assets		
Inventories	17.8	
Trade and other receivables	13.3	
Other current assets	2.0	
Cash and cash equivalents	0.7	
		33.8
Total assets		256.4
Equity and liabilities		
Share capital	50.0	
Retained earnings (accumulated profits)	60.6	
Other components of equity	31.9	
Total equity		142.5
	Rs. m	Rs. m
Non-current liabilities		
Long-term borrowings	30.0	
Deferred tax	4.5	
Total non-current liabilities	34.5	
Current liabilities		
Trade and other payables	67.1	
Short-term borrowings (bank overdraft)	3.2	
Current portion of long-term borrowing	5.0	
Current tax payable	4.1	
Total current liabilities	79.4	
Total liabilities		113.9
Total equity and liabilities		256.4

.

Illustration: Statement of financial position

Peshawar Trading Company: Statement of financial position as at 31 December 2013

	Rs. m	Rs. m
Assets		
Non-current assets		
Land and buildings	56.2	
Plant and machinery	28.0	
		84.2
Current assets		
Inventories	16.4	
Trade and other receivables	17.0	
Prepayments and accrued income	2.0	
Cash	1.2	
		36.6
Total assets		120.8
Equity and liabilities		
Capital		67.8
Non-current liabilities		
Long-term loans		30.0
Current liabilities		
Trade and other payables	18.0	
Accruals liability	1.5	
Short-term borrowings (bank overdraft)	3.5	
		23.0
Total equity and liabilities		120.8

1.4 Statement of comprehensive income

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

- a statement of profit or loss – a list that summarizes the revenues, costs and expenses incurred during a specified period which result in a profit or loss for the period; and
- a statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

The statement of comprehensive income shows the performance of the business in terms of its main activities. It is a structured presentation of all revenue, other income earned in a period and the costs of earning those.

Information to be presented on the face of the statement of comprehensive income

As a **minimum**, IAS 1 requires that the statement of comprehensive income should include line items showing the following amounts for the financial period:

(a) revenue
(b) finance costs (for example, interest costs)
(c) tax expense
(d) an amount related to the profit or loss from discontinued operations (IFRS5)
(e) profit or loss
(f) each component of ‘other comprehensive income
(g) total comprehensive income.

Additional line items should be presented on the face of the statement of comprehensive income when it is relevant to an understanding of the entity’s financial performance.

Example: statement of comprehensive income of an individual entity

IAS 1 does not specify formats.

The example below is based on a suggested presentation included in the implementation guidance to IAS 1.

XYZ Entity: Statement of comprehensive income for the year ended 31 December 20XX

	Rs. 000
Revenue	678
Cost of sales	250
Gross profit	428
Other income	44
Distribution costs	(98)
Administrative expenses	(61)
Other expenses	(18)
Finance costs	(24)
Profit before tax	271
Taxation	(50)
PROFIT FOR THE YEAR	221
Other comprehensive income	
Gains on property revaluation	46
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	267

A single statement or two statements

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

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

IAS 1 allows an entity to present the two sections in a single statement or in two separate statements. If two separate statements are used they should include all the information that would otherwise be included in the single statement of comprehensive income.

The statement of profit or loss shows the components of profit or loss, beginning with 'Revenue' and ending with 'Profit (or Loss)' for the period after tax.

Examples of other comprehensive income include Gains and losses arising on the revaluation of property. plant and equipment under the rules in IAS 16.

There are many transactions which must be recognised in the statement of other comprehensive income but these are not in the scope of this syllabus. You will study them in papers at a higher level.

Definition of total comprehensive income

Total comprehensive income during a period is the sum of:

- the profit or loss for the period and
- other comprehensive income.

Information to be shown on the face of the statement of comprehensive income (or the statement of profit or loss, if separate) or in the notes

The following information may be shown either on the face of the statement of comprehensive income or in a note to the financial statements:

- **material items** of income and expense
- an **analysis of expenses**, providing either:
  - expenses analysed by their nature, or
  - expenses analysed by the function that has incurred them.

IAS 1 encourages entities to show this analysis of expenses on the face of the statement of comprehensive income, rather than in a note to the accounts.

Material items that might be disclosed separately include:

- a write-down of inventories from cost to net realisable value, or a write-down of items of property, plant and equipment to recoverable amount
- the cost of a restructuring of activities disposals of items of property, plant and equipment
- discontinued operations
- litigation settlements

a reversal of a provision Analysis of expenses by their function

When expenses are analysed according to their function, the functions are commonly 'cost of sales', 'distribution costs', 'administrative expenses' and 'other expenses'. This method of analysis is also called the 'cost of sales method'.

In practice, most entities use this method.

An example of a statement of comprehensive income, showing expenses by function (cost of sales, distribution costs, administrative expenses) is as follows.

Statement of comprehensive income (analysis of expenses by function)

Illustration: Statement of comprehensive income (analysis of expenses by function)

Statement of comprehensive income for the year ended 31 December 2013

	Rs. m
Revenue	X
Cost of sales	(X)
Gross profit	X
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Finance costs	(X)
Profit before tax	X
Taxation	(X)
PROFIT FOR THE YEAR	X
Other comprehensive income	
Gains on property revaluation	X
Other gains and losses	X
Other comprehensive income for the year	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X

Example: Analysis of expenses by function

The following is an extract from the accounts of Entity Red for the year to 30 June 20X5, after the year-end adjustments had been made:

	Debit	**Credit**
	Rs. 000	Rs. 000
Cost of sales	6,214	
Distribution costs	3,693	
Revenue		14,823
Other expenses	248	
Administrative expenses	3,901	
Other income		22

The first part of Entity Red's statement of comprehensive income using the 'cost of sales' analysis method shall be as follows:

Entity Red: Statement of comprehensive income for the year ended 30 June 20X5

	Rs. 000
Revenue	14,823
Cost of sales	6,214
Gross profiit	8,609
Other income	22
Distribution costs	(3,693)
Administrative expenses	(3,901)
Other expenses	(248)
Profit before tax	789

The basis for separating these costs between the functions would be given in the question.

Analysis of expenses by their nature

When expenses are analysed according to their nature, the categories of expenses will vary according to the nature of the business.

In a manufacturing business, expenses would probably be classified as:

- ☐ raw materials and consumables used;
- ☐ staff costs ('employee benefits costs'); and
- ☐ depreciation.

Items of expense that on their own are immaterial are presented as 'other expenses'.

There will also be an adjustment for the increase or decrease in inventories of finished goods and work-in-progress during the period.

Other entities (non-manufacturing entities) may present other expenses that are material to their business.

An example of a statement of comprehensive income, showing expenses by their nature, is shown below, with illustrative figures included.

Statement of comprehensive income (analysis of expenses by nature)

Illustration: Statement of comprehensive income (analysis of expenses by nature)

Statement of comprehensive income for the year ended 31 December 2013

	Rs. m
Revenue	X
Other income	X
Changes in inventories of finished goods and work-in-progress	X
Raw materials and consumables used	X
Staff costs (employee benefits costs)	(X)
Depreciation and amortisation expense	(X)
Other expenses	(X)
Finance costs	(X)
Profit before tax	X
Taxation	(X)
PROFIT FOR THE YEAR	X
Other comprehensive income	
Gains on property revaluation	X
Other gains and losses	X
Other comprehensive income for the year	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X

Example: Analysis of expenses by nature

The following is an alternative method of presenting the accounts of Entity Red.

	Rs. 000
Increase in inventories of finished goods and work-in-progress	86
Revenue	14,823
Raw materials and consumables	5,565
Depreciation	1,533
Other income	22
Staff costs	4,926
Other operating expenses	2,118

The first part of Entity Red's statement of comprehensive income using the 'nature of expenditure' method, down to the operating profit level shall be as follows:

Entity Red: Statement of comprehensive income for the year ended 30 June 20X5

	Rs. 000	Rs. 000
Revenue		14,823
Other income		22
		14,845
Changes in inventories of finished goods and work-in-progress (reduction = expense, increase = negative expense)	(86)	
Raw materials and consumables used	5,565	
Staff costs (employee benefits costs)	4,926	
Depreciation and amortisation expense	1,533	
Other operating expenses	2,118	
		14,056
Profit before tax		789

Illustration: Statement of comprehensive income

Peshawar Trading Company: Statement of comprehensive income for the year ended 31 December 2013

	Rs.m	Rs.m	Chapter
Revenue		120.0	
Cost of sales			
Opening inventory	8.0		
Purchases	80.0		
	88.0		
Closing inventory	(10.0)		
		(78.0)	
Gross profit		42.0	
Other income:			
Rental income			
Expenses:			
Wages and salaries	8.0		
Depreciation	6.0		
Rental costs	4.0		
Telephone charges	3.0		
Advertising costs	5.0		
Interest charges	1.0		
Bad debts	3.0		
		(30.0)	
		12.0	

2 PREPARING FINANCIAL STATEMENTS

Section overview

- Useful guidelines
- Year-end
- Preparation of financial statements: Approach 1
- Preparation of financial statements: Approach 2
- Service organizations

2.1 Useful guidelines

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

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

Opening and closing inventory and the cost of sales

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

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

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

Illustration: Cost of sales

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

Example: Cost of sales

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

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

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

2.2 Year-end

Earlier chapters have explained how transactions are first entered into books of prime entry and how totals from these are transferred into ledger accounts in the general ledger.

At the year end a trial balance is extracted and various year-end adjustments are then made to the accounts after which a statement of comprehensive income and then a statement of financial position can be prepared, using these adjusted balances.

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

At the end of the period there is another exercise performed in order to prepare the general ledger for use in the next accounting period. This involves transferring all income and expense items into a single account (perhaps via intermediate accounts like cost of sales and statement of comprehensive income) in order to produce a single figure as profit or loss for the period which is then transferred to capital.

Earlier chapters have covered the year-end adjustments. They explained how each type of adjustment is measured and then explained the double entry necessary to account for these amounts. The double entry explanation used “T” accounts in order to explain the full workings of the double entry system.

In this exam you will be expected to prepare a statement of financial position and statement of comprehensive income from a trial balance. These questions are usually quite time pressured so you need to develop a good technique in order to execute such tasks in an effective way.

The rest of this chapter use the following example to illustrate how such questions might be approached. You will need to choose an approach and practice it.

Example:

ABC – Trial balance as at 31 December 2013

	Rs.	Rs.
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000	
Inventory as at 1 January 2013	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2013		121,600
	627,600	627,600

Further information:.

a) Rs. 400 is owed for heating and lighting expenses.

b) Rs. 700 has been prepaid for rent.

c) It is decided that a bad debt of Rs. 1,200 should be written off, and that the allowance for doubtful debts should be increased to Rs. 4,500.

d) Depreciation is to be provided for the year at 10% on cost

e) Inventory at 31st December 2013 was valued at Rs. 16,500.

The journals

The business needs to process the following double entries to take account of the "further information" given above.

Example: Closing journals

		Debit	Credit
a)	**Accrual**		
	Heating an lighting expense	400	
	Accrual		400
	Being: Accrual for heating and lighting expense		
b)	**Rent prepayment**		
	Prepayment	700	
	Rent expense		700
	Being: Adjustment to account for rent prepayment		
c)	**Bad and doubtful debt**		
	Bad and doubtful debt expense	1,200	
	Receivables		1,200
	Being: Write off of bad debt		
	Bad and doubtful debt expense	500	
	Allowance for doubtful debts		500
	Being: Increase in the allowance for doubtful debts		
d)	**Depreciation**		
	Depreciation expense	14,600	
	Accumulated depreciation		14,600
	Being: Depreciation for the year (10% of 146,000)		
e)	**Closing inventory**		
	Inventory (asset)	16,500	
	Inventory (cost of sales)		16,500
	Being: Recognition of inventory at the year-end		

These journals are only given to explain the double entry required. You should never write something like this in a preparation of financial statements question. It uses up too much time. You want to do double entry rather than write journals.

The chapter continues to show two possible approaches that you might follow. You do not have to do either. If you decide on a way that suits you then use it.

If you attend courses your lecture will show you how to do this. They are very experienced. Do as they advise.

2.3 Preparation of financial statements: Approach 1

Step 1: Perform double entry on the face of the question and open up new accounts as you need them in any space that you have.
(DO NOT COPY OUT THE TRIAL BALANCE).

After this your question paper should look something like the following (with the double entries are shown in bold italics):

Example: ABC – Trial balance as at 31 December 2013

	Rs.	Rs.
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	***700***[b]
Heating and lighting	5,000 + ***400***[a]	
Inventory as at 1 January 2013	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000+ ***500***[c]
Non-current assets	146,000	
Accumulated depreciation:		32,000 + ***14,600***[d]
Trade receivables	51,000	***1,200***[c]
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2013		121,600
	627,600	627,600
Accruals		***400***[a]
Prepayments	***700***[b]	
Bad and doubtful debt expense	***1200***[c] + ***500***[c]	
Depreciation expense	***14,600***[d]	
Closing inventory (asset)	***16,500***[e]	
Closing inventory (cost of sales)		***16,500***[e]

Step 2: Draft pro-forma financial statements including all of the accounts that you have identified. (A pro-forma is a skeleton document into which you can copy numbers later)

Step 3: Copy the numbers from the trial balance into the pro-forma statements. Note that if a number copied onto the financial statements is made up of a number provided in the original trial balance that has been adjusted, you must show the marker what you have done. This may involve adding in an additional explanation below the main answer or may be shown on the face of the statements.

Step 4: Calculate profit for the year.

Step 5: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position

Assets	**Rs. m**	**Rs. m**
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

Example: ABC – Statement of comprehensive income

	Rs.m	Rs.m
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation **(W1)**	14,600	
Rent (14,000 – 700)	13,300	
Heating an lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

2.4 Preparation of financial statements: Approach 2

Step 1: Draft pro-forma financial statements including all of the accounts that you have identified from reading the question. Leave spaces in case you have missed an account that you might need to insert later.

Step 2: Copy the numbers from the trial balance into the pro-forma statements. If you know that a number is not to be adjusted then you can copy it straight to its destination. Otherwise set up bracketed workings next to the narrative in the pro-forma.

After step 2 your answer might look like this:

Example: ABC – Statement of financial position

	Rs. m	Rs. m
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000		
Current assets		
Inventories		
Trade receivables (51,000		
Allowance for doubtful debts (4,000		
Prepayments		
Cash	6,200	
Total assets		
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year		
Drawings	(22,000)	
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)		
Total equity and liabilities		

Example: ABC – Statement of comprehensive income

	Rs.m	Rs.m
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory		
Gross profit		
Expenses:		
Wages and salaries	64,000	
Depreciation		
Rent (14,000		
Heating an lighting (5,000		
Bad and doubtful debts		

Step 3: Perform double entry on the face of your answer.

Step 4: Complete the bracketed workings and copy totals into their final destinations.

Step 5: Calculate profit for the year.

Step 6: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position

	Rs. m	Rs. m
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

Example: ABC – Statement of comprehensive income

	Rs.m	Rs.m
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation **(W1)**	14,600	
Rent (14,000 – 700)	13,300	
Heating an lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

2.6 Service Organizations

Service organizations do not sell goods but provides services to its clients by using the innovative and technical skillset and expertise of its personnel. Examples include investment banking, consulting, audit, accounting and advisory firms.

Difference between the financial statements of Manufacturing/Trading company and Service Company

Financial Statements of Merchandise/trading Company	Financial Statements of Service Company
A large percentage of the assets comprise inventory.	A large percentage of the assets comprise receivables.
They have less cash on hand than service businesses as their capital is tied up in relatively illiquid assets.	The funds of service companies are usually tied up towards accounts receivable.
Such companies' income statement shows calculation of costs of goods sold.	There is no line item for the cost of goods sold in the income statement of service companies.

Example: Statement of financial position of an advertising agency

Statement of Financial Position at June 30, 2018

	2018 **Rs. in '000'**
Current assets	
Cash and cash equivalents	120,000
Short term investments	50,000
Trade receivables	150,000
Other receivables	5,000
Total current assets	**325,000**
Non-current assets	
Property, plant and equipment	20,000
Other receivables	300
Goodwill	50,000
Website and domains	46,000
Other intangible assets	12,000
Deferred tax asset	250
Total non-current assets	**153,550**
Total assets	**478,550**
Current liabilities	
Trade and other payables	900
Borrowings	150
Provisions	5
Total current liabilities	**1,040**
Non-current liabilities	
Provisions	65
Other non-current liabilities	90
Total non-current liabilities	**405**
Total Liabilities	**1,445**
Equity	
Share capital	850
Share premium	20,000
Retained earnings	454,755
Non-controlling interests	1,500
Total equity	**477,105**
	478,550

Example: Statement of comprehensive income of an advertising agency

Statement of comprehensive income for the year ended June 30, 2018

	Rs. in '000'
Revenue	628,000
Cost of revenues	(200,000)
Gross profit	**428,000**
Research and development expenses	(10,000)
Selling and marketing expenses	(15,000)
General and administrative expenses	(45,000)
	(70,000)
Operating profit	358,000
Finance income	15,000
Finance expense	(1200)
Profit on ordinary activities before taxation and members' remuneration	**371,800**
Taxes on income	115,200
Net income and other comprehensive income	**256,600**
Attributable to:	
Equity holders of the company	236,600
Non-controlling interests	20,000

Example: Starter

The following information is available for Starter's business for the year ended 31 December. He started his business on 1 January.

	Rs.(000)
Trade payables	6,400
Trade receivables	5,060
Purchases	16,100
Revenue	28,400
Motor van	1,700
Drawings	5,100
Insurance	174
General expenses	1,596
Rent and rates	2,130
Salaries	4,162
Inventory at 31 December	2,050
Sales returns	200
Cash at bank	2,628
Cash in hand	50
Capital introduced	4,100

A statement of comprehensive income for the year ended 31 December and a statement of financial position at that date shall be prepared as follows:

Statement of comprehensive income for the year ended 31 December

	Rs. in 000
Revenue (W1)	28,200
Cost of sales (W2)	(14,050)
Gross profit	**14,150**
Operating expenses (W3)	(8,062)
Net profit	**6,088**

Statement of financial position at 31 December

Non-current assets	
Motor van	1,700
Current assets	
Inventory	2,050
Trade receivables	5,060
Cash at bank	2,628
Cash in hand	50
Total assets	**11,488**
Owner's equity (W4)	**5,088**
Current liabilities	
Trade payables	6,400
Total equity and liabilities	**11,488**

W1: Revenue

Gross revenue	28,400
Less Sale returns	(200)
	28,200

W2: Cost of sales

Opening stock (business commenced during the year)	-
Purchases	16,100
Less Closing inventory	(2,050)
	14,050

W3: Operating expenses

Salaries	4,162
Rent and rates	2,130
Insurance	174
General expenses	1,596
	8.062

W4: Owner's equity

Capital introduced	4,100
Profit for the year	6,088
	10,188
Less: Drawings	(5,100)
	5,088

Example: Black

Black – Trial balance as at 31 December 2013

	Debit	Credit
	Rs.	Rs.
Purchases	54,261	
Gross revenue		135,650
Sales returns	50	
Purchase returns		61
Carriage inwards (delivery cost of purchases)	100	
Carriage outwards (cost of deliveries to customers)	150	
Inventory – 1 January 2013	7,500	
Wages and salaries	8,900	
Rent	4,500	
Telephone	560	
Heat and lighting	890	
Motor van running expenses	1,250	
Bank interest	534	
Land and buildings	60,000	
Motor van	5,000	
Payables		5,900
Bank overdraft		6,500
Receivables	8,700	
Cash in hand	150	
Drawings	15,000	
Capital		19,434
	167,545	167,545

Inventory at 31 December 2013 was Rs. 9,500.

Using the above information, prepare the statement of comprehensive income for Black for the year ended 31 December 2013 and a statement of financial position as at that date shall be prepared as follows:

Statement of comprehensive income for the year ended 31 December 2013

	Rs.
Revenue (W1)	135,600
Cost of sales (W2)	(52,300)
Gross profit	**83,300**
Operating expenses (W3)	(16,784)
Net profit	**66,516**

Statement of financial position as at 31 December 2013

	Rs.
Non-current assets	
Land and buildings	60,000
Motor vehicle	5,000
	65,000
Current assets	
Inventory	9,500
Receivables	8,700
Cash in hand	150
	18,350
Total assets	**83,350**
Owner's equity (W4)	**70,950**
Current liabilities	
Bank overdraft	6,500
Payables	5,900
	12,400
Total equity and liabilities	**83,350**

W1: Revenue

Gross revenue	135,650
Less Sale returns	(50)
	135,600

W2: Cost of sales

Opening inventory at 1 January	7,500
Purchases less returns (54,261 – 61)	54,200
	61,700
Carriage inwards	100
	61,800
Less: Closing inventory at 31 December	(9,500)
	52,300

W3: Operating expenses	**Rs.**
Wages and salaries	8,900
Rent	4,500
Telephone	560
Heat and lighting	890
Motor van running expenses	1,250
Carriage outwards	150
Bank interest	534
	16,784

W4: Owner's equity	
At 1 January	19,434
Net profit for the year	66,516
	85,950
Drawings	(15,000)
At 31 December	70,950

Example: Worth

The following is a trial balance for Worth after his first year's trading:

Worth - Trial balance as at 30 June 2013

	DR Rs.(000)	CR Rs.(000)
Revenue		28,794
Purchases	23,803	
Rent	854	
Lighting and heating expenses	422	
Salaries and wages	3,164	
Insurance	105	
Land and buildings	50,000	
Fixtures and fittings	1,000	
Receivables	3,166	
Sundry expenses	506	
Payables		1,206
Cash at bank	3,847	
Drawings	2,400	
Motor vans	5,500	
Motor running expenses	1,133	
Capital		65,900
	95,900	95,900

Inventory at 30 June 2013 was Rs.4,166,000.

A prepare a statement of comprehensive income for the year ended 30 June 2013 and a statement of financial position as at that date shall be prepared as follows:

Statement of comprehensive income for the year ended 30 June 2013

	Rs.(000)
Revenue	28,794
Cost of sales (W1)	(19,637)
Gross profit	**9,157**
Operating expenses (W2)	(6,184)
Net profit	**2,973**

Statement of financial position as at 30 June 2013

	Rs.(000)
Non-current assets	
Land and buildings	50,000
Motor vans	5,500
Fixtures and fittings	1,000
	56,500
Current assets	
Inventory	4,166
Receivables	3,166
Cash at bank	3,847
	11,179
Total assets	**67,679**
Owner's equity (W3)	**66,473**
Current liabilities	
Payables	1,206
Total equity and liabilities	**67,679**

W1: Cost of sales	
Opening stock (business commenced during the year)	-
Purchases	23,803
Less Closing inventory	(4,166)
	19,637

W2: Operating expenses	
Salaries and wages	3,164
Rent	854
Insurance	105
Lighting and heating expenses	422
Sundry expenses	506
Motor running expenses	1,133
	6,184

W3: Owner's equity	**Rs.(000)**
Initial capital at 1 July 2009	65,900
Net profit for the year	2,973
	68,873
Drawings	(2,400)
At 30 June 2013	66,473

Practice question: Steven Chee

The following trial balance was extracted from the main ledger of Steven Chee, a sole trader, as at 31 May 2013 – the end of his financial year.

Steven Chee: Trial balance as at 31 May 2013

	DR	**CR**
	Rs.(000)	**Rs.(000)**
Land and buildings at cost	120,000	
Equipment at cost	80,000	
Accumulated depreciation (as at 1 June 2012)		
On land and buildings		20,000
On equipment		38,000
Purchases	250,000	
Revenue		402,200
Inventory as at 1 June 2012	50,000	
Discounts allowed	18,000	
Discounts received		4,800
Returns outwards		15,000
Wages and salaries	61,800	
Bad debts	4,600	
Loan interest	2,100	
Other operating expenses	17,700	
Trade payables		36,000
Trade receivables	38,000	
Cash in hand	300	
Bank	1,300	
Drawings	24,000	
Allowance for doubtful debts		500
7% long-term loan		30,000
Capital as at 1 June 2012		121,300
	667,800	667,800

The following additional information is available:

(a) Inventory as at 31 May 2013 has been valued at cost at Rs.42,000,000.

(b) There are accrued wages and salaries of Rs.800,000.

(c) Other operating expenses are prepaid by Rs.300,000.

(d) The allowance for doubtful debts is to be adjusted so that it is 2% of trade receivables.

(e) Depreciation for the year ended 31 May 2013 should be provided for as follows:

- Land and buildings – 1.5% per annum on cost, using the straight-line method.
- Equipment – 25% per annum, using the reducing balance method.

Steven Chee's statement of comprehensive income for the year ended 31 May 2013 and his statement of financial position as at that date shall be prepared as follows:

Statement of comprehensive income for the year ended 31 May 2013

	Rs.(000)
Revenue	402,200
Cost of sales (W1)	(243,000)
Gross profit	**159,200**
Operating expenses (W2)	(117,260)
Other income (W3)	4,800
Net profit	**46,740**

Statement of financial position as at 31 May 2013

Non-current assets	**Rs.(000)**
Land and buildings (W5)	98,200
Equipment (W5)	31,500
	129,700
Current assets:	
Inventory	42,000
Trade receivables (W6)	37,240
Prepayment	300
Bank	1,300
Cash in hand	300
	81,140
Total assets	**210,840**
Owner's Equity (W7)	**144,040**
Non-current liabilities	
7% long-term loan	30,000
Current liabilities	
Trade payables	36,000
Accrued wages and salaries	800
	36,800
Total equity and liabilities	**210,840**

W1 – Cost of sales	**Rs.(000)**
Opening inventory at 1 June 2012	50,000
Purchases less returns (250,000 – 15,000)	235,000
	285,000
Less: Closing inventory at 31 May 2013	(42,000)
Cost of sale	243,000

W2 – Operating expenses

Wages and salaries (61,800 + accrual 800)	62,600
Other operating expenses (17,700 – prepayment 300)	17,400
Depreciation, land and buildings: (1.5% x 120,000,000)	1,800
Depreciation, equipment: (25% x (80,000 – 38,000))	10,500
Discounts allowed	18,000
Loan interest	2,100
Bad debts	4,600
Increase in allowance for doubtful debts (W4)	260
	117,260

W3 – Other income

Discounts received	4,800

W4

Allowance for doubtful debts at 31 May 2013: (2% x 38,000)	760
Allowance for doubtful debts at 1 June 2012	(500)
Increase in allowance	260

W5 – Property, plant and equipment

	Cost	**Accumulated depreciation**	**Carrying Amount**
		Rs.(000)	
Land and buildings	120,000	21,800	98,200
Equipment	80,000	48,500	31,500
	200,000	70,300	129,700

	Rs.(000)
W6 – Trade receivable	
Trade receivables (W6)	38,000
Less allowance for doubtful debts	(760)
	37,240

W7 – Owners' Equity

At 1 June 2012	121,300
Net profit for the year	46,740
	168,040
Drawings	(24,000)
At 31 May 2013	144,040

Practice question: Herbert **1**

The following trial balance has been extracted from the ledger of Herbert, a sole trader, as at 31 May 2013, the end of his most recent financial year.

Herbert: Trial balance as at 31 May 2013

	DR Rs.(000)	CR Rs.(000)
Land and buildings at cost	90,000	
Equipment at cost	57,500	
Accumulated depreciation (as at 1 June 2012)		
On land and buildings		12,500
On equipment		32,500
Inventory as at 1 June 2012	27,400	
Revenue		405,000
Purchases	259,600	
Discounts allowed	3,370	
Discounts received		4,420
Wages and salaries	52,360	
Bad debts	1,720	
Loan interest	1,560	
Other operating expenses	38,800	
Trade receivables	46,200	
Trade payables		33,600
Allowance for doubtful debts		280
Cash in hand	151	
Bank overdraft		14,500
Carriage out	5,310	
Drawings	28,930	
10% loan		15,600
Capital as at 1 June 2012		94,501
	612,901	612,901

The following additional information as at 31 May 2013 is available:

(a) Inventory as at 31 May 2013 was valued at Rs.25,900,000.

(b) Depreciation for the year ended 31 May 2013 has yet to be provided as follows:

- Property – 1% using the straight-line method;
- Equipment – 15% using the straight-line method.

(c) There are accrued wages and salaries of Rs.140,000.

(d) Other operating expenses include some prepaid expenses of Rs.500,000 and some accrued expenses of Rs.200,000.

(e) The allowance for doubtful debts should be adjusted to 5% of trade receivables as at 31 May 2013.

(f) The amount for purchases includes goods valued at Rs.1,040,000 which were withdrawn by Herbert for his own personal use.

Required

Prepare Herbert's statement of comprehensive income for the year ended 31 May 2013 and his statement of financial position as at that date.

Practice question: Bradbury and Co **2**

The following trial balance has been extracted from the ledger of Bradbury and Co, as at 31 December 2013, the end of its most recent financial year.

Bradbury and Co: Trial balance as at 31 December 2013

	DR	CR
	Rs.	Rs.
Plant and machinery at cost	920,000	
Allowance for depreciation (as at 1 January 2013)		215,000
Inventory as at 1 January 2013	39,000	
Revenue		1,292,000
Purchases	550,000	
Capital		173,000
Distribution expenses	116,000	
Administrative expenses	241,000	
Bad debts	23,500	
Loan (charging interest at 6%)		400,000
Receivables control account	200,000	
Payables control account		73,500
Allowance for doubtful debts		6,000
Interest paid on bonds	12,000	
Bank	58,000	
	2,159,500	2,159,500

The following additional information as at 31 December 2013 is available:

(a) Inventory as at 31 December 2013 was valued at Rs.35,000.

(b) Depreciation on plant and machinery for the year ended 31 December 2013 is to be provided at the rate of 10% of cost.

(c) There are accrued distribution expenses of Rs.7,500 and prepaid administrative expenses of Rs.4,000.

(d) The allowance for doubtful debts should be adjusted to 2% of trade receivables as at 31 December 2013

(e) No interest has been accrued on the loan.

Required

Prepare the statement of comprehensive income of Bradbury and Co for the year ended 31 December 2013 and its statement of financial position as at that date in a format suitable for publication.

Practice question: Maria **3**

The following information relates to the business of Maria for the year ended 31 December 2012.

	Rs.	Rs.
Capital account, 1 January 2012		13,640
Freehold properties at cost	7,500	
Furniture and fittings at cost	2,000	
Motor cars at cost	6,300	
Accumulated depreciation to 1 January		
Freehold properties		450
Furniture and fittings		800
Motor cars		2,370
Inventory 1 January	6,740	
Purchases	54,520	
Revenue		79,060
Salaries	8,760	
Rates	1,170	
Office expenses	3,950	
Motor expenses	3,790	
Drawings	4,800	
Allowance for doubtful debts 1 January		600
Loan		4,000
Trade receivables	9,240	
Trade payables		10,040
Bank balance	2,190	
	110,960	110,960

You are also supplied with the following information.

(1) Inventory at 31 December 2012 was Rs.7,330.

(2) Rates paid in advance at 31 December 2012 amounted to Rs.250.

(3) Allowance for doubtful debts is to be made equal to 5% of accounts receivable at 31 December 2012.

(4) Depreciation is to be provided for the year at the following annual rates calculated on cost at the year end

Freehold properties	1%
Furniture and fittings	10%
Motor cars	20%

(5) Interest on the loan at 5% per annum is to be provided.

Required:

Prepare a statement of comprehensive income for the year ended 31 December 2012 and a statement of financial position at that date.

Practice question: Scotty **4**

Scotty is in business as an antique dealer. The trial balance of his business at 1 January 2013 was as follows.

	Dr	Cr
	Rs.(000)	Rs.(000)
Capital		5,000
Cash	4,200	
Motor van	600	
Trade payable – A		200
Trade receivable – B	300	
Rates prepaid	100	
	5,200	5,200

Cash transactions during the period to 31 March 2013 were

	Rs.(000)
Purchases	2,000
Revenue	3,000
Drawings	500
Motor running expenses	350
Rates	250

At 31 March inventory was Rs.700,000 and rates paid in advance amounted to Rs.150,000.

Required:

(a) Prepare the trial balance at 31 March 2013.

(b) Prepare the statement of comprehensive income for the period to 31 March 2013 and a statement of financial position at that date.

Practice question: Sulu **5**

The following list of account balances was extracted from the books of Sulu at 30 April 2013.

	Dr	Cr
	Rs.(000)	Rs.(000)
Revenue		18,955
Purchases	12,556	
Inventory 1 May 2012	3,776	
Salaries and wages	2,447	
Motor expenses	664	
Rent	456	
Rates	120	
Insurance	146	
Packing expenses	276	
Lighting and heating expenses	665	
Sundry expenses	115	
Motor vehicles	2,400	
Fixtures and fittings	600	
Trade receivables	4,577	
Trade payables		3,045
Cash at bank	3,876	
Cash in hand	120	
Drawings	2,050	
Capital		12,844
	34,844	34,844

Notes at 30 April

(1) Expenses which have been prepaid – Rates Rs.20,000; Insurance Rs.35,000.

(2) Expenses which are owing – Motor expenses Rs.56,000; Rent Rs.24,000; Sundry expenses Rs.26,000.

(3) Inventory Rs.4,998,000.

Required:

From the list of balances and the notes prepare Sulu's statement of comprehensive income for the year ended 30 April 2013 and a statement of financial position at that date.

Practice question: Federov **6**

The following is the trial balance extracted from the books of Federov at 31 December 2012.

	Rs.	Rs.
Capital		20,000
Loan account		2,000
Drawings	1,750	
Freehold premises	8,000	
Furniture and fittings – cost and accumulated depreciation at 1 January	700	200
Plant and machinery – cost and accumulated depreciation at 1 January	8,000	2,500
Inventory at 1 January	8,000	
Cash at bank	650	
Allowance for doubtful debts		740
Purchases	86,046	
Revenue		124,450
Bad debts	256	
Bad debts recovered		45
Trade receivables	20,280	
Trade payables		10,056
Bank charges	120	
Rent	2,000	
Returns inwards	186	
Returns outwards		135
Salaries	3,500	
Wages	8,250	
Travelling expenses	1,040	
Carriage inwards	156	
Discounts allowed	48	
Discounts received		138
General expenses	2,056	
Gas, electricity and water	2,560	
Carriage outwards	546	
Travellers' salaries and commission	5,480	
Printing and stationery	640	
	160,264	160,264

The following matters should be taken into account.

(1) Inventory at 31 December 2012 was Rs.7,550.

(2) Federov's son works in the business, receiving a salary of Rs.500 pa, which had been included in the drawings.

(3) Interest on the loan at 5% pa had not been paid at 31 December 2012.

(4) Rent includes Rs.250 for premises paid in advance for the half year to 31 March next.

(5) Depreciation is to be provided at the following rates on the reducing balance basis.

Plant and equipment by 10% pa

Furniture and fittings by 5% pa

(6) The allowance for doubtful debts is to be maintained at 3% of trade accounts receivable.

Required:

Prepare the statement of comprehensive income for the year ended 31 December 2012 and the statement of financial position at that date.

Practice question: Stewart 7

Stewart is a sole trader, supplying building materials to local builders. He prepares his accounts to 30 June each year. At June 30 2013, his trial balance was as follows:

	Dr	Cr
	Rs.	Rs.
Capital at 1 July 2012		55,550
Purchases and sales	324,500	625,000
Returns	2,300	1,700
Discounts	1,500	2,500
Building materials at 1 July 2012	98,200	
Packing materials purchased	12,900	
Distribution costs	17,000	
Rent, rates and insurance	5,100	
Telephone	3,200	
Car expenses	2,400	
Wages	71,700	
Allowance for doubtful debts at 1 July 2012		1,000
Heat and light	1,850	
Sundry expenses	6,700	
Delivery vehicles – cost	112,500	
Delivery vehicles – depreciation at 1 July 2012		35,000
Equipment – cost	15,000	
Equipment – depreciation at 1 July 2012		5,000
Trade receivables and payables	95,000	82,000
Loan		10,000
Loan repayments	6,400	
Bank deposit account	15,000	
Bank current account	26,500	
	817,750	817,750

The following additional information at 30 June 2013 is available:

(i)	Inventory of building materials	Rs.75,300
	Inventory of packing materials	Rs.700

There was also an unpaid invoice of Rs.200 for packing materials received and consumed during the year.

(ii) Prepayments:

– rent, rates and insurance	Rs.450

(iii) Accrued expenses:

– heat and light	Rs.400
– telephone	Rs.500

(iv) Wages include Rs.23,800 cash withdrawn by Stewart.

(v) Trade receivables have been analysed as follows:

	Rs.
Current month	60,000
30 to 60 days	20,000
60 to 90 days	12,000
over 90 days	3,000

Allowance is to be made for doubtful debts as follows:

30 to 60 days	1%	
60 to 90 days	2.5%	
over 90 days	5%	(after writing off Rs.600)

(vi) Sundry expenses includes Rs.3,500 for Stewart's personal tax bill.

(vii) The loan was taken out some years ago, the final payment is due on 31 March 2014. The figure shown in the trial balance for "loan repayments" includes interest of Rs.800 for the year.

(viii) The bank deposit account was opened on 1 January 2013 as a short-term investment; interest is credited at 31 December annually; the average rate of interest since opening the account has been 6% per annum.

(ix) At 1 July 2012, Stewart decided to bring one of his family cars, valued at Rs.8,000, into the business. No entries have been made in the business books for its introduction.

(x) Depreciation is to be provided as follows:

- 20% on cost for delivery vehicles
- 25% on the reducing balance for the car
- 25% on the reducing balance for the equipment

Required:

(a) Prepare a statement of comprehensive income for the year ended 30 June 2013.

(b) Prepare a statement of financial position at 30 June 2013.

Practice question: Mr. Bowie **8**

Mr Bowie is a sole trader and prepares his accounts to 30 September each year. At 30 September 2013, his trial balance is as follows:

	Dr	Cr
	Rs.	Rs.
Plant and machinery		
– cost	125,000	
– depreciation at 1 October 2012		28,000
Office equipment		
– cost	45,000	
– depreciation at 1 October 2012		15,000
Inventory at 1 October 2012	31,000	
Purchases and sales	123,000	194,000
Selling expenses	12,000	
Heat and light	8,000	
Wages and salaries	19,000	
Printing and stationery	6,000	
Telephone and fax	6,000	
Rent, rates and insurances	4,000	
Trade receivables and payables	35,000	33,000
Allowance for doubtful debts at 1 October 2012		4,000
Bank	3,000	
Petty cash	1,000	
Drawings	22,000	
Capital at 1 October 2012		169,000
Suspense account	3,000	
	443,000	443,000

The following additional information at 30 September 2013 is available:

(i)	Closing Inventory goods for resale	Rs.53,000
(ii)	Prepayments:	
	– telephone and fax rental	Rs.1,000
	– rates and insurance	Rs.1,000
(iii)	Accruals:	
	– wages and salaries	Rs.5,000

(iv) Specific bad debts to be written off amount to Rs.3,000.

(v) Allowance for doubtful debts to be amended to 5% of debtors, after adjusting for bad debts written off.

(vi) The following book-keeping errors are discovered:

- the purchase of an item of inventory has been debited to the office equipment account, cost Rs.1,200.
- the payment of Rs.1,300 to a trade payable has been recorded by debiting the bank account and crediting the trade payable's account
- a payment of rent of Rs.1,500 has been credited to the bank and credited to the rent account.

(vii) The figure in the trial balance for the bank balance is the balance appearing in the cash book, prior to the reconciliation with the bank statement. Upon reconciliation, it is discovered that:

- unpresented cheques amount to Rs.3,000; and
- bank charges not entered in the ledgers amount to Rs.4,000.

(viii) Depreciation of non-current assets is to be provided as follows:

- plant and machinery 10% on cost
- office equipment 331/3 % on the reducing balance at the end of the year.

Required:

(a) Show the journal entries and suspense account to correct the bookkeeping errors identified in note (vi). (Narrative descriptions are not required)

(b) Prepare a statement of comprehensive income for the year ended 30 September 2013.

(c) Prepare a statement of financial position at 30 September 2013.

Practice question: Sofia Trader **9**

Following is the trial balance of Sofia Trader (ST) for the year ended 30 June 2018:

	Debit	Credit
	—— Rs.'000 ——	
Equipment - cost	17,000	
Equipment - accumulated depreciation - 1 Jul 2017		4,800
Vehicles - cost	3,000	
Vehicles - accumulated depreciation - 1 Jul 2017		1,200
Inventory - 1 Jul 2017	5,500	
Trade receivables	5,350	
Provision for doubtful receivables		220
Prepaid insurance - 1 Jul 2017	140	
Advance	384	
Bank deposit (invested on 1 Feb 2017 at 7%)	1,400	
Cash and bank balances	620	
Capital		16,000

	Debit	Credit
	—— Rs.'000 ——	
Drawings	352	
Trade payables		3,500
Accruals and other payables		1,520
Sales		32,350
Purchases	21,000	
Returns	950	700
Salaries and utilities	2,790	
Rent	1,000	
Discounts	270	220
Other expenses	480	
Insurance	300	
Bad debts	106	
Interest income on bank deposit		82
Suspense account		50
	60,642	60,642

Following further information is available:

i. Cost of closing physical inventory was Rs. 7,400,000. Inventory included goods costing Rs. 240,000 which were damaged in the warehouse. These goods can be sold for Rs. 250,000 after incurring a cost of Rs. 16,000.

ii. Rent includes payment of annual rent of Rs. 240,000 expiring on 30 November 2018 for owner's residence.

iii. Prepaid insurance represents premium which expired on 31 January 2018 while insurance represents annual premium which is expiring on 31 January 2019.

iv. Suspense account represents goods returned by ST which were debited to supplier's account.

v. On 29 June 2018, dishonoured cheque of Rs. 285,000 was returned by a bank. No entry has been made in the books for this return. This cheque was received from a customer net of 5% settlement discount.

vi. ST maintains a 4% provision against trade receivables.

vii. ST paid Rs. 388,000 (net of 3% settlement discount) which was debited to supplier's account with the same amount.

viii. On 1 March 2018, an equipment was sold for Rs. 400,000 and its sale proceeds were credited to the equipment account. This equipment had been purchased at a cost of Rs. 500,000 and on 1 July 2017 its book value was Rs. 360,000.

ix. Advance represents 40% payment made for purchase of vehicle. Remaining balance would be paid in September 2018. No entry was passed when the vehicle was delivered on 1 June 2018.

x. ST depreciates equipment and vehicles at 15% and 25% respectively using reducing balance method.

Required:

a) Prepare statement of profit or loss for the year ended 30 June 2018

b) Prepare statement of financial position as at 30 June 2018.

Practice question: Tulip Enterprises

10

Following is the trial balance of Tulip Enterprises (TE) for the year ended 31 December 2017:

Rs. in '000

	Debit		Credit
Cash and bank balances	2,320	Trade payables	3,250
Trade receivables	4,400	Accruals and other payables	1,320
Stock-in-trade 31-12-2017	3,900	Provision for doubtful receivables	220
Prepayments and advances	1,740	Accumulated depreciation	4,630
Property, plant & equipment – cost	12,500	12% Long-term loan	5,150
Drawings	490	Capital	6,000
Cost of sales	23,580	Sales	35,230
Salaries and wages	2,610	Miscellaneous income	940
Fuel and power	450		
Bad debt expense	230		
Rent and insurance	2,900		
Repair and maintenance	920		
Financial charges	700		
	56,740		56,740

Additional information:

i. While carrying out the physical inventory count at year-end, following matters were identified:

- Goods costing Rs. 1,000,000 were slightly defective. These can be sold for Rs. 1,130,000 after incurring a cost of Rs. 200,000.
- Goods costing Rs. 670,000 purchased on credit were returned to a supplier on 28 December 2017 but the return was not recorded in the books.

ii. A machine costing Rs. 450,000 was received on 1 October 2017 against 100% advance payment. The advance has not yet been adjusted due to non-receipt of the invoice.

iii. On 1 October 2017, 50% advance received for an annual maintenance contract of Rs. 480,000 was credited to miscellaneous income. Remaining amount would be received at the end of the contract. Services are rendered evenly throughout the contract period.

iv. Maintenance services for Rs. 150,000 were rendered in December 2017 but income has been recorded in January 2018 on receipt of the amount.

v. Interest on the loan is paid in arrears on 1 April and 1 October each year. Interest accrued for the quarter ended 31 December 2017 has been credited to loan account.

vi. Rent and insurance include:

- annual insurance premium of Rs. 800,000 for the health policy arranged by TE for the department heads and the owner's family members. Premium pertaining to the owner's family members is Rs. 200,000. The policy is valid up to 30 June 2018.
- Rs. 1,200,000 paid against the annual rent agreement expiring on 31 August 2018. According to the rent agreement, the rent paid would not be refunded in case the building is vacated earlier.

vii. TE maintains provision for doubtful receivables according to the age analysis of the outstanding balances. Relevant details are as un1der:

	Trade receivables as on 31 December 2017				**Total**
	Less than 3 months	**4-6 months**	**7-12 months**	**More than 1 year**	
Outstanding balances (Rs. in '000)	1,970	1,000	900	530	4,400
Required provision	-	5%	10%	20%	

viii. TE depreciates property, plant & equipment at 15% per annum on reducing balance method.

Required:

Prepare the following:

a) Statement of profit or loss for the year ended 31 December 2017

b) Statement of financial position as at 31 December 2017.

Practice question: Home Appliances **11**

Following is the summarised trial balance of Home Appliances (HA) for the year ended 30 June 2017:

	Debit	**Credit**
	── Rs. in '000 ──	
Fixed assets – cost	35,000	
Accumulated depreciation – 1 July 2016		8,000
Inventory – 1 July 2016	8,200	
Trade receivables	12,500	
Provision for doubtful receivables – 1 July 2016		750
Prepayments and other receivables	2,350	
Cash and bank balances	1,300	
Capital		25,500
Drawings	4,500	
Trade payables		10,200
Accruals and other payables		5,310
Sales		101,120

	Debit	Credit
	── Rs. in '000 ──	
Return inwards	3,000	
Purchases	70,000	
Wages and salaries	5,900	
Discounts	1,600	
Utility charges	2,350	
Carriage inwards	1,360	
Running and maintenance expenses	3,290	
Financial charges	580	
Miscellaneous income		110
Suspense account		940
	151,930	151,930

Additional information:

i. Cost of closing physical inventory was Rs. 9,000,000. However, goods returned by a credit customer on 30 June 2017 were received after completion of the count, therefore, not included in the inventory. These goods had been sold for Rs. 400,000 at cost plus 25%. However, the goods are damaged and can be sold at normal price after a repair cost of Rs. 90,000. The return has not yet been accounted for.

ii. Suspense account represents an online transfer of funds by a customer who availed 5% discount on settlement of the pending amount by 30 June 2017. The amount was credited by the bank net of its charges of Rs. 10,000.

iii. HA maintains a 5% provision against trade receivables.

iv. Running and maintenance expenses totaling Rs. 110,000 were incurred in June 2017.

v. Related invoices were received and accounted for in July 2017.

vi. A machine was rented-out to Zee Trader (ZT) on 1 October 2016. Annual rent of Rs. 120,000 received in advance is included in 'Accruals and other payables'. However, on 16 June 2017, the machine was sold to ZT for Rs. 450,000. The sale proceed net of rent adjustment was received in July 2017. The disposal has not yet been accounted for.

The machine had been purchased on 1 January 2016 and had written down value of Rs. 540,000 as at 1 July 2016.

vii. HA depreciates its fixed assets at 20% per annum from the month of addition to the month prior to disposal using reducing balance method. There were no additions/disposals during the year except as mentioned above.

Required:

a) Prepare statement of profit or loss for the year ended 30 June 2017.

b) Prepare statement of financial position as at 30 June 2017.

Practice question: Rainbow Lights **12**

Following is the summarised trial balance of Rainbow Lights (RL) for the year ended 31 December 2016:

	Debit	Credit
	—— Rs. in million ——	
Capital – 1 January 2016		100
Profit and loss account – 1 January 2016	30	
Drawings	50	
Fixed assets – cost	270	
Accumulated depreciation		150
Closing inventory	170	
Trade debtors	400	
Provision for doubtful debts		12
Prepayments and other receivables	45	
Cash and bank	20	
10% Long-term loan		120
Trade creditors		240
Accruals and other payables		28
Sales		750
Cost of sales	304	
Selling and administration expenses	146	
Financial charges	10	
Miscellaneous income		45
	1,445	1,445

Additional information:

i. RL uses perpetual inventory method to record its inventory. During the physical inventory count carried out on 31 December 2016, following matters were noted:

   - Inventory shortages amounted to Rs. 2 million which is considered to be normal.
   - Goods costing Rs. 15 million were damaged in fire and have no sales value.
   - Goods costing Rs. 1 million were withdrawn by the owner for his personal use but no adjustment was made in the books.
   - Goods sold on credit for Rs. 7 million were returned but have not been accounted for. These goods were sold at cost plus 40%.

ii. Goods sold on credit at a trade discount of 5% were recorded at gross amount of Rs. 20 million.

iii. Rs. 2 million were recovered in full and final settlement of an old outstanding balance of Rs. 3 million which had been written-off last year. The amount recovered was credited to trade debtors account.

iv. RL maintains a provision for doubtful debts at 3% of the year-end balance.

v. Miscellaneous income includes Rs. 12 million received against an annual maintenance contract expiring on 30 April 2017.

vi. Annual rent amounting to Rs. 24 million was paid in advance on 1 October 2016 and charged as an expense.

vii. Long-term loan was acquired on 1 February 2016 and is repayable in 2020. Interest thereon is due semi-annually on 1 August and 1 February each year. Interest is charged to expenses at the time of payment.

viii. An equipment costing Rs. 8 million was purchased on 1 September 2016 against advance payment. The equipment was not used and returned on 31 December 2016. The supplier agreed to set-off the cost of the equipment against the amount payable by RL. The return as well as reversal of depreciation is yet to be recorded in the books.

ix. Depreciation on fixed assets is charged at 15% per annum from the month of addition to the month prior to disposal using reducing balance method.

Required:

a) A statement of comprehensive income for the year ended 31 December 2016.

b) A statement of financial position as at 31 December 2016.

Practice question: Fortune Traders **13**

Following is the summarised trial balance of Fortune Traders (FT) for the year ended 30 June 2016:

	Debit	Credit
	── Rs. in '000 ──	
Buildings - cost	3,700	
Buildings - accumulated depreciation as at 1 July 2015		1,436
Plant and machinery - cost	6,650	
Plant and machinery - accumulated depreciation as at 1 July 2015		2,414
Stock-in-trade as at 1 July 2015	1,045	
Purchases	16,000	
Purchase returns		220
Sales		28,900
Sales returns	90	
Capital as at 1 July 2015		3,000
Selling and administration expenses	5,855	
12% loan payable		5,000
Trade receivables	3,600	
Provision for doubtful debts as at 1 July 2015		180
Prepayments and other receivables	380	
Trade and other payables		2,080
Cash and bank balances	5,850	
Suspense account	60	
	43,230	43,230

Additional information:

i. FT depreciates its fixed assets from the month of addition. Depreciation is to be charged on written-down value (WDV) as follows:

Buildings	5%
Plant & machinery	10%

ii. On 1 March 2016, FT paid an advance of Rs. 330,000 for purchase of a machine and debited it to plant and machinery. The machine was delivered on 1 September 2016.

iii. Closing inventory was valued at Rs. 1,560,000. This included goods costing Rs. 35,000 returned by a customer on 30 June 2016 but not yet accounted for. These goods were earlier sold at cost plus 40%.

iv. The loan was acquired on 1 January 2016 and the principal amount is repayable in eight equal half yearly installments commencing from 1 January 2017. Interest is payable half yearly on 1 January and 1 July each year.

v. Selling and administration expenses include fire insurance premium amounting to Rs. 430,000 and Rs. 240,000 paid for office and owner's personal premises respectively. The policies are valid upto 31 December 2016.

vi. Rent and salaries amounting to Rs. 137,000 and Rs. 89,000 respectively are to be accrued at 30 June 2016.

vii. At 30 June 2016, the provision for doubtful debts is to be reduced by Rs. 30,000.

viii. Suspense account represents an error which occurred when a credit note of Rs. 30,000 received for goods returned to a supplier was mistakenly posted as credit to trade payable account.

Required:

a) Prepare a statement of comprehensive income for the year ended 30 June 2016.

b) Prepare a statement of financial position as at 30 June 2016.

Practice question: Moon Trading **14**

Following summarised trial balance as at 31 December 2015 pertains to Moon Trading (MT) who deals in office machines:

	Debit	Credit
	—— Rs. in million ——	
Fixed assets at cost	150	
Accumulated depreciation		45
Trade debtors	200	
Provision for doubtful debts		6
Inventory	410	
Prepayments, advances and other receivables	9	
Cash and bank balances	5	
Capital		50
Bank loan		160
Trade creditors		320

	Debit	Credit
	—— Rs. in million ——	
Accruals and other payables		25
Sales revenue		2,840
Purchases	2,141	
Selling and administration expenses	540	
Interest on bank loan	8	
Bank charges	2	
Other income		15
Suspense account		4
	3,465	3,465

Additional information:

i. Inventory is valued under the FIFO method. Value of inventory as at 31 December 2015 amounted to Rs. 530 million.

ii. During stock taking, it was noted that:

- A photocopy machine appearing in inventory is being used in the office since 1 October 2015. The cost of the machine is Rs. 0.78 million.
- Four computers were found to be short. It was discovered that these computers costing Rs. 0.32 million had been issued for use by the proprietor's family members.
- Items costing Rs. 4.5 million were returned to a supplier on 31 December 2015. The return was recorded in January 2016.
- Items having invoice value of Rs. 2.4 million sold on credit were returned by a customer on 31 December 2015. A credit note was issued and recorded by MT on 12 January 2016. The profit margin on these items was 20% of cost.

iii. Depreciation is charged on all fixed assets at 20% per annum under the straight line method.

iv. A recovery of Rs. 3.5 million against debts written off in prior years was credited to trade debtors. MT's policy is to provide doubtful debts at 3% on year-end balance.

v. Review of other income revealed the following information:

- Services for certain contracts amounting to Rs. 1.2 million were rendered in December 2015 but invoices thereof were processed in January 2016.
- On 1 August 2015, MT received an amount of Rs. 1.8 million as 50% advance against a maintenance contract covering the period from 1 September 2015 to 31 May 2016 and was credited to other income. The balance amount would be paid on completion of the contract.

vi. Office supplies purchased during the year are directly debited to expenses. Unused office supplies at beginning and close of the year amounted to Rs. 0.45 million and Rs. 0.6 million respectively.

vii. The bank loan was acquired on 1 April 2015. The principal amount is repayable in five equal annual instalments on 31 March each year. Interest is payable at 10% per annum on six monthly basis and is recorded at the time of payment.

viii. Suspense account represents a commission (net of bank charges amounting to Rs. 0.25 million) received on 1 September 2015.

Required:

a) Prepare a statement of comprehensive income for the year ended 31 December 2015.

b) Prepare a statement of financial position as at 31 December 2015.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Statement of comprehensive income for the year ended 31 May 2013

	Rs.(000)
Revenue	405,000
Cost of sales (W1)	(260,060)
Gross profit	**144,940**
Operating expenses (W3)	(114,515)
Other income (W6)	4,420
Net profit	**34,845**

Workings

W1 – Cost of sales	**Rs.(000)**
Opening inventory at 1 June 2012	27,400
Purchases (W2)	258,560
	285,960
Less: Closing inventory at 31 May 2013	(25,900)
	260,060

W2 - Purchases	**Rs.(000)**
Purchases in the trial balance	259,600
Less: goods taken by the owner for his own use	(1,040)
	258,560

W3 – Operating expenses	**Rs.(000)**
Wages and salaries (52,360 + accrual 140)	52,500
Other operating expenses (W4)	38,500
Depreciation, land and buildings: (1% x Rs.90,000)	900
Depreciation, equipment: (15% x Rs.57,500,000)	8,625
Carriage out	5,310
Discounts allowed	3,370
Loan interest	1,560
Bad debts	1,720
Increase in allowance for doubtful debts (W5)	2,030
	114,515

W4 – Other operating expenses	**Rs.(000)**
Expenses in the trial balance	38,800
Add: accrual	200
Less: prepayment	(500)
Expenses in the statement of comprehensive income	38,500

W5 – Change in allowance for doubtful debts	**Rs.(000)**
Allowance for doubtful debts at 31 May 2013: (5% x 46,200,000)	2,310
Allowance for doubtful debts at 1 June 2012	(280)
Increase in allowance	2,030

W6 – Other income	**Rs.(000)**
Discounts received	4,420

Statement of financial position as at 31 May 2013

	Rs.(000)
Non-current assets	
Land and buildings (W7)	76,600
Equipment (W7)	16,375
	92,975
Current assets	
Inventory	25,900
Trade receivables (46,200 – 2,310)	43,890
Prepayments	500
Cash in hand	151
	70,441
Total assets	**163,416**
Owner's Equity (W8)	**99,376**
Non-current liabilities	
10% loan	15,600
Current liabilities	
Bank overdraft	14,500
Trade payables	33,600
Accruals (140 wages + 200 operating expenses)	340
	48,440
Total equity and liabilities	**163,416**

W7 - Non-current assets

	Cost	Accumulated depreciation	Carrying amount
	----------	Rs.(000)	----------
Land and buildings	90,000	13,400	76,600
Equipment	57,500	41,125	16,375
	147,500	54,525	92,975

W8 - Owner's Equity	**Rs.(000)**
At 1 June 2012	94,501
Net profit for the year	34,845
	129,346
Drawings (28,930 + 1,040)	(29,970)
At 31 May 2013	99,376

Solutions **2**

Bradbury and Co: Statement of comprehensive income for the year ended 31 December 2013

	Rs.
Revenue	1,292,000
Cost of sales (W1)	(554,000)
Gross profit	**738,000**
Operating expenses	(498,000)
Net Profit	**240,000**

Bradbury Limited: Statement of financial position as at 31 December 2013

Non-current assets	**Rs.**
Plant and machinery (W3)	613,000
Current assets	
Inventory	35,000
Receivables (200,000 – 4,000 allowance)	196,000
Prepayment	4,000
Bank	58,000
	293,000
Total assets	**906,000**

	Rs.
Owner's Equity (W4)	**413,000**
Non-current laibilities	
Loan	400,000
Current liabilities	
Payables	73,500
Accruals	19,500
Total equity and liabilities	**906,000**

Workings

W1- Cost of sales	**Rs.**
Opening inventory at 1 January 2013	39,000
Purchases	550,000
	589,000
Less: Closing inventory at 31 December 2013	(35,000)
	554,000

W2 – Operating expenses	**Rs.**
Administrative expenses (241,000 – 4,000 prepayment)	237,000
Distribution expenses (116,000 + 7,500 accrual)	123,500
Depreciation, land and buildings: (10% x Rs.920,000)	92,000
Bad and doubtful debts (see W2A)	21,500
Bond interest (6% x Rs.400,000)	24,000
	498,000

W2A - Bad and doubtful debts	**Rs.**
Allowance for doubtful debts at 31 December 2013: (2% x Rs.200,000)	4,000
Allowance for doubtful debts at 1 January 2013	(6,000)
Reduction in allowance	(2,000)
	23,500
Bad and doubtful debts expense	21,500

W3 - Non-current assets	**Rs.**
Plant and machinery at cost	920,000
Accumulated depreciation (Rs.215,000 + Rs.92,000)	(307,000)
	613,000

W4 – Owner's equity	Rs.
Capital at 1 January 2013	173,000
Profit for the year	240,000
Capital at 31 December 2013	413,000

Solutions **3**

Statement of comprehensive income for the year to 31 December 2012

	Rs.
Revenue	79,060
Cost of sales (W1)	(53,930)
Gross profit	**25,130**
Operating expenses (W2)	(19,071)
Net profit	**6,113**

Statement of financial position at 31 December 2012	**Rs.**
Non-current assets (W3)	**10,645**
Current assets	
Inventory	7,330
Trade receivables - net (W4)	8,778
Prepayments	250
Bank balance	2,190
Total Assets	**29,193**
Owners' equity (W5)	**14,953**
Non-current liabilities: Loan	4,000
Current liabilities	
Trade payables	10,040
Accrued expenses	200
	10,240
Total equity and liabilities	**29,193**

W1- Cost of sales	**Rs.**
Opening inventory	6,740
Purchases	54,520
	61,260
Closing inventory	(7,330)
	53,930

W2 – Operating expenses	**Rs.**
Salaries	8,760
Rates (1,170 – 250)	920
Office expenses	3,950
Motor expenses	3,790
Doubtful debt allowance written back (W)	(138)
Loan interest (5% x Rs.4,000)	200
Depreciation	1,535
	19,017

W3 – Non-current assets

	Cost	***Depn***	***NBV***
	---------------- Rs.		**----------------**
Freehold properties	7,500	525	6,975
Furniture and fittings	2,000	1,000	1,000
Motor vans	6,300	3,630	2,670
	15,800	5,155	10,645

W4 – Allowance for doubtful debts

	Rs.		**Rs.**
SOCI		Balance b/d	600
(allowance no longer required)	138		
Balance c/d (5% × Rs.9,240)	462		
	600		600

W5 – Owner's equity	**Rs.**
Capital at 1 January 2012	13,640
Profit for year	6,113
	19,753
Drawings	(4,800)

Solutions **4**

(a) Trial balance at 31 March 2013

	Dr Rs.(000)	Cr Rs.(000)
Capital		5,000
Cash at bank (W)	4,100	
Motor van	600	
Trade payable A		200
Trade receivable B	300	
Rates	350	
Purchases	2,000	
Revenue		3,000
Drawings	500	
Motor running expenses	350	
	8,200	8,200

WORKING

Bank a/c

	Rs.(000)		Rs.(000)
Balance b/d	4,200	Purchases a/c	2,000
Revenue a/c	3,000	Drawings a/c	500
		Motor running expenses a/c	350
		Rates a/c	250
		Balance c/d	4,100
	7,200		7,200

(b) Statement of comprehensive income for the three months ended 31 March 2013

	Rs.(000)
Revenue	3,000
Cost of sales (W1)	(1,300)
Gross profit	**1,700**
Operating expenses (W2)	(550)
Net profit	**1,150**

Statement of financial position at 31 March 2013

	Rs.(000)
Non-current assets	
Motor van	600
Current assets	
Inventory	700
Trade receivables	300
Prepayment	150
Cash	4,100
Total assets	**5,850**

Owner's equity (W3)	**5,650**
Current liabilities	
Trade payables	200
Total quity and liabilities	**5,850**

W1 – Cost of sales

Opening inventory	-
Purchases	2,000
Closing inventory	(700)
	1,300

W2 – Operating expenses

Motor running expenses	350
Rates (350 – 150)	200
	550

W3 – Owner's equity

At 1 January	5,000
Add Net profit for the period	1,150
	6,150
Less Drawings	(500)
	5,650

Solutions **5**

Statement of comprehensive income for the year ended 30 April 2013

	Rs.(000)
Revenue	18,955
Cost of sales (W1)	(11,334)
Gross profit	**7,621**
Operating expenses (W2)	(4,940)
Net profit	**2,681**

Statement of financial position at 30 April 2013

Non-current assets	
Fixtures and fittings	600
Motor vehicles	2,400
	3,000
Current assets	
Inventory	4,998
Trade receivables	4,577
Prepayments (Rs.20,000+ Rs.35,000)	55
Bank	3,876
Cash	120
	13,626
Total assets	**16,626**

	Rs.(000)
Owner's equity	**13,475**
Current liabilities	
Trade payables	3,045
Accrued expenses (56,000 + 24,000 + 26,000)	106
	3,151
Total equity and liabilities	**16,626**

W1 – Cost of sales

Opening inventory	3,776
Purchases	12,556
	16,332
Less Closing inventory	(4,998)
	11,334

W2 – Operating expenses

Insurance (146 – 35)	111
Lighting and heating	665
Motor expenses (664 + 56)	720
Packing expenses	276
Rates (120 – 20)	100
Rent (456 + 24)	480
Salaries	2,447
Sundry expenses (115 + 26)	141
	4,940

W3 – Owner's equity

Capital account	
Opening capital	12,844
Add Profit for year	2,681
	15,525
Less Drawings	(2,050)
	13,475

Solutions **6**

Statement of comprehensive income for the year ended 31 December 2012

	Rs.
Revenue (124,450 – 186)	124,264
Cost of sales (W1)	(86,517)
Gross profit	**37,747**
Operating expenses (W2)	(5,010)
Administration and general costs (W3)	(14,946)
Selling and distribution expenses (W4)	(7,066)
Finance costs (W5)	(209)
Net profit	**10,516**

Statement of financial position at 31 December 2012

Non-current assets (W12)	**13,425**
Current assets	
Inventory	7,550
Trade receivables (net) Rs.(20,280 – 608) (W10)	19,672
Prepayments	125
Cash at bank	650
Total assets	**41,422**
Owner's equity (W13)	**29,266**
Non-current liabilities	
Loan	2,000
Current liabilities	
Trade payables	10,056
Loan interest/accrued expenses	100
Total equity and liabilities	**41,422**

W1 - Cost of sales

Opening inventory	8,000
Purchases Rs.(86,046 – 135)	85,911
	93,911
Carriage inwards	156
	94,067
Closing inventory	(7,550)
	86,517

W2 – Operating Expenses

Rent (W6)	1,875
Gas, electricity and water	2,560
Depreciation	
Plant and equipment 10% × Rs.(8,000 – 2,500)	550
Furniture and fittings 5% × Rs.(700 – 200)	25
	5,010

W3 - Administration and general costs

Salaries (W7)	4,000
Wages	8,250
Printing and stationery	640
General expenses	2,056
	14,946

W4 - Selling and distribution expenses

Travellers' salaries and commission	5,480
Travellers' expenses	1,040
Carriage outwards	546
	7,066

W5 - Finance costs

Bank charges	120
Loan interest (W9)	100
Bad and doubtful debts (W11)	79
Discounts (net) Rs.(48 – 138)	(90)
	209

W6 **Rent a/c**

	Rs.		Rs.
Per TB	2,000	SOCI	1,875
		Balance c/d ($^3/_6$ × Rs.250)	125
	2,000		2,000

W7 **Salaries a/c**

	Rs.		Rs.
Per TB	3,500	SOCI	4,000
Drawings a/c (transfer)	500		
	4,000		4,000

W8 **Drawings a/c**

	Rs.		Rs.
Per TB	1,750	Salaries a/c (transfer)	500
		Balance c/d	1,250
	1,750		1,750

W9 **Loan interest a/c**

	Rs.		Rs.
Balance c/d (5% × Rs.2,000)	100	SOCI	100

W10 **Allowance for doubtful debts**

	Rs.		Rs.
Bad debt expense	132	Balance b/d	740
Balance c/d (3% × Rs.20,280)	608		
	740		740

W11 **Bad debts expense**

	Rs.		Rs.
Written off (receivables)	256	Recovered	45
		Decrease in allowance	132
		SOCI	79
	256		256

	Cost	*Dep'n*	*NBV*
W12		**Rs.**	
Non-current assets			
Freehold premises	8,000	–	8,000
Plant and equipment	8,000	3,050	4,950
Fixtures and fittings	700	225	475
	16,700	3,275	13,425

W 13 – Owner's equity	**Rs.**
Capital at 1 January 2012	20,000
Profit for the year	10,516
	30,516
Less Drawings (W5)	(1,250)
	29,266

Solutions **7**

(a) Statement of comprehensive income for the year ended 30 June 2013

	Rs.
Revenue (625,000 – 2,300)	622,700
Cost of sales (W1)	(345,700)
Gross profit	**277,000**
Operating expenses (W2)	(123,020)
Other income (W3)	2,950
Net profit	**156,930**

W1 – Cost of sales

Opening inventory	98,200
Purchases (324,500 –1,700)	322,800
Closing inventory	(75,300)
	345,700

W2 – Operating expenses

	Rs.
Packing materials (12,900 – 700 + 200)	12,400
Discount allowed	1,500
Distribution costs	17,000
Rents, rates and insurances (5100 – 450)	4,650
Telephone (3,200 + 500)	3,700
Car expenses	2,400
Wages (71,700 – 23,800)	47,900
Heat and light (1,850 + 400)	2,250
Sundry expenses (6,700 – 3,500)	3,200
Bad debt	600
Decrease in allowance for bad debts (W4)	(380)
Loan interest	800
Depreciation	
– Delivery vehicle (112,500 × 20%)	22,500
– Car (8,000 × 25%)	2,000
– Equipment (15,000 – 5,000) × 25%	2,500
	123,020

W3 - Other income

Discount received	2,500
Bank interest (15,000 × 6% × 6/12)	450
	2,950

W4 - Allowance for bad debts

Age	*Amount*	*%*	*Allowance*
30 – 60	20,000	1	200
60 – 90	12,000	2.5	300
90 +	3,000 – 600	5	120
Closing allowance			620
Opening allowance			1,000
Decrease in allowance			380

(b) Statement of financial position as at 30 June 2013

	Rs.	
Non–current assets (W5)		**68,500**
Current assets		
Inventory	75,300	
Packing materials	700	
Trade receivables (94,400 – 620)	93,780	
Prepayments	450	
Interest receivable	450	
Bank deposit	15,000	
Bank current	26,500	
		212,180
Total Assets		**280,680**
Owner's equity (W6)		**193,180**
	Rs.	
Current liabilities		
Trade payables	82,000	
Accruals (400 + 500 + 200)	1,100	
Loan	4,400	
		87,500
Total equity and liabilities		**280,680**

W5 – Non – current assets	**Cost**	**A. Dep.**	**NBV**
	-----------------	Rs.	-----------------
Delivery vehicles	112,500	57,500	55,000
Car	8,000	2,000	6,000
Equipment	15,000	7,500	7,500
	135,500	67,000	68,500

W6 – Owner's equity	**Rs.**
Opening capital	55,550
Capital introduced	8,000
Profit for year	156,930
Drawings (23,800 + 3,500)	(27,300)
	193,180

Solutions **8**

(a) **Journal entries**

		Dr	***Cr***
(i)	Purchases	1,200	
	Office equipment		1,200
(ii)	Trade payable	2,600	
	Bank		2,600
(iii)	Rent	3,000	
	Suspense		3,000

Suspense a/c

	Rs.		**Rs.**
Bal b/d	3,000	Rent	3,000

(b) **Statement of comprehensive income for the year ended 30 September 2013**

	Rs.
Revenue	194,000
Cost of sales **(W1)**	(102,200)
Gross profit	**91,800**
Operating expenses **(W2)**	(87,700)
Net profit	**4,100**

W1 – Cost of sales	**Rs.**
Opening inventory	31,000
Purchases (123,000 + 1,200)	124,200
	155,200
Closing inventory	(53,000)
Cost of sales	102,200

W2 - Operating expenses

Selling expenses	12,000
Heat and light	8,000
Wages and salaries (19,000 + 5,000)	24,000
Printing and stationary	6,000
Telephone and fax (6,000 – 1,000)	5,000
Rents, rates and insurances (4,000 + 3,000 – 1,000)	6,000
Bad debt	3,000
Decrease in allowance for bad debts (4,000 – (32,000 × 5%))	(2,400)
Bank charges	4,000
Depreciation	
– Plant and machinery (125,000 × 10%)	12,500
– Office equipment (45,000 – 1,200 – 15,000) × $^1/_3$	9,600
	87,700

(c) **Statement of financial position as at 30 September 2013**

	Rs.
Non-current assets (W3)	**103,700**
Current Assets	
Inventory	53,000
Trade receivables [(35,000 – 3,000) – 1,600]	30,400
Prepayments	2,000
Cash	1,000
	190,100
Owner's equity (W4)	**151,100**
Current liabilities	
Trade payables (33,000 – 2,600)	30,400
Accruals	5,000
Bank overdraft (3,000 – 2,600 – 4,000)	3,600
	39,000
Total equity and liabilities	**190,100**

W3 - Non-current assets	**Cost**	**Acc. Depreciation**	**Carrying Amount**
	----------	**Rs.**	----------
Plant and machinery	125,000	40,500	84,500
Office equipment	43,800	24,600	19,200
	168,800	65,100	103,700

W4 – Owner's equity

Opening capital	169,000
Profit for year	4,100
Drawings	(22,000)
	151,100

Solutions **9**

(a) Statement of profit or loss for the year ended 30 June 2018

	Rs. in '000'
Revenue (W1)	31,400
Cost of sales (W2)	(18,356)
Gross profit	**13,044**
Selling and administration expenses (W3)	(7,004)
Other income (W4)	406
Net profit	**6,446**

(b) Statement of financial position as at 30 June 2018

Assets

Non-current assets

Equipment (W5)		10,404
Vehicle (W5)		2,290
		12,694
Current assets		
Trade debtors (W6)		5,424
Inventory	7,400–6**(PL)**	7,394
Prepayments	**PL**	175
Accrued income/Interest receivable	**PL**	16
Deposits at 7%		1,400
Cash and bank balances	620–285	335
		13,344
Total Assets		**27,438**

		Rs. in '000'
Owner's equity		21,854
Current liabilities		
Trade creditors	3,500–12**(PL)**	3,488
Accruals and other payables	1,520+**576**[960**(BS)**×0.6]	2,096
		5,584
Total equity and liabilities		**27,438**

W1 - Revenue

Sales		32,350
Return inward		(950)
		31,400

W2 - Cost of sales

Opening inventory		5,500
Purchases		21,000
Return outward	700+50	(750)
Closing inventory	7,400–**6**{240–(250–16)}	(7,394)
		18,356

W3 - Selling and administration expenses

Salaries and utilities		2,790
Rent	1,000–240	760
Discount allowed	270–**15**[300**(BS)**–285]	255
Insurance	300–**175**(300×7/12)+140	265
Bad debts	106+{226**(BS)**–220}	112
Depreciation - equipment		1,872
Disposal	(500–140)×15%×8/12 = 36	
Others	[(17,000+400–500)–(4,800–140)]×15% = 1,836	
Depreciation- vehicle		470
Addition	960**(BS)**×25%×1/12 = 20	
Others	(3,000–1,200)×25% = 450	
Other expenses		480
		7,004

		Rs. in 000
W4 - Other income		
Gain on disposal	400–[360–36**(PL)**]	76
Discount received	220+**12**(388/97×3)	232
Interest income	82+**16**{1,400×7%–82}	98
		406
W5 - Non-current assets		
Equipment - cost	17,000+400–500	16,900
Accumulated depreciation	4,800+1,872**(PL)**–**176**(140+36)	(6,496)
		10,404
Vehicle - cost	3,000+960(384/0.4)	3,960
Accumulated depreciation	1,200+470(PL)	(1,670)
		2,290
W6 - Trade debtors		
Gross Trade debtors	5,350+**300**(285/0.95)	5,650
Provision of doubtful debts	(5,650×4%)	(226)
		5,424
W7 – Owner's equity		
Capital		16,000
Profit for the year		6,446
Drawings	352+240	(592)
		21,854

Solutions **10**

(a) Statement of profit or loss for the year ended 31 December 2017

		Rs. in '000
Sales		35,230
Cost of sales	23,580+**70**{1,000-(1,130-200)	(23,650)
Gross profit		**11,580**
Selling and administration expenses (W1)		(7,033)
Other income (W2)		970
Financial charges		(700)
Net profit		**4,817**

			Rs. in '000
(b)	**Statement of financial position as at 30 June 2017**		
	Assets		
	Non-current assets		
	Property, plant and equipment (W3)		7,123
	Current assets		
	Trade receivables		4,154
	Inventory	3,900-70**(PL)**-670	3,160
	Prepayments & advances	1,740 +300**(PL)**+800**(PL)**-450	2,390
	Other receivables		150
	Cash and bank		2,320
			12,174
	Total Assets		**19,297**
	Owner's Capital (W5)		10,127
	12% Long-term loan	5,150-**150**(5,150×3÷103)	5,000
			15,127
	Current liabilities		
	Trade payables	3,250-670	2,580
	Accruals and other payables	1,320+120**(PL)**+150**(BS)**	1,590
			4,170
	Total equity and liabilities		**19,297**

W1 - Selling and administration expenses

Salaries and wages		2,610
Fuel and power		450
Bad debt expense	230+[246**(BS)**-220]	256
Rent and insurance	2,900-200-**300{**(800-200)×0.5)}**-800**(1,200×8÷12)	1,600
Depreciation expense	[**1,180.5**{(12,500-4,630) ×0.15}]+{**16.88**(450×0.15×3÷12)}	1,197
Repair and maintenance		920
		7,033

		Rs. in 000
W2 – Other income		
Miscellaneous income	940-**120**(480×0.5×3÷6)+150	970
W3 - Property, plant and equipment		
Property, plant and equipment – cost	12,500+450	12,950
Accumulated depreciation	4,630+ 1,197**(PL)**	(5,827)
		7,123
W4 – Trade receivables		
Trade receivables		4,400
Provision for doubtful debts	(1,000×0.05)+(900×0.1)+(530×0.2)	(246)
		4,154
W5 – Owner's equity		
Capital		6,000
Net profit	**PL**	4,817
Drawings	490+200	(690)
		10,127

Solutions **11**

(a) Home Appliances

Statement of profit or loss for the year ended 30 June 2017	**Rs. in '000**
Revenue (W1)	97,720
Cost of sales (W2)	(70,250)
Gross profit	**27,470**
Operating expenses (W3)	(19,281)
Other income (W4)	399
Net profit	**8,588**

(b)

Statement of financial position as at 30 June 2017		**Rs. in '000**
Assets		
Non-current assets (W5)		21,168
Current assets		
Closing inventory	**PL**	9,310
Trade receivable (W6)		10,545
Prepayments and other receivables	2,350+[450 – (120×3.5÷12)]	2,765
Cash and bank		1,300
		23,920
Total Assets		**45,088**

		Rs. in 000
Owners' equity (W7)		**29,588**
Current liabilities		
Trade payables		10,200
Accruals and other payables	5,310 – 120+110	5,300
		15,500
Total equity and liabilities		**45,088**

W1 – Revenue

Sales		101,120
Sales return	3,000+400	(3,400)
		97,720

W2 - Cost of sales

Opening inventory		8,200
Purchases		70,000
Carriage inwards		1,360
Available for sale		79,560
Closing inventory	9,000+310 [**Cost:** 320 (400÷1.25), **NRV:310** (400–90)]	(9,310)
		70,250

W3 - Operating expenses

Wages and salaries			5,900
Discounts		1,600+50 [(940+10)÷95%×5%]	1,650
Utility charges			2,350
Running and maintenance charges		(3,290+110)	3,400
Financial Charges		580+10	590
Depreciation expense -	Excl. sold machine	[34,400–(8,000-60)]×20%	5,292
	Sold machine	(600-60)×20%×11÷12	99
			19,281

W4 - Other income

Machine rent income		120×8.5÷12	85
Gain on disposal of machine	(600×20%×6÷12)	450-WDV i.e. [600–(99+60)]	9
Decrease in provision for doubtful debts		750–555	195
Misc. income			110
			399

		Rs. in 000
W5 - Non-current assets		
Fixed assets – cost	35,000 – (540÷90%)	34,400
Accumulated depreciation	8,000 + [(5,292+99) – (60+99) **(PL)**	(13,232)
		21,168
W6 - Trade receivables		
Trade receivables	[12,500–400] – [(940+10)÷95%]	11,100
Provision for doubtful receivables	11,100×5%	(555)
		10,545
W7 – Owners' equity		
Capital		25,500
Drawings		(4,500)
Profit for the year	**PL**	8,588
		29,588

Solutions **12**

(a) Statement of comprehensive income for the year ended 31 December 2016

		Rs. in million
Revenue	[750–(20×5%)–7]	742.00
Cost of sales	[304+2–(7/1.4)]	(301.00)
Gross profit		**441.00**
Selling and administration expenses	**W.1**	(140.42)
Other income	[45–(12/12×4)]	41.00
Financial charges	[10+(120×10%×5/12)]	(15.00)
Net profit		**326.58**

W.1: Selling and administration expenses

As per trial balance		146.00
Decrease in bad debts expense	**W.2**	(2.18)
Inventory damaged in fire (abnormal loss)		15.00
Building rent paid in advance	(24/12×9)	(18.00)
Reversal of depreciation on equipment returned	(8×15%×4/12)	(0.40)
		140.42

		Rs. in million

(b) Rainbow Lights

Statement of financial position as at 31 December 2016

Assets		
Non-current assets	**W3**	**112.40**
Current assets		
Trade debtors	**W4**	382.18
Inventory	[170–2–15–1+(7/1.4)]	157.00
Prepayments and other receivables	[45+(24/12×9)]	63.00
Cash and bank		20.00
		622.18
Total Assets		**734.58**
Equity	**W5**	**345.58**
Long-term loans		**120.00**
Current liabilities		
Trade creditors	(240–8)	232.00
Accruals and other payables	[28+(120×10%×5/12)+(12×4/12)]	37.00
		269.00
Total equity and liabilities		**734.58**

W2:		**Trade debtors**	**Provision for doubtful debts**
		Rs. in million	
As per trial balance		400.00	12.00
Sales return		(7.00)	**-**
Sales net of 5% trade discount recorded at gross (20×5%)		(1.00)	**-**
Correction of recovery of previously written off debtors		2.00	2.00
		394.00	**14.00**
Decrease in provision	**Balancing**		(2.18)
Provision at 3% of the year-end balance	(394×3%)		**11.82**

		Rs. in million
W3:		
Property, plant and equipment - cost	(270–8)	262.00
Accumulated depreciation	(150–0.4) **(W.1)**	(149.60)
		112.40
W4:		
Trade debtors	**W.2**	394.00
Provision of doubtful debts	**W.2**	(11.82)
		382.18

		Rs. in million
W5:		
Capital		100.00
Profit and loss account balance as at 31 December 2016	(326.58–30)	296.58
Drawings	(50+1)	(51.00)
		345.58

Solutions **13**

		Rs. in '000
(a) Fortune Traders		
Statement of comprehensive income for the year ended 30 June 2016		
Revenue	[28,900 – 90 – (35 × 1.4)]	28,761
Cost of sales	(W-1)	(15,265)
Gross profit		**13,496**
Selling and administration expenses	(W-2)	(6,130)
Other income	(W-3)	30
Finance charges	(5,000 × 12% × 1 ÷ 2)	(300)
Net profit		**7,096**

W-1: Cost of sales

Opening inventory		1,045
Purchases	(16,000 – 220)	15,780
Closing inventory		(1,560)
		15,265

W-2: Selling and administration expenses

Selling and administration expenses		5,855
Depreciation expense – building	(3,700–1,436)×5%	113
Depreciation expense – plant and machinery	(6,650–330–2,414)×10%	391
Fire insurance – prepaid	430÷2	(215)
Fire insurance – for owner private property		(240)
Office rent accrued		137
Salaries accrued		89
		6,130

W-3: Other income

Bad debt expense (reversal of excess provision)	30

		Rs. in '000
(b) Statement of financial position as at 30 June 2016		
Assets		
Non-current assets	**(W-4)**	**5,666**
Current assets		
Trade receivables	**(W-5)**	3,401
Inventory		1,560
Prepayments and other receivables	[380+(430÷2)+330]	925
Cash and bank balances		5,850
		11,736
Total assets		**17,402**
Owners' Equity	**(W-6)**	**9,856**
Long-term loans	[5,000–(5,000÷8×2)]	**3,750**
Current liabilities		
Current maturity of long-term-loan	(5,000–3,750)	1,250
Trade and other payables	(2,080–60+137+89)	2,246
Interest payable	(5,000×12%×1÷2)	300
		3,796
Total equity and liabilities		**17,402**

W-4: Non-current assets

Property, plant and equipment – cost	(3,700+6,650–330)	10,020
Accumulated depreciation	(1,436+2,414+113+391)	(4,354)
		5,666

W-5: Trade receivables

Trade receivables	[3,600– (35×1.4)]	3,551
Provision of doubtful debts	(180–30)	(150)
		3,401

W-6: Owners' Equity

Opening balance		3,000
Profit for the year	**PL**	7,096
Drawings		(240)
		9,856

Solutions **14**

			Rs. in million
(a)	**Moon Trading**		
	Statement of comprehensive income for the year ended 31 December 2015		
	Revenue	2840-2.4	2,837.60
	Cost of sales:	**(W1)**	(2,019.00)
	Gross profit		**818.60**
	Selling and administration expenses:	**(W2)**	(536.42)
	Financial charges	8+(160×10%×3÷12)+2+0.25	(14.25)
	Operating profit		267.93
	Other income	15 + 1.2 - [1.8 - (3.6×4÷9)] + (4 + 0.25)	20.25
	Net profit		**288.18**
	W-1: Cost of sales:		
	Opening inventory		410.00
	Purchases	2,141 - 0.78 - 0.32 - 4.5	2,135.40
	Closing inventory	530-0.78 -0.32 -4.5+(2.4÷1.2)	(526.40)
			2,019.00
	W.2: Selling and administration expenses:		
	As per trial balance:		540.00
	Add: Dep. on items in office use	0.78×20%×3÷12	0.04
	Less: Decrease in bad debt expense	(**BS**) 6.03-(6+3.5)	(3.47)
	Less: Office supplies in hand	0.45-0.6	(0.15)
			536.42
(b)	**Statement of financial position as at 31 December 2015**		
	Assets:		
	Non-current assets	**(W3)**	**105.74**
	Current Assets		
	Trade debtors	(W4)	195.07
	Inventory	**P&L**	526.40
	Prepayments, advances and other receivables	9+1.2-0.45 +0.6	10.35
	Cash and bank balances		5.00
			736.82
	Total assets		**842.56**

		Rs. In million
Equity and current liabilities		
Owners' Equity	**(W5)**	**337.86**
Long-term bank loan	160×4÷5	128.00
Current liabilities:		
Current maturity of long-term bank loan	160×1÷5	32.00
Trade creditors	320-4.5	315.50
Accruals & other payables	25+(160×10%×3÷12)+[1.8-(3.6×4÷9)]	29.20
		376.70
Total equity and liabilities		**842.56**

W-3: Non-current assets

Fixed assets	150+0.78	150.78
Accumulated depreciation	45+0.04 (**W3)**	(45.04)
		105.74

W-4: Trade debtors

Trade debtors	200+3.5 -2.4	201.10
Provision for doubtful debts	201.1×3%	(6.03)
		195.07

W-5: Owners' Equity

Opening balance		50.00
Profit for the year	**P&L**	288.18
Drawings		(0.32)
		337.86

3 OBJECTIVE BASED QUESTIONS

01. A complete set of financial statement does not include;

- **(a)** a statement of financial position as at the end of the period
- **(b)** a statement of comprehensive income for the period
- **(c)** Aging analysis of receivables
- **(d)** a statement of changes in equity for the period

02. Following is the trial balance of Salman for the year ended 30 June 2014

	Rs.
Insurance	2,000,000

Insurance is prepaid to the extent of Rs. 650,000.

What is the amount of insurance premium to be shown in the statement of comprehensive income and statement of financial position?

- **(a)** Insurance expense Rs. 2,000,000; Prepaid insurance Rs. 650,000
- **(b)** Insurance expense Rs. 2,650,000; Prepaid insurance Rs. 650,000
- **(c)** Insurance expense Rs. 650,000; Prepaid insurance Rs. 2,000,000
- **(d)** Insurance expense Rs. 1,350,000; Prepaid insurance Rs. 650,000

03. Salman has prepared his trial balance for the year ended 30 June 2014.

He has provided following information relating to stock: Closing stock as on 30 June 2014 amounted to Rs. 237,500 thousand.

What is the correct accounting entry to record the adjustment?

- **(a)** Dr inventory Rs. 237,500,000 Cr Cost of sales Rs. Rs. 237,500,000
- **(b)** Dr Cost of sales Rs. 237,500,000 Cr Inventory Rs. Rs. 237,500,000
- **(c)** Dr inventory Rs. 237,500,000 Cr Purchases Rs. Rs. 237,500,000
- **(d)** Dr Purchases Rs. 237,500,000 Cr Inventory Rs. Rs. 237,500,000

04. Salman has prepared his trial balance for the year ended 30 June 2014. He has provided following information relating to drawings:

	Debit Rs. 000
Drawings	30,500

Salman's son works as the head of administration and received a salary of Rs. 150 thousand per month, which has been included in drawings.

What is the amount of drawings to be shown in the statement of financial position?

- **(a)** Rs. 30,500
- **(b)** Rs. 30,350
- **(c)** Rs. 32,300
- **(d)** Rs. 28,700

05. Azam is in process of preparation of trial balance for the year ended 30 June 2015.

	Debit	**Credit**
	Rs. in ‘000’	
Purchases	105,950	

Azam withdrew goods costing Rs. 4,000 thousand for personal use during the year. However, no entry was made to record the withdrawal of goods.

What is the amount of purchases to be shown in statement of comprehensive income?

(a) Rs. 105,950,000

(b) Rs. 4,000,000

(c) Rs. 101,950,000

(d) Rs. 109,950,000

06. Following is the trial balance of Salman for the year ended 30 June 2014:

Rs. in ‘000

	Debit		**Credit**
Trade discount	2,432	Sales	353,300
Sales return	10,000		
Discount allowed	4,500		

What is the amount of sales to be shown in statement of comprehensive income?

(a) Rs. 353,300

(b) Rs. 340,868

(c) Rs. 336,368

(d) Rs. 346,368

07. Following summarised trial balance as at 31 December 2015 pertains to Moon Trading (MT) who deals in office machines:

	Debit		**Credit**
	Rs. in million		
Bank loan			160
Interest on bank loan	8		

Additional information

The bank loan was acquired on 1 April 2015. The principal amount is repayable in five equal annual installments on 31 March each year. Interest is payable at 10% per annum on six monthly basis and is recorded at the time of payment.

What adjusting entry is required to record interest payable as at 31 December 2015?

(a) Dr Interest expense Rs. 4 million Cr Interest payable Rs. 4 million

(b) Dr Interest expense Rs. 4 million Cr Bank loan Rs. 4 million

(c) Dr Interest expense Rs. 8 million Cr Interest payable Rs. 8 million

(d) Dr Interest expense Rs. 12 million Cr Interest payable Rs. 12 million

08. Following summarised trial balance as at 31 December 2015 pertains to Moon Trading (MT) who deals in office machines:

	Debit		**Credit**
	Rs. in million		
Other income			15

Additional information

Review of other income revealed the following information:

On 1 August 2015, MT received an amount of Rs. 1.8 million as 50% advance against a maintenance contract covering the period from 1 September 2015 to 31 May 2016 and was credited to other income. The balance amount would be paid on completion of the contract.

What is the amount of unearned income to be shown in statement of financial position?

- **(a)** Rs. 1.8 million
- **(b)** Rs. 3.6 million
- **(c)** Rs. 0.2 million
- **(d)** Rs. 1.6 million

09. Following summarised trial balance as at 31 December 2015 pertains to Moon Trading (MT) who deals in office machines:

	Debit		**Credit**
	Rs. in million		
Other income			15

Additional information

On 1 August 2015, MT received an amount of Rs. 1.8 million as 50% advance against a maintenance contract covering the period from 1 September 2015 to 31 May 2016 and was credited to other income. The balance amount would be paid on completion of the contract.

What is the amount of other income to be shown in statement of comprehensive income?

- **(a)** Rs. 15 million
- **(b)** Rs. 14.8 million
- **(c)** Rs. 13.2
- **(d)** Rs. 11.4

10. Which of the following is not a characteristic of service organization?

- **(a)** A large percentage of assets comprise inventory
- **(b)** A large percentage of assets comprise receivable
- **(c)** The funds of service companies are usually tied up towards accounts receivable
- **(d)** There is no line item for the cost of goods sold in the income statement of service companies.

11. A business has provided following extracts from trial balance as at 31 December 2018;

	Debit		**Credit**
	Rs. in million		
Receivables	100		
Provision for doubtful debts – 1.1.18			4
Bad debts	3		

Additional information

A customer included in receivables in trial balance above owing Rs. 1 million gone bankrupt and is unable to pay anything.

It has been decided to calculate a provision of 6% for the year.

What is the amount of closing balance of provision for doubtful debts account?

- **(a)** Rs. 5.94 million
- **(b)** Rs. 3 million
- **(c)** Rs. 6 million
- **(d)** Rs. 5.76 million

12. A business has provided following extracts from trial balance as at 31 December 2018;

	Debit		**Credit**
	Rs. in million		
Receivables	100		
Provision for doubtful debts – 1.1.18			4.5
Bad debts	3		

Additional information

A customer included in receivables in trial balance above owing Rs. 1 million gone bankrupt and is unable to pay anything.

It has been decided to calculate a provision of 6% for the year.

What is the amount of bad and doubtful debts expense in statement of comprehensive income?

- **(a)** Rs. 4.44
- **(b)** Rs. 5.44 million
- **(c)** Rs. 1.44
- **(d)** Rs. 5.94

13. A business has provided following extracts from trial balance as at 31 December 2018;

	Debit		**Credit**
	Rs. in million		
Receivables	100		
Provision for doubtful debts – 1.1.18			4
Bad debts	3		

Additional information

A customer included in receivables in trial balance above owing Rs. 1 million gone bankrupt and is unable to pay anything.

It has been decided to calculate a provision of 6% for the year.

What is the number of receivables to be shown in statement of financial position?

(a) Rs. 92 million

(b) Rs. 94.06

(c) Rs. 91.06

(d) Rs. 90.06

14. A business has provided following extracts from trial balance as at 31 December 2018;

	Debit		Credit
	Rs. in million		
Administration expenses	150		

Additional information

Electricity expense of Rs. 1.5 million is outstanding. No adjustment for bill payable has been recorded. Electricity expense paid during the year have already been included in administration expenses.

Included in the administration expenses in trial balance advance rent is Rs. 1.2 million.

What is the amount of administration expenses to be shown in statement of comprehensive income?

(a) Rs. 150.3 million

(b) Rs. 151.5

(c) Rs. 152.7

(d) Rs. 150

15. A business has provided following extracts from trial balance as at 31 December 2018:

	Debit		Credit
	Rs. in million		
Administration expenses	150		

Additional information

Electricity expense of Rs. 1.5 million is outstanding. No adjustment for bill payable has been recorded.

Electricity expense paid during the year have already been included in administration expenses.

Included in the administration expenses in trial balance advance rent is Rs. 1.2 million.

Which of the following is correct regarding administration expenses?

(a) Accrued expense Rs. 1.2 million; Prepayment Rs. 1.5 million

(b) Accrued expense Rs. 1.5 million; Prepayment Rs. 1.2 million

(c) Accrued expenses Rs. 2.7 million

(d) Prepayment Rs. 2.7 million

16. Following is the summarised trial balance of Fortune Traders (FT) for the year ended 30 June 2016;

	Debit	**Credit**
	Rs. 000	
Plant & machinery - cost	6,650	
Plant & mach. – Acc. Dep. as at 1 July 2015		2,414

Additional information:

(i) On 1 March 2016, FT paid an advance of Rs. 330,000 for purchase of a machine and debited it to plant and machinery. The machine was delivered on 1 September 2016.

(ii) FT depreciates its fixed assets from the month of addition. Depreciation is to be charged on written-down value (WDV) as follows:

Plant & machinery	10%

What is the amount of depreciation to be charged to statement of profit or loss?

Rs. ___________

17. Following is the summarised trial balance of Fortune Traders (FT) for the year ended 30 June 2016;

	Debit	**Credit**
	Rs. 000	
Plant & machinery - cost	6,650	
Plant & mach. – Acc. Dep. as at 1 July 2015		2,414

Additional information:

(iii) On 1 March 2016, FT paid an advance of Rs. 330,000 for purchase of a machine and debited it to plant and machinery. The machine was delivered on 1 September 2016.

(iv) FT depreciates its fixed assets from the month of addition. Depreciation is to be charged on written-down value (WDV) as follows:

Plant & machinery	10%

What is the amount of Plant & machinery to be shown in statement of financial position?

Rs. ___________

18. Azam owns a retail outlet with the name Azam Autoparts Store. The trial balance as at 30 June 2015 is as follows:

	Debit	**Credit**
	Rs. in ‘000’	
Bank loan		5,050
Interest expenses	600	
	167,436	167,436

Bank loan was received on 1 July 2014. Interest payable for the month of June 2015 has been credited to the loan account.

What is the amount of interest payable to be shown in statement of financial position?

Rs. ___________

19. Rainbow Lights (RL) has prepared a trial for the year ended 31 December 2016:

	Debit	**Credit**
	Rs. in million	
Miscellaneous income		45

Additional information

Miscellaneous income includes Rs. 12 million received against an annual maintenance contract expiring on 30 April 2017.

What is the amount of Miscellaneous income to be shown in statement of comprehensive income?

Rs. ___________

20. Rainbow Lights (RL) has prepared a trial for the year ended 31 December 2016:

	Debit	**Credit**
	Rs. in million	
Miscellaneous income		45

Additional information

Miscellaneous income includes Rs. 12 million received against an annual maintenance contract expiring on 30 April 2017.

What is the amount of Miscellaneous income to be shown in statement of financial position as unearned income?

Rs. ___________

21. An asset posses which of the following?

(a) Future economic benefits for the business

(b) All kind of benefits for the business

(c) Expenses for the business

(d) Merits and Demerits for the business

22. Liabilities are which of the following?

(a) Resources

(b) Obligations

(c) Future benefits

(d) Expenses

23. What is equity?

(a) Cash from the business

(b) Liability of a business

(c) Owner's claim on netl assets

(d) Owner's claim on total liabilities

24. Which of the following transactions represent an expense?

- **(a)** The owner withdrew Rs. 1,600 from the business for personal use
- **(b)** Purchased a photocopying machine for Rs. 2,750 cash
- **(c)** Purchased medical supplies for cash from Healthcare Labs. Rs. 1,630
- **(d)** Received a telephone bill amounting to Rs. 550 to be paid within ten days

25. Expense is recorded in the accounting records when:

- **(a)** Cash is paid
- **(b)** The purchase order is placed with the supplier
- **(c)** Purchases are made
- **(d)** None of these

26. The gross decrease in economic benefits for the business are what?

- **(a)** Expenses
- **(b)** Obligations
- **(c)** Gain
- **(d)** Income

27. Net loss occurs when

- **(a)** Expenses are greater than income
- **(b)** Expenses are less than Income
- **(c)** Expenses=Income
- **(d)** Liabilities are greater than income

28. _______ the withdrawal of cash and goods by the owner of the business for his/her personal use

- **(a)** Depreciation
- **(b)** Drawings
- **(c)** Outflow of cash
- **(d)** Appreciation

29. Which of the following will be debited if a business purchases goods on credit?

- **(a)** Cash
- **(b)** Debtor
- **(c)** Creditor
- **(d)** Purchases

30. Outsider’s claim against the assets of the business is called:

- **(a)** Capital
- **(b)** Liability
- **(c)** Expense
- **(d)** Income

31. Operating expenses in often named as:

- **(a)** Manufacturing cost plus commercial expenses
- **(b)** Prime cost plus factory overheads
- **(c)** Direct material plus direct labour
- **(d)** Selling plus administrative expenses

32. Discount for quick repayment of debt is normally referred as:

- **(a)** Trade discount
- **(b)** Prompt payment discount
- **(c)** Cash discount
- **(d)** Bulk discount

33. Identify the asset from the following

- **(a)** Prepayment
- **(b)** Creditors
- **(c)** Notes payable
- **(d)** Bank loan

34. Assets minus liabilities equal to

- **(a)** Goodwill
- **(b)** Working capita
- **(c)** Net income
- **(d)** Capital

3 OBJECTIVE BASED ANSWERS

01.	**(c)**	
02.	**(d)**	Prepaid insurance is deducted from the amount shown in trial to arrive at expense for the year.
03.	**(a)**	
04.	**(d)**	Drawings = Rs. 30,500 – (150x12) = Rs. 28,700
05.	**(c)**	Purchases = 105,950 – 4,000 = Rs. 101,950
06.	**(b)**	**Rs. 000** Sales 353,300 – 2,432 *trade discounts*: 350,868 Less: sales return: (10,000) 340,868
07.	**(a)**	160 x 10% x 3/12 = 4 million
08.	**(c)**	Total contract price 1.8 + 1.8 = 3.6 x 4/9 months = 1.6 less advance 1.8 = 0.2 million unearned
09.	**(b)**	Other income = 15 – 0.2 (unearned income) = 14.8 Total contract price 1.8 + 1.8 = 3.6 x 4/9 months = 1.6 less advance 1.8 = 0.2 million unearned
10.	**(a)**	
11.	**(a)**	Closing provision **Rs. million** Receivables as per trial: 100 Bad debts: (1) Receivables: 99 Provision @ 6%: 5.94
12.	**(b)**	Bad and doubtful debts expense **Rs. million** Bad debts 3+1: 4 Increase in provision = 5.94 – 4.5: 1.44 5.44

<table>
<tr><td></td><td></td><td>Closing provision
<table>
<tr><td></td><td>Rs. million</td></tr>
<tr><td>Receivables as per trial</td><td>100</td></tr>
<tr><td>Bad debts</td><td>(1)</td></tr>
<tr><td>Receivables</td><td>99</td></tr>
<tr><td>Provision @ 6%</td><td>5.94</td></tr>
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<tr><td>13.</td><td>(d)</td><td>
<table>
<tr><td></td><td>Rs. million</td></tr>
<tr><td>Receivables as per trial</td><td>100</td></tr>
<tr><td>Bad debts 3+1</td><td>(4)</td></tr>
<tr><td></td><td>96</td></tr>
<tr><td>Closing provision</td><td>(5.94)</td></tr>
<tr><td></td><td>90.06</td></tr>
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Closing provision
<table>
<tr><td></td><td>Rs. million</td></tr>
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<tr><td>Provision @ 6%</td><td>5.94</td></tr>
</table></td></tr>
<tr><td>14.</td><td>(a)</td><td>= Rs. 150 + 1.5 -1.2 = Rs. 150.3 million</td></tr>
<tr><td>15.</td><td>(b)</td><td></td></tr>
<tr><td>16.</td><td>Rs. 391,000</td><td>Depreciation charge = [6,650 – 330-2,414] x 10% = Rs. 391,000</td></tr>
<tr><td>17.</td><td>Rs. 3,515,000</td><td>= 6,650 – 330 – 2,414 - 391 = 3,515
Depreciation charge = [6,650 – 330-2,414] x 10% = Rs. 391,000</td></tr>
<tr><td>18.</td><td>Rs. 50,000</td><td>Interest classified to current liabilities 600 x 1/12 = 50</td></tr>
<tr><td>19.</td><td>Rs. 41 million</td><td>Misc. income = Rs. 45 million – 4 million = Rs. 41 million
Unearned income = 12 million x 4/12 = Rs. 4 million</td></tr>
<tr><td>20.</td><td>Rs. 4 million</td><td>Unearned income = 12 million x 4/12 = Rs. 4 million</td></tr>
<tr><td>21.</td><td>(a)</td><td></td></tr>
</table>

22.	**(b)**	
23.	**(c)**	
24.	**(d)**	
25.	**(c)**	
26.	**(a)**	
27.	**(a)**	
28.	**(b)**	
29.	**(d)**	
30.	**(b)**	
31.	**(d)**	
32.	**(c)**	
33.	**(a)**	
34.	**(d)**	

CHAPTER

13

Partnership accounts

Contents

1 FEATURES OF PARTNERSHIPS

Section overview

- Partnerships
- Partnership accounts
- Partners' capital

1.1 Partnerships

A partnership is a type of business structure.

Definition: Partnership

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

They are carrying on a business in common with a view to making a profit.

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

Persons who have entered into partnership with one another are called individually ***partners*** and collectively a ***firm*** and the name under which their business is carried on is called the ***firm name***.

Features of a partnership

There must be an association of two or more persons to carry on a business.

There must be an agreement entered into by all the persons concerned.

The agreement must be to share the profits of a business.

The business must be carried on by all or any of the persons concerned acting for all.

1.2 Partnership accounts

Partnership accounts are the financial accounts of a partnership business.

The financial statements of partnerships are the same as those of a sole proprietor with the exception of capital. The major difference between a partnership and a sole proprietor business is that a partnership has several joint owners.

Ownership is reflected in the capital of a business so whereas there is a single capital account in the statement of financial position of a sole proprietor the capital section of the statement of financial position of a partnership must reflect the fact that there is more than one owner.

The accounts of the partnership must record the capital and profits that are attributable to each individual partner.

The profit of a sole proprietor is simply added to the capital balance brought forward. In the case of a partnership the profit belongs to the partners so there must be a mechanism by which this is shared. Partners' shares are then added to their personal capital accounts.

1.3 Partners' capital

Each partner contributes capital to the business and shares in the profit (or loss) of the business. The capital of each partner must be identified separately.

The capital of each partner is usually contained in two accounts.

- ☐ Capital account
- ☐ Current account

Capital account

The partnership agreement usually specifies that each partner must contribute a minimum amount of ‘fixed’ capital and that partners cannot draw out any of their fixed capital.

In addition, each partner might retain some of his or her share of accumulated profits in the business. The partnership agreement should allow partners to draw out their share of accumulated profits, if they wish to do so.

The capital account records the fixed capital or long-term capital of the partner that the partner must retain in the business and cannot take out in drawings.

The balance on this account does not change very often.

Current account

A current account is used to record the accumulated profits of the partner and the partner’s drawings.

- ❑ The profits of the business are shared between the partners. The share of each partner is credited to (added to) his or her current account.
- ❑ Each partner may take drawings out of the business. Drawings are a withdrawal of profit. These are recorded by debiting the current account of the partner (and crediting the Bank account).

Illustration: Partner X: current account

Partner X: current account	Rs.
Opening balance	X
Partner’s share of profit for the year	X
Drawings by the partner during the year	(X)
Closing balance	X

2 SHARING THE PROFITS BETWEEN THE PARTNERS

Section overview

- Profit-sharing ratio
- Notional salaries and commission for partners
- Notional interest on long-term capital and on drawings
- Guaranteed minimum profit share
- Profits, drawings and the partners' current accounts

2.1 Profit-sharing ratio

The profit or loss for the financial period is calculated according to the normal rules (as described already for a sole trader). This total profit or loss figure is then divided between the partners and credited to their current account.

The partners are free to decide on how the profit (or loss) of the partnership is shared between the partners. The profit sharing arrangements are set out in the partnership agreement.

- ☐ The profit for the period might be shared in agreed profit sharing ratio. This is sometimes abbreviated as PSR. (The term profit sharing ratio covers the sharing of both profit and loss).
- ☐ Alternatively, there might be other means of allocating a first share of profit with the residual profit being shared in the agree profit sharing ratio. Methods of allocating a first share of profit include:
  - Notional salaries;
  - Notional interest on long term capital.

The first example shows the use of a profit sharing ratio without any other method of allocating a first share of profit.

Example:

The WXY Partnership has three partners, W, X and Y, who share profits and losses in an agreed ratio of 3:5:8. (Profit is divided into 16 parts {3 + 5 +8} and W, X and Y receives 3 parts, 5 parts and 8 parts respectively).

Profits for the year were Rs. 1,920,000.

The total profits are divided between the partners as follows:

Partner		**Rs.**
W	Rs. 1,920,000 × $^3/_{16}$	360,000
X	Rs. 1,920,000 × $^5/_{16}$	600,000
Y	Rs. 1,920,000 × $^8/_{16}$	960,000
		1,920,000

This might be recorded using an appropriation account.

The profit would first be transferred into the appropriation account:

Illustration:

	Debit	**Credit**
Statement of comprehensive income account	1,920,000	
Appropriation account		1,920,000

The profit would then be transferred from the appropriation account to the partners' current accounts:

Illustration:

	Debit	Credit
Appropriation account	1,920,000	
Partner W's current account		360,000
Partner X's current account		600,000
Partner Y's current account		960,000

2.2 Notional salaries and commission for partners

A partnership agreement might recognise the different amount of work done by partners by awarding one or more of the partners with a notional salary and/or commission.

A notional salary and commission are an agreed amount awarded to the individual partner from the partnership profits.

Note that a notional salary and commission are not a business expense in the same way that salary to employees is. It is a share of the partnership profits.

Also note that notional salary and commission may not be paid to a partner in the same way that salary is paid to employees. A partner takes cash out of the business through drawings.

The salary and commission are awarded to each partner from the profits, and the residual profit after such deductions is then divided between the partners in the agreed profit-sharing ratio.

Example:

The PQR Partnership has three partners, P, Q and R.

The partnership agreement provides for the residual profit (or loss) to be shared between them in the ratio 4:3:2, after allowing a notional salary of Rs. 21,000 to R and commission of 4% of profit to P.

The profit for the year is Rs.. 350,000

Residual profits = Rs. 350,000 – Rs. 21,000 – Rs 14,000 = Rs. 315,000.

Profits are shared as follows:

			Profit share	
	Total	**P**	**Q**	**R**
	Rs.	**Rs.**	**Rs.**	**Rs.**
Notional salary	21,000			21,000
Commission	14,000	14,000		
Residual profit:				
P share				
Rs. 315,000 × ⁴⁄₉	140,000	140,000		
Q share				
Rs. 315,000 × ³⁄₉	105,000		105,000	
R share				
Rs. 315,000 × ²⁄₉	70,000			70,000
	315,000			
Profit share	350,000	154,000	105,000	91,000

The profit share of each partner is added to the balance on their individual current accounts.

Practice question **1**

A, B and C are in partnership sharing profits and losses in the ratio of 2: 2: 1.

B is allowed a salary of Rs. 10,000 per annum and C is allowed a salary of Rs. 15,000 per annum.

The net profit for year was Rs. 100,000.

Show how profit should be shared between the partners.

2.3 Notional interest on long-term capital and on drawings

The partnership agreement might provide for the partners to obtain notional interest on the long-term capital they have invested in the business. This is interest on the balance in their capital account.

Notional interest on long-term capital is not interest expense, because the capital in the partners' capital account is equity, not a liability of the business.

The notional interest is a share of the partnership profits. Like notional salaries, the notional interest is awarded to each partner in accordance with the partnership agreement.

In contrast to interest on capital, partnership agreement may also provide for interest to be charged on drawings by partners. The partners' share of profits is reduced by interest charged on their drawings. This interest charged to all partners is added to total profit of firm before any allocation.

The residual profit shared between the partners in the profit-sharing ratio is the profit after notional salaries and notional interest on capital are deducted and interest on drawings is added.

Example:

Partnership DEF has three partners, D, E and F.

Partner D has contributed Rs. 100,000 of fixed capital, Partner E Rs. 120,000 and Partner F Rs. 60,000.

They have agreed to share profits in the following way.

1. **Partner D to receive a salary of Rs. 4,000 and Partner F a salary of Rs. 7,000.**
2. **All three partners receive interest at 5% on the fixed capital contributed.**
3. **Residual profit or loss to be shared between D, E and F in the ratio 3:5:2.**

The profit of the partnership for the year is Rs. 95,000.

The partnership profits would be shared between the partners as follows:

				Profit share	
		Total	**D**	**E**	**F**
		Rs.	Rs.	Rs.	Rs.
Notional salary		11,000	4,000		7,000
Notional interest at 5%		14,000	5,000	6,000	3,000
Residual profit (balance):					
D share	Rs. 70,000 × $^{3}/_{10}$	21,000	21,000		
E share	Rs. 70,000 × $^{5}/_{10}$	35,000		35,000	
F share	Rs. 70,000 × $^{2}/_{10}$	14,000			14,000
		70,000			
Profit share		95,000	30,000	41,000	24,000

Practice question **2**

G, H and I are in partnership.

The profit of the partnership for the year is Rs. 1,146,000.

Partner G has contributed Rs. 500,000 of fixed capital, Partner H Rs. 400,000 and Partner I Rs. 300,000.

The partners have agreed to share profits in the following way.

1. Partner H should receive a salary of Rs. 50,000 and Partner I a salary of Rs. 100,000.
2. All three partners should receive interest at 8% on the fixed capital contributed.
3. Residual profit (or losses) should be shared between G, H and I in the ratio 3: 2: 1.

Show how the partnership profits should be shared between the partners

2.4 Guaranteed minimum profit share

A partnership agreement might guarantee a minimum profit share for one (or more) of the partners.

In these cases:

- ❑ The partnership profits are shared according to the partnership agreement, ignoring the minimum profit agreement.
- ❑ If the normal sharing mechanism does not result in a partner receiving the minimum guaranteed profit the other partners must make up the shortfall out of their profit share, in their profit-sharing ratio.

Example:

The XYZ Partnership has three partners, X, Y and Z.

The partnership agreement provides for Partner X to receive a notional salary of Rs. 20,000 and residual profits or losses are shared between X, Y and Z in the ratio 2:4:6.

In addition, the agreement guarantees a minimum profit share of Rs. 32,000 to Partner Y.

The partnership profit for the current year is Rs. 80,000.

The partnership profits would be shared between the partners as follows:

			Profit share		
		Total	**X**	**Y**	**Z**
		Rs.	Rs.	Rs.	Rs.
	Notional salary	20,000	20,000		
	Residual profit (balance)				
X share	Rs. 60,000 × $^{2}/_{12}$	10,000	10,000		
Y share	Rs. 60,000 × $^{4}/_{12}$	20,000		20,000	
Z share	Rs. 60,000 × $^{6}/_{12}$	30,000			30,000
		60,000			
		80,000	30,000	20,000	30,000
Transfer to meet shortfall:					
X share	Rs. 12,000 × $^{2}/_{8}$		(3,000)	3,000	
Z share	Rs. 12,000 × $^{6}/_{8}$			9,000	(9,000)
				12,000	
Profit share		80,000	27,000	32,000	21,000

2.5 Profits, drawings and the partners' current accounts

For each partner, the share of the annual profit is added to the partner's current account. Any drawings during the year are deducted. Drawings may be in cash or any other asset.

Example:

There are three partners in the ABC Partnership, A, B and C. The capital and current accounts of the partners at the beginning of the year were as follows:

Partner	Capital account (Rs.)	Current account (Rs.)
A	100,000	6,000
B	200,000	3,000
C	160,000	8,000

The profit for the year was Rs. 103,000.

Profit sharing agreement:

Partner A is given a salary of Rs. 17,000 and Partner C has a salary of Rs. 15,000

The partners pay themselves interest on capital at 5% per year

The residual profit or loss is shared between A, B and C in the ratio 1:3:2.

During the year, drawings by each partner were:

A	Rs. 20,000
B	Rs. 25,000
C	Rs. 40,000

The profit share is as follows:

		Total	A	B	C
		Rs.	Rs.	Rs.	Rs.
Notional salary		32,000	17,000		15,000
Notional interest at 5%		23,000	5,000	10,000	8,000
Residual profit (balance)					
A share	Rs. 48,000 x $^{1}/_{6}$	8,000	8,000		
B share	Rs. 48,000 x $^{3}/_{6}$	24,000		24,000	
C share	Rs. 48,000 x $^{2}/_{6}$	16,000			16,000
		48,000			
Profit share		103,000	30,000	34,000	39,000

Example (continued):

The partners' capital accounts are the same at the end of the year as at the beginning of the year.

The current accounts are as follows (all amounts in Rs. 000):

Current accounts

	A	B	C		A	B	C
				Balance b/d	6	3	8
Drawings	20	25	40	Profit share	30	34	39
Balance c/d	16	12	7				
	36	37	47		36	37	47
				Balance b/d	16	12	7

The current accounts can also be set out in columnar form as follows:

Current accounts	**Partner A**	**Partner B**	**Partner C**
	Rs.	Rs.	Rs.
Beginning of the year	6,000	3,000	8,000
Add share of profit	30,000	34,000	39,000
	36,000	37,000	47,000
Deduct drawings	(20,000)	(25,000)	(40,000)
End of the year	16,000	12,000	7,000

Example: Famous Garments

Famous Garments (FG) has three partners M, A and J sharing profits and losses in the ratio of 2:3:1. Following information pertains to the year ended 31 December 2017:

	M	A	J
		—— Rs. in '000 ——	
Opening balances: Capital account	3,000	5,000	4,000
Current account	800	(200)	600
Drawings for the year (other than salaries)	4,500	6,250	5,000

As per the partnership agreement:

- ☐ M and J are entitled for a monthly salary of Rs. 45,000 each;
- ☐ Interest on the partners' opening capital balances is allowed at 10% per annum; and
- ☐ J is entitled to a minimum profit share of Rs. 3,500,000 per annum. Any shortfall is to be shared by M and A in their profit sharing ratio.

FG's draft statement of profit or loss for the year ended 31 December 2017 shows net profit of Rs. 15,000,000 after incorporating bonus to fashion designers (5% of the profit after the bonus). On review of the financial statements, the partners have identified the following errors:

i. M and J withdrew cash against their salaries for nine and ten months respectively. Salaries withdrawn by M and J were charged to salary expense.

ii. On 1 January 2017, partners had agreed to sell a vehicle to M at book value. The disposal has not been recorded in the books.

The vehicle was purchased on 1 October 2015 at a cost of Rs. 1,200,000 and its book value as at 31 December 2017 is Rs. 660,000. FG uses straight line method to depreciate its vehicles.

iii. A sales invoice for Rs. 400,000 was wrongly raised against goods costing Rs. 300,000 withdrawn by A and the amount is included in trade receivables.

For the year ended 31 December 2017

a) The corrected profit and the share of each partner in the profit shall be as follows:

Correction of profit and distribution of profit among the shareholders

		Rs. in '000
	Net profit	15,000
	Correction of errors:	
i	Partners' salaries mistakenly charged to P&L account **(45×9+45×10)**	855
	Reversal of depreciation for 2017 on a vehicle sold to A **(1,200-660)÷2.25**	240
	Goods withdrawn by A were mistakenly recorded as sale **(400-300)**	(100)
		995
		15,995
	Reversal of bonus to fashion **(15,000×5%)**	750
	Bonus to fashion designers based on revised profit **(15,995+750)×(5÷105)**	(797)
		*(47)
	Corrected profit	**15,948**

Distribution of profit	**M**	**A**	**J**	**Total**
		Rs. in '000		
Net profit after correction				**15,948**
Salaries entitlement for M and J	540	-	540	(1,080)
Interest at 10% on partners' opening capital balances	300	500	400	(1,200)
Remaining profit in the ratio of 2:3:1	4,556	6,834	2,278	(13,668)
	5,396	7,334	3,218	
Shortfall in guaranteed profit of J **(3,500-3,218)**	-	-	282	
Shortfall to be to be shared by M and A in the ratio of 3:2 **(282÷5×2:3)**	(113)	(169)	-	
Share of profit for the year ended 31 December 2017	**5,283**	**7,165**	**3,500**	-

b) The partners' current accounts shall be prepared as follows:

Partners' current account

Description	**M**	**A**	**J**	**Description**	**M**	**A**	**J**
	Rs. in '000				**Rs. in '000**		
Opening balance	-	200	-	Opening balance	800	-	600
Drawings	4,500	6,250	5,000	Share of profit	5,283	7,165	3,500
Salaries drawn	405	-	450	Closing balance			1,350
Vehicle (660+240)	900		-				
Purchases		300	-				
Closing balance	278	415	-				
	6,083	**7,165**	**5,450**		**6,083**	**7,165**	**5,450**

Practice question **3**

X, Y and Z are in partnership.

Partner	**Capital account at the start of the year**	**Current account at the start of the year**	**Drawings during the year**
	Rs.	Rs.	Rs.
X	1.000,000	20,000	780,000
Y	800,000	50,000	580,000
Z	600,000	10,000	350,000

The profit for the year was Rs. 1,944,000.

Profits are shared as follows:

1 The partners pay themselves interest on capital at 6% per year.

2 The residual profit or loss is shared between X, Y and Z in the ratio 4: 3: 2.

Show how the profits should be shared between the partners, and show their capital and current accounts as at the end of the year.

Practice question **4**

Ayaz and Urooj

Ayaz and Urooj are in partnership sharing profits and losses in the ratio 2:3. Partners are allowed Interest on capital at the rate of 7% per annum. Ayaz is entitled to a salary of Rs. 20,000 per annum. The following balances were extracted from the books on 30th April 2013:

	Rs.
Capital accounts	
Ayaz	120,000
Urooj	100,000
Current accounts	
Ayaz	500 Cr
Urooj	2,700 Dr
Accumulated profit at 1 January	
Drawings	
Ayaz	20,000
Urooj	14,000
6% Loan repayable 31 December 2021	80,000
Trade receivables	58,000
Provision for doubtful debts	2,500
Inventory at 1 May 2012	53,750
Trade payables	20,340
Bank deposit	5,000
Bank	9,150 Cr
Land and Buildings (cost)	200,000
Equipment (cost)	48,000
Fixtures and Fittings (cost)	35,000
Provisions for Depreciation:	
Land and Buildings	14,000
Equipment	12,000
Fixtures and fittings	26,000
Revenue	380,000
Purchases	170,000
Returns from customers	11,100
Returns to suppliers	8,900
Carriage outwards	6,290
Wages and salaries	69,530
Loan interest paid	3,600
Postage expenses	8,900
Marketing expenses	17,800
Administration expenses	25,720
Building works	24,000

Additional information

1 Inventory was valued at 30th April, 2013, Rs.48,500.

2 At 30th April, 2013, Postage expenses, Rs.890, were prepaid and marketing expenses, Rs.4,000 were accrued.

3 Depreciation is to be charged on all non-current assets owned at the end of the year as follows:

  (i) Buildings at the rate of 2% per annum on cost. No depreciation is charged on land. On 1st of April 2012 the land was valued at Rs.75,000

  (ii) Equipment at the rate of 20% per annum using the diminishing (reducing) balance method.

  (iii) Fixtures and fittings at the rate of 10% using the straight line method.

4 The salary paid to Ayaz had been posted to the wages and salaries account.

5 Trade receivables contain a debt of Rs.3000 which is considered irrecoverable.

6 Building works consisted of an extension to the building, Rs.20,000 and repairs to the existing air conditioning, Rs.4,000.

7 The provision for doubtful debts is to be maintained at 6% of remaining trade receivables.

Required:

a Prepare the Statement of comprehensive income of Ayaz and Urooj for the year ended 30th April 2013

b Prepare the appropriation account of Ayaz and Urooj for the year ended 30th April 2013.

c Prepare the current accounts of Ayaz and Urooj.

d Prepare the Statement of financial position of the Partnership at 30th April 2013.

Practice question: Hamza and Daniyal **5**

Hamza and Daniyal are in partnership. As per the partnership deed they share profits and losses equally. Partners are allowed Interest on capital at the rate of 3% per annum. Interest on drawings is charged at the rate of 4% per annum. The following balances were extracted from the books on 30th April 2015:

	Rs.
Premises (cost)	120,000
Delivery vehicles (cost)	60,000
Office fixtures (cost)	30,000
Provisions for depreciation	
Premises	7,200
Delivery vehicles	20,000
Office Fixtures	22,000
Trade payables	7,900
Bank Overdraft	92,600
Purchases	81,250
Trade Receivables	18,750
Provision for doubtful debts	500
Capital accounts:	
Hamza	50,000
Daniyal	30,000
Current accounts at 1 May 2014:	
Hamza	3,250
Daniyal	1,850
Drawings:	
Hamza	6,000
Daniyal	6,000
Revenue	190,000
Returns inwards	8,600
Inventory at 1 May 2014	15,600
Advertising expenses	11,000
Wages and Salaries	31,450
Delivery vehicle expenses	14,900
Heat and light	9,750
Other operating expenses	12,000

Additional information

The following information was available at 30 April 2015:

(1) Inventory was valued at Rs.13,650.

(2) Heat and light Rs.150 was accrued.

(3) Depreciation is to be charged on all non-current assets owned at the end of the year as follows:

   i. remises at the rate of 2% on cost per annum
   ii. Delivery vehicles at the rate of 20 % per annum using the diminishing (reducing) balance method
   iii. Office Fixtures at the rate of 10% per annum using the straight line method.

(4) Advertising expenses prepaid were Rs.800

(5) The provision for doubtful debts is to be maintained at 4 %

(6) A cheque payment of Rs.550 made to a credit supplier on 15 April, had not been recorded in the books.

Required:

(a) Prepare the Statement of comprehensive income of Hamza and Daniyal for the year ended 30th April 2015

(b) Prepare the appropriation account of Hamza and Daniyal for the year ended 30th April 2015.

(c) Prepare the current accounts of Hamza and Daniyal.

(d) Prepare the Statement of financial position of the Partnership at 30th April 2015.

Practice question: Dee and Eee **6**

Dee and Eee are in partnership. The profit sharing ratio between the partners is 3:2. Partners are allowed Interest on capital at the rate of 5% per annum. Eee is entitled to a salary of Rs.6000 per annum. The following balances were extracted from the books on 31st July 2015:

	Rs.
Buildings (cost)	75,000
Vans (cost)	40,000
Equipment (cost)	25,000
Provisions for depreciation	
Buildings	18,000
Vans	10,000
Equipment	15,000
Trade payables	55,900
Trade receivables	39,500
Bank	31,400
Purchases	148,300
Trade Receivables	39,500
Provision for doubtful debts	1900
8% Bank loan (repayable 31 March 2016)	40,000
Capital accounts:	
Dee	40,000
Eee	40,000
Current accounts at 1 August 2014:	
Dee	500 Cr
Eee	900 Cr

Drawings:	
Dee	12,000
Eee	12,000
Revenue	256,000
Returns inwards	5,200
Inventory at 1 August 2014	25,800
Van expenses	11,000
Salaries	28,950
Bank interest paid	1,600
Rent receivable	3,500
Rent payable	12,000
Heat and light	7,600
Other operating expenses	6,350

Additional information

The following information was available at 31 July 2015:

(1) Inventory was valued at Rs.34,100.

(2) Rent receivable of Rs.1500 was outstanding.

(3) Depreciation is to be charged on all non-current assets owned at the end of the year as follows:

  i. Straight line method to be used for buildings which are held on a 25 year lease.

  ii. Vans at the rate of 30 % per annum using the diminishing (reducing) balance method

  iii. Equipment at the rate of 10% per annum using the straight line method.

(4) On 31st January 2015 the partners had agreed to allow Eee to increase his capital by Rs.20,000. Eee paid a cheque into the partnership bank account on that date.

(5) Trade receivables of Rs.4,500 are irrecoverable. The provision for doubtful debts is to be maintained at 4 %

(6) Other operating expenses prepaid Rs.1,800.

Required:

(a) Prepare the Statement of comprehensive income of Dee and Eee for the year ended 31st July 2015.

(b) Prepare the appropriation account of Dee and Eee for the year ended 31st July 2015.

(c) Prepare the current accounts of Dee and Eee.

(d) Prepare the Statement of financial position of Dee and Eee at 31st July 2015.

Practice question: FAIZ, JALIB AND IQBAL **7**

Faiz Jalib and Iqbal are partners sharing profits and losses in the ratio 2:2:1 in a retail business. Interest on capital is allowed at the rate of 4% per annum whereas interest on drawings is charged at the rate of 5% per annum on the balances at 30 April 2015.

The following balances were extracted from the books on 30 April 2015:

	Rs.
Building	44,750
Motor vehicles (cost)	16,000
Fixtures and fittings (cost)	30,000
Provisions for depreciation	
Motor vehicles	3,200
Fixtures and fittings	17,500
Trade payables	54,700
Trade receivables	45,000
Provision for doubtful debts	1,500
Bank	7,560 Dr
Purchases	111,200
Revenue	209,500
Returns outwards	4,750
Inventory at 1 May 2014	30,650
Salaries expense	42,100
Heat and light	3,890
General expenses	16,750
Discount received	5,300
Marketing and communication expenses	12,050
Rent	7,500
Capital accounts	
Faiz	40,000
Jalib	35,000
Iqbal	25,000
Current accounts	
Faiz	2,500 Cr
Jalib	1,500 Cr
Iqbal	1,000 Dr
Drawings	
Faiz	10,000
Jalib	10,000
Iqbal	12,000

Additional information

The following information was available at 30 April 2015:

(1) Inventory was valued at Rs.28,100.

(2) The provision for doubtful debts is to be maintained at 5% of trade receivables

(3) Depreciation is to be charged as follows:

  i. Motor vehicles at the rate of 20% per annum using the diminishing (reducing) balance method.

  ii. Fixtures and fittings at the rate of 10% per annum on cost, using the straight line method

(4) General expenses, Rs. 4,200, were prepaid.

(5) Rent Rs.2,500 was accrued.

(6) On 30 April 2015 the partners agreed to allow Iqbal to reduce his capital balance by Rs.10,000. The sum was transferred to his current account on that date. The transfer took place after calculating the interest on capital for the year.

Required:

(a) Prepare the Statement of comprehensive income of Faiz, Jalib and Iqbal for the year ended 30 April 2015

(b) Prepare the appropriation account of Faiz, Jalib and Iqbal for the year ended 30 April 2015.

(c) Prepare the current accounts of Faiz, Jalib and Iqbal.

(d) Prepare the Statement of financial position of Faiz, Jalib and Iqbal at 30 April 2015.

3 CHANGES IN THE PARTNERSHIP AGREEMENT ON PROFIT-SHARING

Section overview

- Introduction
- Apportionment of profit
- Goodwill

3.1 Introduction

Partners may change the partnership agreement anytime regarding profit sharing ratios (and so capital ratios) in the business. This change might result in following issues:

- Apportionment of profit
- Calculation and adjustment of goodwill

3.2 Apportionment of profit

The agreement on how the partners should share the profits of the business may be changed anytime during a financial year. If it changes at the start of the year, profit for the current year will be allocated to all partners with new ratios. And if it changes at the end of the year, profit for the current year will be allocated to all partners with old ratios. But, when agreement changes during the year, the total profits for the year should be apportioned, on a time basis, between:

- profits before change, and
- profits after change.

The profits for each time period are then shared between the partners in accordance with the agreement for that period.

Example:

The DEF Partnership has three partners, D, E and F.

In the first half of year 1, to 30 June Year 1, Partner D and Partner F each received an annual salary of Rs. 30,000.

Residual profits or losses are shared between D, E and F in the ratio 3:5:2. (There is no interest on capital.)

In the second half of the year, from 1 July to 31 December, Partner D's salary was increased to Rs. 40,000, and the partners altered the profit-sharing ratio to 1:3:1 for D:E:F). The salary of Partner F was unchanged at Rs. 30,000 per year.

The profit for the year was Rs. 220,000 (arising evenly throughout the year).

The annual profit would be shared as follows:

		Total	**D**	**E**	**F**
First six months		Rs.	Rs.	Rs.	Rs.
Notional salary (6 months)		30,000	15,000		15,000
Residual profit (balance)					
D share	Rs. 80,000 × 3/10	24,000	24,000		
E share	Rs. 80,000 × 5/10	40,000		40,000	
F share	Rs. 80,000 × 2/10	16,000			16,000
		80,000			
		110,000	39,000	40,000	31,000

Second six months					
Notional salary (6 months)		35,000	20,000		15,000
Residual profit (balance)					
D share	Rs. 75,000 × 1/5	15,000	15,000		
E share	Rs. 75,000 × 3/5	45,000		45,000	
F share	Rs. 75,000 × 1/5	15,000			15,000
		75,000			
		110,000	35,000	45,000	30,000
Total for the year		220,000	74,000	85,000	61,000

Example: Chagi Prides

Chagi Prides has three partners B, P and S. Following information pertains to the year ended 31 December 2016:

	B	P	S
	—— Rs. in '000 ——		
Opening balances:			
Capital accounts	21,000	13,500	9,000
Current accounts	2,000	(2,000)	2,300
Drawings for the year (other than salary)	5,500	3,800	3,500

As per the partnership agreement applicable up to 31 May 2016:

i. B, P and S share profit in the ratio of 3:2:1 respectively.

ii. Interest on partners' capital is allowed at 8% per annum.

The partnership agreement was revised with effect from 1 June 2016 as follows:

i. There will be no change in B’s share of profit whereas P and S will have equal share.

ii. Interest on partners' capital will be increased to 12% per annum.

iii. S will be entitled to a monthly salary of Rs. 135,000.

iv. Goodwill will be recognized at two years purchase of average net profit of the last three completed years.

Profits for the relevant years are as under:

2013	2014	2015	Jan-May 2016	Jun-Dec 2016
—— Rs. in '000 ——				
11,000	9,300	13,000	6,100	8,000

S has not withdrawn salaries for the months of November and December 2016 due to weak liquidity position of the firm.

For the year ended 31 December 2016:

a) **Show the partnership profits should be shared among the partners as follows:**

Profit sharing for the year ended 31 December 2016

	Profit for the period	Profit Sharing		
		B	P	S
	——— Rs. in '000 ———			
Profit sharing for the five months ended 31 May 2016: (A)	6,100			
▪ 5 months' interest at 8% p.a. on opening capital bal.	(1,450)	700	450	300
▪ Profit sharing in the ratio of 3:2:1	4,650	2,325	1,550	775
Profit sharing for the seven months ended 31 December 2016: (B)	8,000			
▪ 7 months' interest at 12% p.a. on capital balances after goodwill share **(W-1)**×12%×7÷12	(4,599)	2,247	1,463	889
▪ Salary to S 135×7	(945)			945
▪ Profit sharing in the new ratio of 3:1.5:1.5 **(W-2)**	2,456	1,228	614	614
(A+B)	**14,100**	**6,500**	**4,077**	**3,523**

W-1: Partners' capital balances after incorporating goodwill:	B	P	S
	——— Rs. in '000 ———		
Opening capital balances	21,000	13,500	9,000
Goodwill distribution as per old ratio of 3:2:1	11,100	7,400	3,700
Goodwill: (11,000+9,300+13,000)÷3×2 **= 22,200**			
	32,100	**20,900**	**12,700**

W-2: New profit sharing ratio:	**3.0**	**1.5**	**1.5**
	(3+2+1)×50%	[(3+2+1)-3] ÷2	

b) **The partners' current accounts shall be prepared as follows:**

Partners' current accounts

Description	B	P	S	Description	B	P	S
	— Rs. in '000 —				— Rs. in '000 —		
Opening balance	-	2,000	-	Opening balance	2,000	-	2,300
Drawings (other than salary)	5,500	3,800	3,500	Appropriation a/c:			
Drawings 5-months' salaries (135×5)	-	-	675	- Interest	2,947	1,913	1,189
Closing balance	3,000	-	1,648	- 7-months'salaries	-	-	945
				- Profit	3,553	2,164	1,389
				Closing balance	-	1,723	-
	8,500	**5,800**	**5,823**		**8,500**	**5,800**	**5,823**

3.3 Goodwill

Goodwill is the amount by which the value of a business exceeds the fair value of its net assets (its assets less liabilities).

The value of a business is usually more than the net assets of the business because it reflects the trading potential that the business, i.e. its ability to generate profits in the future. All successful businesses have goodwill, which means that buyers will be prepared to pay more to acquire the business than the value of its net assets.

Illustration: Goodwill

Value of the firm (what another party would pay for it)	X
Assets less liabilities of the firm (net assets)	(X)
Goodwill	X

Strictly speaking the assets and liabilities of the firm should be restated to their fair value in order to measure goodwill. Fair value is a very important concept in financial reporting but that is beyond the scope of this syllabus. For the purposes of this chapter it is sufficient to think of it as the market value of an asset, i.e. how much it is worth.

Example:

A firm has net assets of Rs. 1,000,000.

One of the assets held by the firm is a property at cost less accumulated depreciation of Rs.400,000. This property has a market value of Rs.600,000 (Rs. 200,000 above its book value.

The firm is valued at Rs. 1,800,000.

Goodwill calculation:	
Value of the firm	1,800,000
Assets less liabilities (at fair value) (1,000,000 + 200,000)	(1,200,000)
Goodwill	600,000
Amount shared by the partners:	
Goodwill	600,000
Revaluation gain	200,000
Amount shared by the partners in the profit sharing ratio:	800,000

Valuing goodwill

The method of arriving at total value of the firm might be based on a formula set out in the partnership agreement.

Example:

The XYZ Partnership values has an agreed method to value the firm for purposes of change in partnership as 10× the average annual profit for the last three years for which financial statements are available.

Profit for the last three years has been as follows:

Year 3	Rs. 100,000
Year 2	Rs. 90,000
Year 1	Rs. 80,000

The average annual profit is: $^{100,000 + 90,000 + 80,000}/_{3}$ = Rs. 90,000

The valuation of the firm is: 10 × Rs. 90,000 = Rs. 900,000

Alternatively, a partnership agreement might specify a method for valuing goodwill directly. One such method is measuring goodwill as a multiple of average annual profits or a multiple of its average annual ‘excess’ profits.

Example:

The XYZ Partnership values its goodwill as two times the average of the annual profits in excess of Rs. 60,000 each year for the last three years.

Profit for the last three years has been as follows:

Year 3	Rs. 100,000
Year 2	Rs. 90,000
Year 1	Rs. 80,000

The profits in excess of Rs. 60,000 have been:

Rs. 40,000 + Rs. 30,000 + Rs. 20,000 = Rs. 90,000

The average annual excess profit is: Rs. $^{90,000}/_{3}$ = Rs. 30,000

The valuation of goodwill is: 2 × Rs. 30,000 = Rs. 60,000

Accounting for goodwill

Goodwill is an intangible asset of a business, but business may opt not to recognise as an asset in the financial statements. If business records goodwill, its effect will be credited to partners' capital account with old ratios.

Practice question **8**

Galaxy Traders is a partnership with three partners, Z, A and B. The following information is available in respect of the year ended 31 December 2016:

i. Partners' balances:

	Z	A	B
	—— Rs. in '000 ——		
Opening balances: Capital accounts	12,000	8,000	10,000
Current accounts	500	700	600
Drawings by the partners during the year	4,500	5,000	4,000

ii. Profit sharing arrangement:

- Z, who is working as managing partner, is entitled to receive commission at 5% on profit after commission.
- A and B are entitled to a monthly salary of Rs. 50,000 each.
- All partners are entitled to receive interest at 8% on their opening capital balances.
- The remaining profit is shared by the partners in the ratio of their opening capital account balances. However, the agreement guarantees a minimum annual profit share of Rs. 5 million to A and Rs. 3 million to B. Further, 20% of the profit allocated to each partner is to be retained for business expansion and transferred to the partners' capital accounts.

iii. The net profit for the year ended 31 December 2016 was Rs. 34 million. However, the partners have noted that no provision for doubtful debts is being maintained. In this respect, ageing analysis of the closing account receivable balances was carried out and it has been agreed that prior to appropriation of profit, provision for doubtful debts is to be accounted for as under:

	Period outstanding			Total
	Less than 3 months	3 to 12 months	More than 1 year	
Customers' balances under dispute (Rs. in '000)	-	10,000	6,000	16,000
Agreed provision % on disputed balances	-	50%	100%	
Other outstanding balances (Rs. in '000)	50,000	35,000	15,000	100,000
Agreed general provision %	2%	8%	10%	
(Rs. in '000)				**116,000**

Required:

Compute the partners' current and capital account balances as on 31 December 2016.

Practice question: TOBY APPARELS **9**

Toby Apparels has three partners A, B and K. The net profit for year ended 30 June 2018 was Rs. 12.5 million which arose evenly throughout the year. Following further information pertains to the year ended 30 June 2018:

	A	B	K
	—— Rs. in ’00 ——		
Opening balances: Capital accounts	5,000	13,000	7,000
Current accounts	(500)	100	2,800
Drawings for the year	3,100	4,300	3,400

As per the partnership agreement valid up to 30 September 2017:

i. A, B and K shared profit in the ratio of 3:7:5 respectively.

ii. All partners were entitled to receive interest on capital at 12% per annum.

iii. A was entitled to monthly salary of Rs. 50,000.

iv. B was entitled to commission of 4% of net profit.

On 1 October 2017, all partners agreed to revise the partnership agreement. Before revision, they agreed to make the following changes in the capital accounts:

i. Goodwill was recognized at 2 times the average annual profit for the last 3 completed years in excess of Rs. 6 million. The profits for the firm were as follows:

30 June 2017	30 June 2016	30 June 2015
———— Rs. in ‘000 ————		
10,500	9,500	9,250

ii. Partner A made additional investment of Rs. 3.5 million while B withdrew Rs. 4.5 million of his capital. Partner K transferred Rs. 2.5 million from his current account to capital account.

As per the revised partnership agreement effective from 1 October 2017:

i. All partners will be entitled to interest on capital at 9% per annum.

ii. A will be entitled to monthly salary of Rs. 60,000 while B and K will be entitled to monthly salary of Rs. 75,000 each.

iii. A, B and K will share profit in the ratio of 2:4:3 respectively.

Required:

For the year ended 30 June 2018:

a) show how the partnership profits would be shared among the partners.

b) prepare partners’ current and capital accounts.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

		Profit share		
	Total	**A**	**B**	**C**
	Rs.	**Rs.**	**Rs.**	**Rs.**
Notional salary	10,000		10,000	
	15,000			15,000
Residual profit:				
P share				
Rs. 75,000 × ²⁄₅	30,000	30,000		
Q share				
Rs. 75,000 × ²⁄₅	30,000		30,000	
R share				
Rs. 75,000 × ¹⁄₅	15,000			15,000
	75,000			
Profit share	100,000	30,000	40,000	30,000

Solutions **2**

		Profit share		
	Total	**G**	**H**	**I**
	Rs.	**Rs.**	**Rs.**	**Rs.**
Notional salary	150,000		50,000	100,000
Notional interest				
Fixed capital		500,000	400,000	300,000
Interest @ (8%)	96,000	40,000	32,000	24,000
Residual profit:				
G share				
Rs. 900,000 × ³⁄₆	450,000	450,000		
H share				
Rs. 900,000 × ²⁄₆	300,000		300,000	
I share				
Rs. 900,000 × ¹⁄₆	150,000			150,000
	900,000			
Profit share	1,146,000	490,000	382,000	274,000

Solutions **3**

The profit share is as follows:

		Total	X	Y	Z
		Rs. (000)	Rs.	Rs.	Rs.
Notional interest					
Fixed capital			1,000,000	800,000	600,000
Interest @ (6%)		144,000	60,000	48,000	36,000
Residual profit (balance)					
X share	Rs. 1.8m x $^4/_9$	800,000	800,000		
Y share	Rs. 1.8m x $^3/_9$	600,000		600,000	
Z share	Rs. 1.8m x $^2/_9$	400,000			400,000
		1,800,000			
Profit share		1,944,000	860,000	648,000	436,000

Current accounts (Rs. 000)

	X	Y	Z		X	Y	Z
				Balance b/d	20	50	10
Drawings	780	580	350	Profit share	860	648	436
Balance c/d	100	118	96				
	880	698	446		880	698	446
				Balance b/d	100	118	96

The current accounts can also be set out in coumnar form as follows:

Current accounts	**Partner X**	**Partner Y**	**Partner Z**
	Rs.	Rs.	Rs.
Beginning of the year	20,000	50,000	10,000
Add share of profit	860,000	648,000	436,000
	880,000	698,000	446,000
Deduct drawings	(780,000)	(580,000)	(350,000)
End of the year	100,000	118,000	96,000

Solutions **4**

(a) Statement of comprehensive income for the year ended 30 April 2013

	Rs.	Rs.
Revenue		380,000
Less Returns		(11,100)
		368,900
Inventory at 1 May 2012	53,750	
Purchases	170,000	
	223,750	
Less Returns	(8,900)	
	214,850	
Less Inventory at 30 April 2013	(48,500)	
		(166,350)
Gross profit		202,550
Less Expenses		
Carriage outwards	6,290	
Administration expenses	25,720	
Marketing (17,800+4,000)	21,800	
Wages and salaries (69,530 – 20,000)	49,530	
Postage expenses (8,900 – 890)	8,010	
Loan interest (3,600+1,200)	4,800	
Building works/Repairs to air cond	4,000	
Bad debt	3,000	
Increase in provision for doubtful debts	800	
Provisions for depreciation-		
Buildings	2,900	
Equipment	7,200	
Fixtures and fittings	3,500	
		(137,550)
Profit for the year		65,000

(b) Ayaz and Urooj

Appropriation Account for the year ended 30 April 2013

Profit for the year		65,000
<u>Less: Appropriations:</u>		
Interest on capital:		
Ayaz	8,400	
Urooj	7,000	
		(15,400)
		49,600
Salary - Ayaz		(20,000)
		29,600
Share of profit:		
Ayaz		11,840
Urooj		17,760
		29,600

(c) Current accounts

	Ayaz Rs.	Urooj Rs.		Ayaz Rs.	Urooj Rs.
Balance b/d		2,700	Balance b/d	500	
Drawings	20,000	14,000	Interest on capital	8,400	7,000
Drawings-Salary	20,000		Salary	20,000	
Balance c/d	740	8,060	Share of profit	11,840	17,760
	40,700	24,760		40,700	24,760
			Balance b/d	740	8,060

(d) Ayaz and Urooj - Statement of financial position at 30 April 2013

Non-current assets	**Rs. Cost**	**Rs. Accumulated Depreciation**	**Rs. NBV**
Land and Buildings	220,,000	16,900	203,100
Equipment	48,000	19,200	28,800
Fixtures and fittings	35,000	29,500	5,500
	303,000	65,600	237,400
Current assets			
Inventory		48,500	
Trade receivables	55,000		
Less: Provision for doubtful debts	(3,300)		
		51,700	
Other receivables		890	
Bank deposit		5,000	
			106,090
Total Assets			343,490
Equity and liabilities			
Capital accounts:			
Ayaz		120,000	
Urooj		100,000	
		220,000	
Current accounts:			
Ayaz		740	
Urooj		8,060	
			8,800
			228,800
Non-current liabilities			
6% Loan			80,000
Current liabilities			
Trade payables		20,340	
Other payables:		4,000	
		1,200	
Bank Overdraft		9,150	
			34,690
			343,490

Solutions **5**

(a) Statement of comprehensive income for the year ended 30 April 2015

	Rs.	Rs.
Revenue		190,000
Less Returns inwards		(8,600)
		181,400
Inventory at 1 May 2014	15,600	
Purchases	81,250	
	96,850	
Less Inventory at 30 April 2015	(13,650)	
Cost of sales		(83,200)
Gross profit		98,200
Less Expenses:		
Other operating expenses	12,000	
Advertising (11,000 – 800)	10,200	
Wages and salaries	31,450	
Delivery vehicle expenses	14,900	
Heat and light (9,750 + 150)	9,900	
Increase in Provision for doubtful debts	250	
Provisions for depreciation-		
Premises	2,400	
Delivery vehicles	8,000	
Office fixtures	3,000	
		(92,100)
Profit for the year		6,100

(b) Hamza and Daniyal

Appropriation Account for the year ended 30 April 2015

	Rs.	Rs.
Profit for the year	6,100	
Add:		
Interest on drawings		
Hamza	240	
Daniyal	240	
		480
		6,580

<u>Less: Appropriations:</u>		
Interest on capital:		
Hamza	1,500	
Daniyal	900	
		(2,400)
		4,180
Share of profit:		
Hamza		2,090
Daniyal		2,090
		4,180

(c) Current accounts

	Hamza	Daniyal		Hamza	Daniyal
	Rs.	Rs.		Rs.	Rs.
			Balance b/d	3,250	1,850
Drawings	6,000	6,000	Interest on capital	1,500	900
Int on Drawings	240	240	Share of profit	2,090	2,090
Balance c/d	600		Balance c/d		1,400
	6,840	6,240		6,840	6,240
Balance b/d		1,400	Balance b/d	600	

(d) Hamza and Daniyal

Statement of financial position at 30 April 2015

	Rs. Cost	Rs. Accumulated Depreciation	Rs. NBV
<u>Non-current assets</u>			
Premises	120,,000	9,600	110,400
Delivery vehicles	60,000	28,000	32,000
Office fixtures	30,000	25,000	5,000
	210,000	62,600	147,400
<u>Current assets</u>			
Inventory		13,650	
Trade receivables	18,750		
Less: Provision for doubtful debts	(750)		
		18,000	
Other receivables		800	
			32,450
Total Assets			179,850

Equity and liabilities		
Capital accounts:		
Hamza	50,000	
Daniya	30,000	
	80,000	
Current accounts:		
Hamza	600	
Daniyal	(1,400)	
		(800)
		79,200
Current liabilities		
Trade payables (7,900 – 550)	7,350	
Other payables	150	
Bank Overdraft (92,600 + 550)	93,150	
		100,650
		179,850

Solutions **6**

(a) Statement of comprehensive income for the year ended 31 July 2015

	Rs.	Rs.
Revenue		256,000
Less Returns inwards		(5,200)
		250,800
Opening Inventory	25,800	
Purchases	148,300	
	174,100	
Less Closing Inventory	(34,100)	
Cost of sales		
		(140,000)
Gross profit		110,800
Rent receivable (3,500 + 1,500)	5,000	
Decrease in provision for doubtful debts	500	
		5,500
		116,300

Less Expenses:		
Rent	12,000	
Salaries	28,950	
Heat and light	7,600	
Other operating expenses (6,350 – 1,800)	4,550	
Van expenses	11,000	
Bank Loan interest (1,600+ 1,600)	3,200	
Depreciation-		
Buildings	3,000	
Van	9,000	
Equipment	2,500	
Bad debts	4,500	
		(86,300)
Profit for the year		30,000

(b) Dee and Eee

Appropriation Account for the year ended 31 July 2015

	Rs.	Rs.
Profit for the year	30,000	
Less: Appropriations:		
Interest on capital:		
Dee	2,000	
Eee	1,500	
		(3,500)
		26,500
Salary – Eee		(6,000)
		20,500
Share of profit:		
Dee	12,300	
Eee	8,200	
		20,500

(c) Current accounts

	Dee	Eee		Dee	Eee
	Rs.	Rs.		Rs.	Rs.
			Balance b/d	500	900
Drawings	12,000	12,000	Interest on capital	2,000	1,500
Balance c/d	2,800	4,600	Share of profit	12,300	8,200
			Salary		6,000
	14,800	16,600		14,800	16,600
			Balance b/d	2,800	4,600

(d) Dee and Eee

Statement of financial position at 31 July 2015

	Rs.	Rs.	Rs.
Non-current assets	**Cost**	**Accumulated Depreciation**	**NBV**
Buildings	75,,000	21,000	54,000
Van	40,000	19,000	21,000
Equipment	25,000	17,500	7,500
	140,000	57,500	82,500
Current assets			
Inventory		34,100	
Trade receivables	35,000		
Less: Provision for doubtful debts	(1,400)		
		33,600	
Other receivables (1,500 + 1,800)		3,300	
Bank		31,400	
			102,400
Total Assets			184,900
Equity and liabilities			
Capital accounts:			
Dee		40,000	
Eee		40,000	
		80,000	
Current accounts:			
Hamza		2,800	
Daniyal		4,600	
			7,400
			87,400

Current liabilities		
Trade payables	55,900	
8% Bank loan	40,000	
Other payables	1,600	
		97,500
		184,900

Solutions **7**

(a) Statement of comprehensive income for the year ended 30 April 2015

	Rs.	Rs.	Rs.
Revenue			209,500
Opening Inventory	30,650		
Add:Purchases	111,200		
Less:Returns	(4,750)		
		106,450	
		137,100	
Less Closing Inventory		(28,100)	
Cost of sales			(109,000)
Gross profit			100,500
Discount received		5,300	
			105,800
Less: Expenses:			
Rent (7,500 + 2,500)		10,000	
Salaries expense		42,100	
Heat and light		3,890	
General expenses (16,750 – 4,200)		12,550	
Marketing and communication expense		12,050	
Depreciation-			
Motor vehicles		2,560	
Fixtures		3,000	
Increase in provision of doubtful debts		750	
			(86,900)
Profit for the year			18,900

(b) Faiz, Jalib and Iqbal

Appropriation Account for the year ended 30 April 2015

	Rs.	Rs.
Profit for the year	18,900	
Interest on drawings:		
Faiz	500	
Jalib	500	
Iqbal	600	
		1,600
		20,500
		20,500
Less: Appropriations:		
Interest on capital:		
Faiz	1,600	
Jalib	1,400	
Iqbal	1,000	
		(4,000)
		16,500
Share of profit:		
Faiz	6,600	
Jalib	6,600	
Iqbal	3,300	
		16,500

(c) Current accounts

	Faiz	**Jalib**	**Iqbal**		**Faiz**	**Jalib**	**Iqbal**
	Rs.	**Rs.**	**Rs.**		**Rs.**	**Rs.**	**Rs.**
Balance b/d			1,000	Balance b/d	2,500	1,500	
Int on Drawings	500	500	600	Capital transfer			10,000
Drawings	10,000	10,000	12,000	Interest on capital	1,600	1,400	1,000
Balance c/d	200		700	Share of profit	6,600	6,600	3,300
				Balance c/d		1,000	
	10,700	10,500	14,300		10,700	10, 500	14,300
Balance b/d		1,000		Balance b/d	200		700

(d) Faiz, Jalib and Iqbal

Statement of financial position at 30 April 2015

	Rs.	Rs.	Rs.
Non-current assets	**Cost**	**Accumulated Depreciation**	**NBV**
Buildings			44,750
Motor vehicles	16,000	5,760	10,240
Fixtures	30,000	20,500	9,500
	46,000	26,260	64,490
Current assets			
Inventory		28,100	
Trade receivables	45,000		
Less: Provision for doubtful debts	(2,250)		
		42,750	
Prepaid		4,200	
Bank		7,560	
			82,610
Total Assets			147,100
Equity and liabilities			
Capital accounts:			
Faiz		40,000	
Jalib		35,000	
Iqbal		15,000	
		90,000	
Current accounts:			
Faiz		200	
Jalib		(1,000)	
Iqbal		700	
			(100)
			89,900
Current liabilities			
Trade payables		54,700	
Other payables		2,500	
			57,200
			147,100

Solutions **8**

Partners' current account:		**Profit**	**Partners' current account**		
			Z	**A**	**B**
			Rupees in '000		
Opening balance		-	500	700	600
Profit for the year		34,000			
Provision for doubt full debts (50,000×2%)+(35,000×8%)+(15,000×10%)+(10,000×50%)+6,000		(16,300)			
		17,700			
Annual commission to Z	(5/105×17,700)	(843)	843	-	-
Salaries of A and B		(1,200)	-	600	600
Interest at 8% on opening capital balances		(2,400)	960	640	800
Profit available for appropriation	**(A)**	**13,257**			
Appropriation of profit	A÷30,000×C		5,303	3,535	4,419
Shortfall in guaranteed profit of A	(5,000 – 3,535)		-	1,465	-
Shortfall to be met by Z and B:					
Z: 1,465 ÷ (12+10) ×12 **B:** 1,465 ÷ (12+10) × 10			(799)	-	(666)
			4,504	5,000	3,753
20% profit transferred to capital accounts	**(B)**		(901)	(1,000)	(751)
Drawings			(4,500)	(5,000)	(4,000)
Closing balance			**1,406**	**940**	**1,002**

Partner's capital account:

		Z	**A**	**B**
		Rupees in thousand		
Opening balance	**(C)**	12,000	8,000	10,000
Profit retained for the business expansion	**As 'B' above**	901	1,000	751
Closing balance		**12,901**	**9,000**	**10,751**

Solutions **9**

Toby Apparels

Appropriation of profit for the year ended 30 June 2018

	Profit for the period	Appropriation of profit		
		A	B	K
	——— Rs. in '000 ———			
Profit for 3 months ended 30 Sep 2017:(12,500,000/12×3)	**3,125**			
– 3 months' interest at 12% p.a. on capital balances	(750)	150	390	210
– Salary to A	(150)	150		
– Commission to B at 4% of net profit (3,125×4%)	(125)		125	
– Remaining profit in the ratio of 3:7:5	(2,100)	420	980	700
Profit for 9 months ended 30 Jun 2018:(12,500,000/12×9)	**9,375**			
– 9 months' interest at 9% p.a. on updated capital	(2,295)	675	810	810
– Salary to B and K @ Rs.75,000 p.m and to A @ Rs.60,000 p.m.	(1,890)	540	675	675
– Remaining profit in the ratio of 2:4:3	(5,190)	1,153	2,307	1,730
	-	**3,088**	**5,287**	**4,125**

Partners' current accounts

Description	A	B	K	Description	A	B	K
	—— Rs. in '000 ——				—— Rs. in '000 ——		
Opening balance	500			Opening balance		100	2,800
Transferred to capital			2,500	Appropriation a/c	3,088	5,287	4,125
Drawings	3,100	4,300	3,400				
Closing balance		1,087	1,025	Closing balance	512		
	3,600	**5,387**	**6,925**		**3,600**	**5,387**	**6,925**

Partners' capital accounts

Description	A	B	K	Description	A	B	K
	—— Rs. in '000 ——				—— Rs. in '000 ——		
Capital withdrawn		4,500		Opening balance	5,000	13,000	7,000
				Goodwill **(W-1)**	1,500	3,500	2,500
				Further investment	3,500		
Closing balance	10,000	12,000	12,000	Transfer from current account			2,500
	10,000	**16,500**	**12,000**		**10,000**	**16,500**	**12,000**

W-1: Goodwill calculation		**Rs. in '000**
3 years average profit	(10,500+9,500+9,250)/3	9,750
Excess over 6 million	9,750 – 6,000	3,750
Goodwill	3,750×2	7,500

4 OBJECTIVE BASED QUESTIONS

01. Haroon, Musa and Dawood are partners in a firm sharing profit or loss in 3:3:4 ratios. Haroon is entitled to an annual commission of Rs. 500,000. The net profit earned by the firm during the year ended Dec 31 2007 is Rs. 3,900,000.

What is Dawood's share of profit?

(a) Rs. 1,360,000

(b) Rs. 1,450,000

(c) Rs. 1,500,000

(d) Rs. 1,550,000

02. What double entry is necessary to reflect interest charged on partner's drawing?

(a) Dr: Partner's current a/c; Cr: Drawings a/c

(b) Dr: Drawings a/c ;Cr: Partner's current a/c

(c) Dr: Partner's current a/c; Cr: Profit and loss appropriation account

(d) Dr: Profit and loss appropriation account ; Cr: Partner's capital a/c

03. Salaries paid to partners is an:

(a) Expense to partnership firm

(b) Income of the partnership firm

(c) Appropriation of profit among partners

(d) None of the above

04. A partnership employs an inexperienced accountant. He has written up the current account of one of the partners as follows:

Current Account

	Rs. 000		**Rs. 000**
Interest on capital	25,000	Balance b/d	50,000
Salary received	8,000	Drawings	10,000
Balance c/d	40,000	Share of residual profit	13,000
	73,000		73,000

The balance brought down is entered correctly and the other entries are all correct in amount. However, the accountant is not very sure of the difference between debits and credits.

What is the correct amount of balance carried down?

(a) Rs. 60,000,000

(b) Rs. 70,000,000

(c) Rs. 86,000,000

(d) Rs. 96,000,000

05. Which of the following account is used to record the profits retained in the business by the partners?

- **(a)** Capital account
- **(b)** Current account
- **(c)** Appropriation account
- **(d)** Bank account

06. Which of the following is a debit entry to a partner's current account?

- **(a)** Interest on capital
- **(b)** Share of profit
- **(c)** Drawings
- **(d)** Salary

07. A partner's private residual rent expense has been treated as part of partnership rent expense. Which of the following entries is necessary to correct the entry?

- **(a)** Dr: Drawings a/c; Cr: Rent a/c
- **(b)** Dr: Rent a/c; Cr: Drawings a/c
- **(c)** Dr: Rent a/c; Cr: Capital a/c
- **(d)** Dr: Capital a/c; Cr: Rent a/c

08. Jazib and Ghalib are in partnership business as equal partners. In partnership agreement it was decided that each partner will receive interest on capital @ 5% per annum. Their capital and current accounts remained almost constant throughout the year and showed as follows:

	Jazib	**Ghalib**
	Rs. 000	**Rs. 000**
Capital account	250,000	200,000
Current account	Rs. 50,000	Rs. 40,000

What was the total interest received by partners on their capital balances?

- **(a)** Rs. 20,000,000
- **(b)** Rs. 18,500,000
- **(c)** Rs. 22,500,000
- **(d)** Rs. 20,500,000

09. Naima, Raima and Saima are in partnership and their profit sharing arrangements are as follows:

	Naima	**Raima**	**Saima**
	Rs. 000	**Rs. 000**	**Rs. 000**
Annual salary	36,000	48,000	60,000
Annual interest on capital	12,000	8,000	6,000
Share of balance of profit	50%	30%	20%

On 1 Oct 2006 it was agreed that the salaries of Raima and Saima should be increased by 8% from that date.

The profit for the year ended 31 March 2007 was Rs. 274,320.

What share of the partnership profits for the year is attributable to Saima?

(a) Rs. 87,920,000

(b) Rs. 88,400,000

(c) Rs. 98,000,000

(d) Rs. 97,400,000

10. Interest charged on drawings of partners:

(a) Decreases the profit available for appropriation to partners

(b) Increases the profit available for appropriation to partners

(c) Increases expense of the business

(d) Decreases expense of business

11. Raees and Ghareeb are partners in “R & G”. The following information is related to Ghareeb for the year ended 31 Dec 2007.

	Rs. 000
Annual salary received	60,000
Drawings during the year	12,000
Share of residual profit received	80,000

Opening credit balance in Ghareeb’s current account is Rs. 120,000.

What is the closing balance in his current account at the year-end?

(a) Rs. 248,000,000

(b) Rs. 250,000,000

(c) Rs. 245,000,000

(d) Rs. 230,000,000

12. G, H and I are in partnership, sharing profits in the ratio 3:1:1, after charging salaries of Rs. 200,000 per year each for Horace and Ivor. On 1 January 2014 they agreed to change the profit sharing ratio to 3:2:1 and to discontinue H's salary. Ivor's salary continued unchanged. The partnership profit for the year ended 30 June 2014 was Rs. 3,800,000, accruing evenly over the year.

How should the Rs. 3,800,000 profit be divided among the partners?

	G	**H**	**I**
(a)	1,920,000	1,040,000	840,000
(b)	1,920,500	1,030,333	840,167
(c)	2,090,000	1,010,333	690,667
(d)	2,090,000	1,110,333	890,667

13. Rafiq, Jameel and Rashid are partners in a firm sharing profit or loss in 1:2:3 ratios. Rafiq is entitled to an annual bonus of Rs. 30,000,000. The net profit earned by the firm during the year ended Dec 31 2007 is Rs. 270,000,000.

What is Rafiq's share of profit?

- **(a)** Rs. 70,000,000
- **(b)** Rs. 85,000,000
- **(c)** Rs. 50,000,000
- **(d)** Rs. 55,000,000

14. P and J are in partnership, sharing profit and loss equally. Their draft accounts for the year ended 31 Dec 2007 shows a profit of Rs. 300,000,000 before taking into account bonus of Rs. 30,000,000 paid to J.

Each partner is entitled to a salary of Rs. 40,000,000 per annum.

What is J's total appropriation of profit for the year ended 31 Dec 2007?

- **(a)** Rs. 122,500,000
- **(b)** Rs. 130,000,000
- **(c)** Rs. 145,500,000
- **(d)** Rs. 165,000,000

15. Junaid, Javaid and Jalib are partners in a firm. Their fixed capital balances are Rs. 250,000, Rs. 260,000 and Rs. 270,000 respectively. Partnership agreement provides as under:

	Junaid	**Javaid**	**Jalib**
	Rs.000	**Rs.000**	**Rs.000**
Annual salary	40,000	50,000	-----
Annual interest on capital	5%	8%	10%
Remaining profit or loss	25%	35%	40%

Total profit for the year was Rs. 350,000,000.

What is the final share of profit of Javaid?

(a) Rs. 102,425,000

(b) Rs. 140,695,000

(c) Rs. 106,880,000

(d) Rs. 122,000,000

16. A, B and C are equal partners in a firm. For the year ended Dec 31, 2007, the firm earned a net profit of Rs. 60,000,000.

What is B's share of profit?

Rs. ___________

17. Sadiq and Ameen are in partnership, sharing profit and loss equally. Their draft accounts for the year ended 30 June 2007 shows a profit of Rs. 2,500,000 before taking into account interest on a loan of Rs. 1,000,000 from Raees at 15%. Each partner is entitled to salary as follows:

Sadiq	Rs. 250,000 per annum
Ameen	Rs. 300,000 per annum

What is Sadiq total appropriation of profit for the year ended 30 June 2007?

Rs. ___________

18. J, T and S are partners in a firm sharing profit or loss in 5:3:2. S is entitled to an annually salary of Rs. 25,000,000. The net profit earned by the firm during the year ended 31 Dec 2007 is Rs. 200,000,000.

What is S's share of profit?

Rs. ___________

19. Tom and Jerry are partners in a design business. Their statement of financial position shows total assets of Rs. 340,800,000 and total liabilities of Rs. 130,788,000. The business has recently been valued at Rs. 245,000,000.

What is the value of goodwill in the business?

Rs. ___________

20. A, B and C are partners in a firm sharing profit or loss in the ratio of 3:2:1. For the year ended 31 Dec 2007, the firm earned a net profit of Rs. 180,000,000.

What is C's share of profit?

Rs. ___________

21. The minimum number of persons required to form a partnership is:

- **(a)** 2
- **(b)** 3
- **(c)** 4
- **(d)** 5

22. A partnership firm comes into existence by agreement between all the partners, and such agreement should be;

- **(a)** Express agreement only
- **(b)** Implied agreement only
- **(c)** Either express or implied
- **(d)** Registered

23. A Partnership firm comes into existence by

- **(a)** Operation of Law
- **(b)** Agreement
- **(c)** Status
- **(d)** None of these

24. One advantage of operating as a partnership would include:

- **(a)** Limited liability for all partners
- **(b)** Being able to raise capital through share issues
- **(c)** Access to a larger amount of initial capital
- **(d)** Greater power than a sole trader for decision making

25. In normal trading circumstances, which of the following would not be found in a partner’s current account?

- **(a)** Drawings
- **(b)** Goodwill
- **(c)** Interest on drawings
- **(d)** Salaries

26. Loss is distributed among the partners:

- **(a)** Equally
- **(b)** As per the partnership deed

(c) Ratio of capitals

(d) None of these

27. A debit balance on a partner’s current account must indicate that:

(a) They have withdrawn more than they have earned in the partnership

(b) They have a credit balance on their capital account

(c) They are insolvent

(d) Drawings are higher than the profit share for that year

28. Which of the following would not be found in a partner’s fixed capital account?

(a) Profits on revaluation

(b) Drawings

(c) Goodwill

(d) Losses on dissolution

29. If goodwill is to be created and then immediately written off, the correct method of entering this in the accounts would be:

Option	**Debit**	**Credit**
1	Capital (in previous profit ratio)	Current (in new profit ratio)
2	Capital (in previous profit ratio)	Capital (in new profit ratio)
3	Current (in new profit ratio)	Current (in previous profit ratio)
4	Capital (in new profit ratio)	Capital (in previous profit ratio)

Which option is correct?

(a) 1

(b) 2

(c) 3

(d) 4

30. Assets and liabilities are revalued at the time of admission of a new partner because:

(a) The new partner should not be benefitted from any appreciation in the value of assets

(b) The new partner should not suffer because of any depreciation in the value of assets

(c) The new partner should not benefit from any diminution in liabilities or suffer from any appreciation in liabilities

(d) All of the above

4 OBJECTIVE BASED ANSWERS

<table>
<tr><td>01.</td><td>(a)</td><td>
<table>
<tr><th></th><th>Haroon
Rs.</th><th>Musa
Rs.</th><th>Dawood
Rs.</th><th>Total
Rs.</th></tr>
<tr><td>Given profit</td><td>-</td><td>-</td><td>-</td><td>3,900,000</td></tr>
<tr><td>Commission</td><td>500,000</td><td>-</td><td>-</td><td>(500,000)</td></tr>
<tr><td>Share 3:3:4</td><td>1,020,000</td><td>1,020,000</td><td>1,360,000</td><td>3,400,000</td></tr>
</table>
</td></tr>
<tr><td>02.</td><td>(c)</td><td></td></tr>
<tr><td>03.</td><td>(c)</td><td></td></tr>
<tr><td>04.</td><td>(c)</td><td>
Current a/c
<table>
<tr><th>Particulars</th><th>Rs. 000</th><th>Particulars</th><th>Rs. 000</th></tr>
<tr><td>Drawings</td><td>10,000</td><td>b/f</td><td>50,000</td></tr>
<tr><td></td><td></td><td>Interest on cap.</td><td>25,000</td></tr>
<tr><td></td><td></td><td>Salary</td><td>8,000</td></tr>
<tr><td>c/f</td><td>86,000</td><td>Share of profit</td><td>13,000</td></tr>
<tr><td></td><td>96,000</td><td></td><td>96,000</td></tr>
</table>
</td></tr>
<tr><td>05.</td><td>(b)</td><td></td></tr>
<tr><td>06.</td><td>(c)</td><td></td></tr>
<tr><td>07.</td><td>(a)</td><td></td></tr>
<tr><td>08.</td><td>(c)</td><td>
<table>
<tr><th></th><th>Jazib
Rs. 000</th><th>Ghalib
Rs. 000</th><th>Total
Rs. 000</th></tr>
<tr><td>Capital</td><td>250,000</td><td>200,0000</td><td>450,000</td></tr>
<tr><td>Interest on capital</td><td>12,500</td><td>10,000</td><td>22,500</td></tr>
</table>
</td></tr>
<tr><td>09.</td><td>(b)</td><td>
<table>
<tr><th></th><th>Naima
Rs.000</th><th>Raima
Rs.000</th><th>Saima
Rs.000</th><th>Total
Rs.000</th></tr>
<tr><td>Profit for the year</td><td></td><td></td><td></td><td>274,320</td></tr>
<tr><td>Salaries first half</td><td>18,000</td><td>24,000</td><td>30,000</td><td>(72,000)</td></tr>
<tr><td>Salaries sec half</td><td>18,000</td><td>25,920</td><td>32,400</td><td>(76,320)</td></tr>
<tr><td>Interest on capital</td><td>12,000</td><td>8,000</td><td>6,000</td><td>(26,000)</td></tr>
<tr><td></td><td></td><td></td><td></td><td>100,000</td></tr>
<tr><td>Share of profit</td><td>50,000</td><td>30,000</td><td>20,000</td><td>(100,000)</td></tr>
<tr><td>Total</td><td>98,000</td><td>87,920</td><td>88,400</td><td>-</td></tr>
</table>
</td></tr>
</table>

10. **(b)**

11. **(a)**

Current a/c

Particulars	**Rs.000**	**Particulars**	**Rs.000**
Drawings	12,000	b/f	120,000
	-	Salary	60,000
c/f	248,000	Share of profit	80,000
	260,000		260,000

12. **(a)**

	G	**H**	**I**	**Total**
1 July – 31 Dec 03 Profit				1,900,000
Salaries × 6/12	–	100,000	100,000	(200,000)
Share of profit (3:1:1)	1,020,000	340,000	340,000	1,700,000
1 Jan – 30 June 04				1,900,000
Salaries × 6/12	–	–	100,000	(10,000)
Remaining profit (3:2:1)	900,000	600,000	300,000	1,800,000
	1,920,000	1,040,000	840,000	3,800,000

13. **(a)**

	Rafiq	**Jameel**	**Rashid**	**Total**
	Rs. 000	**Rs. 000**	**Rs. 000**	**Rs. 000**
Profit for the year				270,000
Bonus	30,000			(30,000)
Share of profit	40,000	80,000	120,000	240,000
	70,000	80,000	120,000	(240,000)

14. **(d)**

	P	**J**	**Total**
	Rs. 000	**Rs. 000**	**Rs. 000**
Profit for the year			300,000
Bonus		30,000	(30,000)
Salaries	40,000	40,000	(80,000)
			190,000
Share of profit	95,000	95,000	(190,000)
	135,000	165,000	-

<table>
<tr><td>15.</td><td>(b)</td><td>
<table>
<tr><th></th><th>Junaid</th><th>Javaid</th><th>Jalib</th><th>Total</th></tr>
<tr><td></td><td>Rs.000</td><td>Rs.000</td><td>Rs.000</td><td>Rs.000</td></tr>
<tr><td>Profit for the year</td><td>-</td><td>-</td><td>-</td><td>350,000</td></tr>
<tr><td>Salaries</td><td>40,000</td><td>50,000</td><td></td><td>(90,000)</td></tr>
<tr><td>Interest on capital</td><td>12,500</td><td>20,800</td><td>27,000</td><td>(60,300)</td></tr>
<tr><td></td><td></td><td></td><td></td><td>199,700</td></tr>
<tr><td>Share of profit</td><td>49,925</td><td>69,895</td><td>79,880</td><td>(199,700)</td></tr>
<tr><td></td><td>102,425</td><td>140,695</td><td>106,880</td><td>-</td></tr>
</table>
</td></tr>
<tr><td>16.</td><td>Rs. 20,000,000</td><td>B’ share = 60,000,000 x 1/3 = Rs. 20,000,000</td></tr>
<tr><td>17.</td><td>Rs. 1,150,000</td><td>
<table>
<tr><th></th><th>Sadiq</th><th>Ameen</th><th>Total</th></tr>
<tr><td></td><td>Rs.</td><td>Rs.</td><td>Rs.</td></tr>
<tr><td>Profit for the year 2,500,000 - 150,000</td><td></td><td></td><td>2,350,000</td></tr>
<tr><td>Salaries</td><td>250,000</td><td>300,000</td><td>(550,000)</td></tr>
<tr><td></td><td></td><td></td><td>1,800,000</td></tr>
<tr><td>Share of profit</td><td>900,000</td><td>900,000</td><td>(1,800,000)</td></tr>
<tr><td></td><td>1,150,000</td><td>1,200,000</td><td></td></tr>
</table>
</td></tr>
<tr><td>18.</td><td>Rs. 60,000,000</td><td>
<table>
<tr><th></th><th>J</th><th>T</th><th>S</th><th>Total</th></tr>
<tr><td></td><td>Rs. 000</td><td>Rs. 000</td><td>Rs. 000</td><td>Rs. 000</td></tr>
<tr><td>Profit for the year</td><td>-</td><td>-</td><td>-</td><td>200,000</td></tr>
<tr><td>Salaries</td><td>-</td><td>-</td><td>25,000</td><td>(25,000)</td></tr>
<tr><td></td><td></td><td></td><td></td><td>175,000</td></tr>
<tr><td>Share of profit</td><td>87,500</td><td>52,500</td><td>35,000</td><td>(175,000)</td></tr>
<tr><td></td><td>87,500</td><td>52,500</td><td>60,000</td><td>-</td></tr>
</table>
</td></tr>
<tr><td>19.</td><td>Rs. 34,988,000</td><td>
<table>
<tr><th></th><th>Rs. 000</th></tr>
<tr><td>Value of business</td><td>245,000</td></tr>
<tr><td>Net assets of business (Rs. 340,800 –130,788)</td><td>(210,012)</td></tr>
<tr><td>Goodwill</td><td>34,988</td></tr>
</table>
</td></tr>
<tr><td>20.</td><td>Rs. 30,000,000</td><td>C’s share = Rs. 180,000,000 x 1/6 = Rs. 30,000,000</td></tr>
<tr><td>21.</td><td>(a)</td><td></td></tr>
<tr><td>22.</td><td>(c)</td><td></td></tr>
</table>

23.	**(b)**	
24.	**(c)**	
25.	**(b)**	
26.	**(b)**	
27.	**(a)**	
28.	**(b)**	
29.	**(d)**	
30.	**(d)**	

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