ACF 255/DBA 239
FINANCIAL ACCOUNTING 1

LESSON 1
The context and purpose of financial reporting

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INTRODUCTION

This lesson aims to introduce the concept of financial reporting by explaining:

- The objectives of financial reporting
- The needs of users and stakeholders
- The main elements of financial reports
- The regulatory framework
- Duties and responsibilities of those charged with governance

The purpose of financial accounting

'Financial accounting' is a term that describes:

i. maintaining a system of accounting records for business transactions and other items of a financial nature, and

ii. reporting the financial position and the financial performance of an entity in a set of 'financial statements'.

By entity, we refer to any type of organization. 'Business entities' include companies, business partnerships and the businesses of 'sole traders'

A business entity is a commercial organization that aims to make a profit from its operations. There are three main types of business entity;

i. a sole trader
ii. a business partnership
iii. a company (a limited liability company).

1.3 Features of different types of business entity

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

Advantages and Disadvantages of Sole-tradership

Advantages

The profits of the business belong to the sole trader.

i. It is easier to bring a sole trader business to an end if needed.
ii. The sole trader is not responsible to anybody but himself.
iii. There is less accounting regulation to deal with.

Disadvantages

i. The owner is personally liable for the debts of the business.
ii. It is more difficult to raise capital for expansion.
iii. There is only one person to manage all aspects of a business (though managers could be recruited by a small privately owned business).

Advantages and Disadvantages of Partnerships

Advantages If one partner leaves the partnership, the business can continue.

i. The partners are free to run the business as they see fit.
ii. Work load is shared between the partners.
iii. There is less accounting regulation to deal with.

Disadvantages

i. The partners are personally liable for the debts of the business.
ii. It is more difficult to raise capital for expansion.
iii. Profits of the business must be shared with others.

Advantages and Disadvantages of Limited Liability Companies

Advantages of being a limited liability company

i. The personal liability of individual shareholders for the liabilities of their company is restricted
ii. Specialist management can be appointed to run the company.
iii. Transferring ownership in companies is much easier than transferring a personal business. Shares can be bought and sold, or transferred as a gift.
iv. A company structure is required for businesses that want to raise capital on a stock market.

Disadvantages of being a limited liability company

i. Companies are subject to stricter regulation
ii. If a small company wants to borrow money, the lender (typically a bank) might demand personal guarantees from the company's owners. If so, the benefits of limited liability are lost.
iii. Companies might be required to make their financial statements available for public inspection

The nature, principles and scope of financial reporting

i. Financial reporting is concerned with preparing a number of financial reports or 'financial statements' about the position and performance of the entity.

ii. This information is provided for the benefit of a number of different users.

iii. Financial statements relate to a given period of time, known as the 'financial year', 'accounting period' or 'reporting period'.

iv. They are prepared from information held in the financial accounting records (the 'books' or 'ledgers')

The nature, principles and scope of financial reporting

Financial statements should be prepared in accordance with accepted rules and principles.

i. Some principles have been established by practice, although a framework of principles and concepts has been issued by the International Accounting Standards Board (IASB). This is called the Conceptual Framework.

ii. Some rules and guidelines are provided by accounting standards. Some countries have their own national accounting standards, but many have adopted the international accounting standards of the IASB.

iii. Each country has its own laws about aspects of the preparation and content of financial statements, especially for companies.

Accounting practice is therefore a mixture of established practice, and the requirements of accounting standards and national laws.

Scope and objective of financial reporting

According to the conceptual framework, financial reporting is primarily for the benefit of the "external" stakeholders of the entity.

Managers can use the information in financial statements if they wish to do so, but they ought to be able to obtain better information about the operations of their business - and more regularly through management accounting systems

Scope and 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.

General purpose financial statements provide information about:

I. the financial position of the entity – information about economic resources and the claims against them; and
II. changes in its financial position which could be due to:
    - financial performance; and/or
    - other events or transactions (e.g. share issues).

Information for economic decisions

The International Accounting Standards Board states that financial statements are produced to enable users to make economic decisions on the basis of the information that the statements provide.

Information – including financial information – has no value unless it is used. Users of financial information usually have an interest in some aspect of what the entity does or might do in the future.

Any person or group of persons with an interest of any kind in a business entity is sometimes referred to as a 'stakeholder' – because they have some stake in what the entity does.

Many users of financial statements are therefore also stakeholders.

Users of financial statements

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. These are the primary users to whom general purpose financial reports are directed.

I. General purpose financial reports cannot provide all the information needed and users also need to consider pertinent information from other sources.

II. General purpose financial reports do not show the value of a reporting entity; but they provide information to help users estimate a value.

III. Individual primary users have different information needs. The aim of IFRSs is to provide information that will meet the needs of the maximum number of primary users.

Users of 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.

Users of financial statements -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.

Users of financial statements -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.

Users of financial statements -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.

Users of financial statements - 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.

Users of financial statements- 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.

Users of financial statements -The Public

In some cases, members of the general public might have an interest in the financial statements of a company.

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.

Users of financial statements- Managers

Managers were not included in the previously published list of users as they would 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 would be interested in the information they contain.

USERS OF FINANCIAL STATEMENTS - Other users:

I. Regulators and members of the public other than investors, lenders and other creditors may also find general purpose financial reports useful but these reports are not primarily directed to these groups.

II. A company's management is of interested in financial information but the management do not need to rely on general purpose financial reports.

FINANCIAL STATEMENTS

Financial statements present information about:

I. the financial position of an entity
II. its financial performance during an accounting period ('reporting period')
III. its cash flows and
IV. changes in its financial position during the period.

They also show the results of how management have used and looked after the resources of the business ('management's stewardship of the resources entrusted to it' (IAS 1: Presentation of Financial Statements).

Financial Statements

To do this, the financial statements provide information about an entity's:

I. assets
II. liabilities
III. equity
IV. income and expenses, including gains and losses
V. contributions by the owners of the entity and distributions by the entity to its owners, in their capacity as owners (e.g. contributions of new capital by the owners, and payments of drawings or dividends to the owners)
VI. cash flows.

Information about the financial position of an entity consists of information about its assets, liabilities and equity. This information is presented in a statement of financial position. (the balance sheet).

FINANCIAL STATEMENTS

Information about the financial performance of an entity consists of information about income and expenses and certain other gains or losses during the period that are not regarded as income or expense, or part of profit or loss.

Entities may report this information in a single statement called the statement of profit and loss and other comprehensive income.

However, a reporting entity is allowed to present the information in two separate statements, being a statement of profit or loss followed by a statement of comprehensive income.

Information about transactions by the entity with its owners in their capacity as owners (for example new share issues or dividend payments by a company) are reported in another financial statement called the statement of changes in equity or SOCIE.

Information about cash flows is reported in a statement of cash flows.

THE STATEMENT OF FINANCIAL POSITION

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

The financial position of an entity is shown by its assets, liabilities and equity (owners' capital).

ASSETS

The Conceptual Framework defines an asset as ‘a present economic resource controlled by the entity as a result of past events. An economic resource is ’a right that has the potential to produce economic benefits.’

ASSETS

In the statement of financial position, assets are categorized into two main types:

I. **Current assets**: assets that are expected to provide economic benefit in the short term. Examples of assets that are owned are inventory and cash.

II. **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. Examples are property, plant and equipment. A machine, for example, might be expected to have a useful life of five years. If so, it is classified as a non-current asset. Non-current assets are sometimes referred to as 'fixed assets'.

LIABILITIES

A liability is defined by the Conceptual Framework as a ‘present obligation of the entity to transfer an economic resource as a result of past events.’

This too is a fairly complex definition. When you are learning about liabilities for the first time, it helps to think of a liability as something that the entity owes. (This is not a strictly accurate definition, but it can be helpful).

Examples of liabilities are amounts owed to suppliers for goods or services purchased (‘trade payables’), amounts owed to a bank (bank loans and a bank overdraft) and taxation owed to the government. I

It is usual to categories liabilities in the statement of financial position into:

I. **Current liabilities**: These are obligations payable within 12 months
II. **Non-current liabilities**: These are amounts not payable within the next 12 months, for example a long-term loan from a bank.

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 = Assets – Liabilities

Equity is therefore sometimes referred to as the ‘net assets’ of the business, in other words assets minus liabilities.

Equity might also be referred to as ‘owners’ capital’ because it represents, in accounting terms, the amount of capital invested in the business by the owners. However, equity consists not only of capital put into the business by its owners, but also profits that the business has made and retained or reinvested within the business

FORMAT OF A SIMPLE STATEMENT OF FINANCIAL POSITION

A simple statement of financial position in a ‘vertical’ format is divided into two parts:

I. 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.

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

The value of total assets in the top part of the statement of financial position must always equal the total of equity plus liabilities.

Example: Statement of financial position

Entity ABC
Statement of financial position as at [date]

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

THE STATEMENT OF PROFIT OR LOSS: INCOME AND EXPENSES

The statement of profit or loss reports the financial performance of an entity during a period of time, such as the financial year. The elements in a statement of profit or loss are income and expenses. The difference between income and expenses is profit or loss.

A statement of profit or loss might be presented as a separate financial statement. Alternatively, the same information might be included as the first part of a statement of profit and loss and other comprehensive income.

The IASB therefore uses the term ‘profit or loss’ to refer to items of income or expense that will be reported in either the statement of profit or loss or in the ‘profit and loss’ part of a statement of profit and loss and other comprehensive income.

INCOME

Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Income consists of:

I. revenue from the sale of goods or services
II. other items of income such as interest received from investments
III. gains from disposing of non-current assets for more than their 'carrying value' or 'net book value'. (This is their value in the statement of financial position). For example, if a machine is sold for $15,000 when its value in the statement of financial position is $10,000, there is a gain on disposal of $5,000.

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

EXPENSES

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

Expenses consist of:

I. expenses arising in the ordinary course of activities, including the cost of sales, wages and salaries, the cost of the depletion of non-current assets, interest payable on loans and so on

II. losses arising from disasters such as fire and flood, and also losses from disposing of non-current assets for less than their carrying value in the statement of financial position.

FORMAT OF A SIMPLE STATEMENT OF PROFIT OR LOSS

A statement of profit or loss is usually presented in a vertical format. The order of presentation is usually as follows:

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

The statement of profit or loss of a company is slightly different – for example, it includes the tax charge on the company's profits.

Example: Statement of profit or loss

Entity ABC
Statement of profit or loss for the year ended [date]

	$	$
Revenue		800,000
Cost of sales		(500,000)
Gross profit		300,000
Other income:		
Gain on disposal of non-current asset		10,000
		310,000
Expenses		
Employees' salaries	120,000	
Depreciation	10,000	
Rental costs	30,000	
Telephone charges	15,000	
Advertising costs	30,000	
Selling costs	40,000	
General expenses	20,000	
Interest charges	3,000	
Bad debts	2,000	
		(270,000)
Net profit		40,000

GROSS PROFIT AND NET PROFIT

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

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

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

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

RELATIONSHIP BETWEEN THE STATEMENT OF PROFIT OR LOSS AND THE STATEMENT OF FINANCIAL POSITION

The statement of profit or loss and the statement of financial position are separate statements but they are also related to each other.

The statement of profit or loss ends with a figure for the net profit for the period. Profit belongs to the owner (or owners) of the business.

It is therefore an addition to the owner's capital.

Profit for the year is therefore added to owners' capital in the statement of financial position at the end of the year.

Accounting regulation and international accounting standards

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

Countries have their own national laws and regulations for financial accounting.

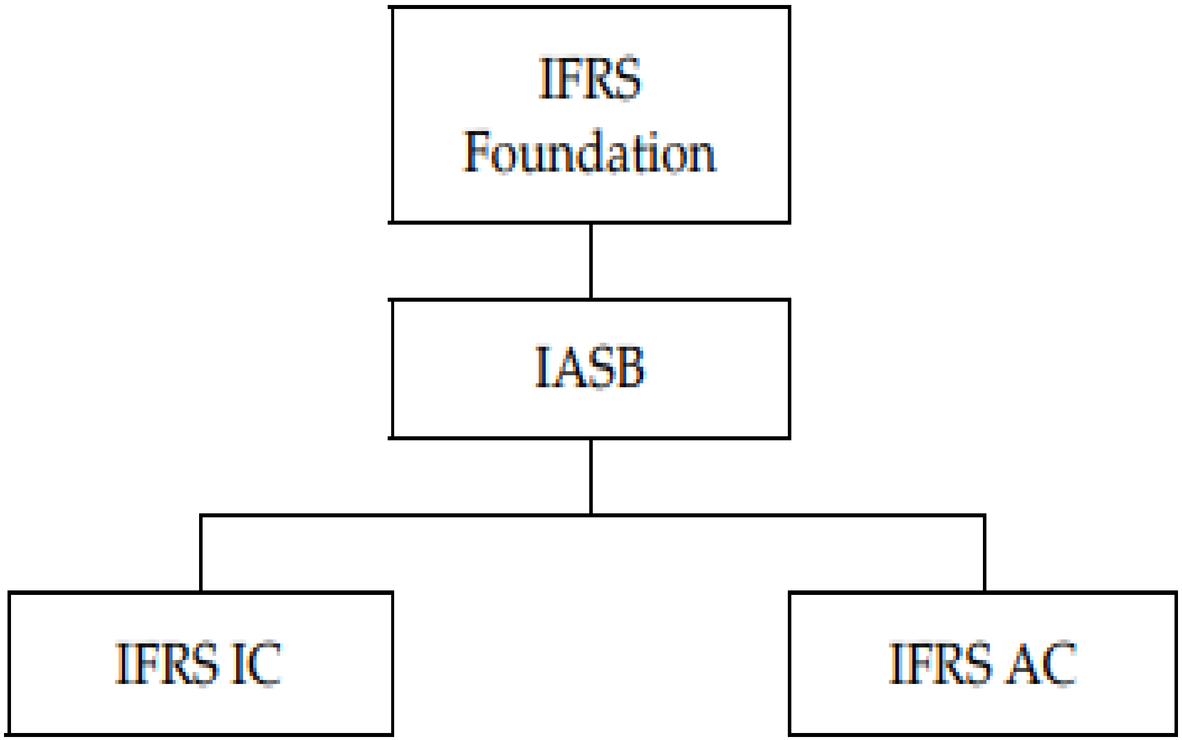
In addition, the accountancy profession has developed a large number of regulations and codes of practice that professional accountants are required to use when preparing financial statements. These regulations are accounting standards issued by the International Accounting Standards Board (IASB).

Accounting standards are applied to companies and corporations, but are not necessarily used to prepare the financial statements of non-corporate businesses, such as sole traders and partnerships.

IASC FOUNDATION AND IASB

The body with overall responsibility for international accounting is the International Accounting Standards Committee Foundation or IASC Foundation. The members of the IASC Foundation have no direct involvement in setting accounting standards, but they have oversight of three bodies that do:

I. The International Accounting Standards Board (IASB)
II. The International Financial Reporting Standards Advisory Council (IFRS AC)
III. The International Financial Reporting Standards Interpretations Committee (IFRS IC).


IFRS Foundation
IASB
IFRS IC
IFRS AC

The IASB

The IASB develops new international accounting standards. These are called International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs). An IAS and an IFRS have equal status: both are international accounting standards.

The 'new' name IFRS was introduced when the current IASB structure was established.

I. Previously, all standards were issued by a body called the International Accounting Standards Committee or IASC. The IASC issued International Accounting Standards or IASs.

II. In 2001, the IASB took over from the IASC as the body responsible for issuing international accounting standards. Standards issued by the IASB are IFRSs.

III. The existing IASs were adopted by the IASB and many have since been amended. All new international accounting standards will now be an IFRS, but there will continue to be IASs as well as IFRSs for the foreseeable future. Each IAS or IFRS has a unique identifying number, such as IAS 7 or IFRS 1. This text will use the term "IFRS" to refer to the total body of rules (i.e. all IFRSs and all IASs together).

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THE IFRS ADVISORY COUNCIL

The IFRS Advisory Council (IFRSAC) provides a forum through which the IASB is able to gather opinions and advice from different countries and industries. The SAC consists of experts from different countries and different business sectors, who offer advice to the IASB.

IFRS INTERPRETATIONS COMMITTEE

Sometimes, when an accounting standard is issued, there is some uncertainty about what the regulations actually mean, or how the standard should be applied to particular transactions. When important questions about interpretation are asked, the matter is referred to IFRSIC.

When uncertainty arises with the meaning of an accounting standard, IFRSIC interprets the rules in an IAS or IFRS, and publishes its official interpretation.

THE ROLE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

International Financial Reporting Standards provide rules and guidelines for the preparation and presentation of financial statements, but they do not cover every aspect of accounting and every type of business transaction.

Where there is no relevant accounting standard for particular aspects of financial reporting, preparers of financial statements are expected to apply the general principles and concepts of accounting that are set out in the Conceptual Framework.

A role of IFRSs is to encourage business entities in all countries to apply similar principles, concepts and accounting methods, so that the financial statements of all companies can be compared.

Global accounting standards will help with the development of international investment, because investors should be able to read and understand the financial statements of companies in any country, and make comparisons.

THE ROLE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

The IASC Foundation and IASB have no power to enforce the International Financial Reporting Standards and in this sense IFRSs are 'voluntary'. The power to enforce the use of international standards belongs to the governments of individual countries. Many countries (over 125) have adopted IFRSs and made them compulsory for some types of business entity. For example, all quoted companies in the European Union must use IFRSs in preparing their financial statements.

IFRS in total is a set of rules and guidelines over 3,000 pages long! In spite of this daunting size the rules can be described under four headings.

I. Recognition rules: This refers to when a transaction should be recorded.
II. Measurement rules: This refers to the amount at which a transaction should be recorded. There are rules on measuring items on initial recognition (when they are first recorded) and measuring items at subsequent dates.
III. Presentation rules: This refers to how an item is described and its location in the main financial statements.
IV. Disclosure rules: This refers to the requirement to provide further information about items in the financial statements to add to the understanding of the users of those statements

Duties and responsibilities of those charged with governance

'Corporate governance is the system by which companies are directed and controlled.' Governance should not be confused with management.

I. Management is concerned with running the business operations of a company.
II. Governance is about giving a lead to the company and monitoring and controlling management decisions, so as to ensure that the company achieves its intended purpose and aims.

Corporate governance is concerned with matters such as:

I. In whose interests is a company governed?
II. Who has the power to make decisions for a company?
III. For what aims or purposes are those powers used?
IV. In what manner are those powers used?
V. Who else might influence the governance of a company?
VI. Are the governors of a company held accountable for the way in which they use their powers?
VII. How are risks managed?

DUTIES AND RESPONSIBILITIES OF THOSE CHARGED WITH GOVERNANCE

Mordern codes of corporate governance require that the Board of Directors should be properly accountable to its shareholders (through the published financial statements), and should be open and transparent with investors generally.

To make a board properly accountable, high standards of financial reporting (and narrative reporting) and external auditing must be upheld. The major ‘scandals’ of corporate governance in the past have been characterised by misleading financial information in the company’s accounts.

For example, in the UK, Maxwell Communications Corporation and Polly Peck International, more recently in the US Enron and WorldCom and Parmalat in Italy. Enron filed for bankruptcy in 2001 after ‘adjusting’ its accounts. WorldCom, which collapsed in 2002 admitted to fraud in its accounting and its chief executive officer was subsequently convicted and jailed.

Duties and responsibilities of directors and others covering the preparation of the financial statements

Compliance with accounting standards is important if the financial statements are to fairly represent the activities of the entity. If accounting standards are not complied with, then it may be that the financial statements are misleading. Investors then stand to lose money if they have made decisions based on misleading financial information.

It is also important that employers have a code of ethics so that employees, in a situation where they feel they may have to act unethically, have somewhere to go for help. Some companies have codes of business ethics so that guidance is there for employees to know how they are expected to act and ask for assistance in an ethical dilemma.

Accountants who are responsible for the preparation of financial information must ensure that the information they prepare is technically correct, reports the substance of the transaction and is adequately disclosed. The danger is that they are put under pressure from senior managers to present figures that inflate profit or assets or understate liabilities. This puts the accountant in a difficult position. On one hand, they wish to prepare proper information and on the other hand, there is a possibility they might lose their job if they do not comply with their managers wishes.

QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

This is covered by 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:

I. fundamental qualitative characteristics; and

II. enhancing qualitative characteristics.

QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Fundamental qualitative characteristics:

I. relevance; and
II. faithful representation.

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

I. comparability;
II. verifiability;
III. timeliness; and
IV. understandability.

RELEVANCE

Information must be relevant to the decision-making needs of users. Information is relevant if it can be used for predictive and/or confirmatory purposes.

I. It has predictive value if it helps users to predict what might happen in the future.

II. It has confirmatory value if it helps users to confirm the assessments and predictions they have made in the past.

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.

I. 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.

II. 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.

FAITHFUL REPRESENTATION

Financial reports represent economic phenomena (economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims) 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:

I. complete – the depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

II. neutral – the depiction is without bias in the selection or presentation of financial information; and

III. 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.

COMPARABILITY

Comparability is the qualitative characteristic that 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 assure users that information faithfully represents the economic phenomena it purports to represent.

I. Verifiability means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

I. 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.

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.

ACCOUNTING CONCEPTS

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 $10,000,000 and each has a profit for the year of $100,000.

Each business discovers a $20,000 error.

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

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.

SUBSTANCE OVER FORM

The information should represent the substance or economic reality of the financial transactions, even if the economic reality is not consistent with the legal position. An example of 'substance over form' arises when an entity effectively controls the use of an item of equipment even though it is not the legal owner. An example is a longterm lease in which an entity pays lease rentals for an item over most of its economic life, controlling the use of the item without becoming the legal owner. The concept of 'substance over form' is that an item should be accounted for as an asset in such a situation, even though the entity is not its legal owner

Going concern

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. For example, 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.

The business entity concept

A concept used in financial reporting is that a business entity is an entity that is separate from its owners. In other words, the business entity and its owners are different. For example, suppose that John Smith sets up a sole trader business as a builder, and he calls the business 'J Smith, Builder'. For the purpose of financial reporting, the business (J Smith, Builder) and John Smith, the owner of the business, are different and separate from each other. The owner of the business is someone who has contributed capital to the business, and who owns the profits that have been made and retained and re-invested in the business. The equity capital of a business can be thought of as an amount that the business entity owes to its owners.

Accruals concept

The accruals basis of preparing financial statements requires the following:

I. The cost of sales in the statement of profit or loss must be matched with the sales. Sales income and 'matching' expenses must be reported in the same financial period.

II. Other expenses should be charged in the period to which they relate, not the period in which they are paid for.

III. Income, such as sales, should be reported in the period when the income arises. This might not be the same as the period when the cash is received.

With the accruals basis, financial transactions and other events are recognized in the financial statements when they occur, and not when the cash relating to the transaction is received or paid.

Accruals basis and the statement of profit or loss:	**$**
Sales income = income arising in the financial period	X
Cost of sales = costs matched with sales arising in the period	(X)
Gross profit	X
Other costs = charged in the period (financial year) to which they relate	(X)
Net profit	X

Example 1: accruals basis A company prepares its financial statements to the 30 June each year. It sells goods for $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. Applying the accruals concept, 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.

PRUDENCE

Financial statements must sometimes recognise the uncertainty in business transactions. For example, if a business is owed $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. In the example of the $1,000,000 of receivables, it might be prudent to recognise that some of the receivables, say, $50,000, will not be collected and will become ‘bad debts’ (‘irrecoverable debts’).

However, the concept of prudence does not allow an entity to create ‘hidden reserves’, by undervaluing an asset or over-stating an expense or a provision. For example, suppose that a company knows from experience that about 2% of its receivables will become bad debts. It would be prudent to make an allowance for bad debts equal to 2% of receivables, but it would be inappropriate to make an excessive allowance, say 10% of receivables.

END

ACF 255/DBA 239
FINANCIAL ACCOUNTING 1

LESSON 2
The main data sources in an accounting system

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The main data sources in an accounting system

- An accounting system or book-keeping system records data about business transactions and this data is eventually used to prepare financial statements at the end of the accounting period.
- The data that is recorded comes from a variety of documents, which are often in paper form but might be in electronic form within a computerised system.
- Businesses sell goods or services to their customers. They also buy materials and parts and services from suppliers. They hire employees and pay them for the work they do. They also incur other expenses, such as the costs of building rentals, and the costs of gas, electricity and water supply. All these transactions – and more – are recorded in the accounting system of the business.

The main data sources in an accounting system

For many businesses, the main types of business transaction are:

- sales, sometimes for cash but often on credit
- purchases of goods and services, usually on credit
- cash receipts and cash payments.

There are other transactions, which are recorded differently. Payments to employees, for example, are recorded within the payroll system. Purchases of noncurrent assets are similar to purchases of goods in many ways, although separate records are maintained of non-current assets (in a 'non-current assets register'). For the purpose of the examination, you need to be aware of the documentation and processes within a normal sales transaction cycle and a normal purchases transaction cycle.

The things you need to know are:

- What are the main documents and what is the purpose of each document?
- What information does each document contain?

Transaction Documents -Sales

- **Sales transactions:** A business might sell goods or services to a customer. This creates revenue or income for the business.
  - **Cash sales:** Sales might be for cash, which means that the customer pays immediately, in notes and coin, by debit card, credit card, cheque or by some less common method such as banker's draft. When a business sells goods for cash, it should give the customer a receipt. It should also keep a record of each sale. In shops, details of each sale transaction are recorded by the equipment at the cash desk. In an old-fashioned cash register, for example, each transaction is printed on a 'till roll'. Computerised point of sale systems in supermarkets and stores record each cash sale transaction automatically.

Transaction Documents -Sales

- **Credit sales:** Many businesses sell their goods or services on credit, which means that they give the customer time to pay. Typically a business will give its customers 30 days credit, meaning that the customer must pay by the end of 30 days from the date of sale. A credit sale transaction may begin with an order from the customer. Orders are documented. The customer might send his own purchase order. Orders taken verbally, say by telephone, are copied on to a sales order document (or into the seller's computer system, as a **sales order**). When the goods are delivered to the customer, the seller often provides a **delivery note**, stating the quantity and type of goods that have been delivered. When goods are sent by post, or when delivery might take some time, the seller might send notice to the customer that the goods have been dispatched and are on their way (in a **goods dispatched note**). For example, with internet sales the seller will often send a goods dispatched note to the customer in the form of an e-mail message. The seller will also send an invoice to the customer.

Transaction Documents -Sales

- **Sales invoices:** For credit sales, the customer is given a sales invoice. A sales invoice is simply a request for the customer to pay, and it includes details such as:
  - the goods or services purchased by the customer
  - the amount payable
  - if sales tax is payable, the invoice shows the amount payable before sales tax, the sales tax and the total amount payable including sales tax ⍰ the time by when the payment should be made.

Transaction Documents -Sales

Customers are expected to pay invoices in full by the latest specified date on the invoice. Sales invoices also include other information, such as:

- the name and address of the business sending the invoice (on the 'letter head' for the invoice)
- other contact details
- the name and address of the customer, and possibly a customer identity number
- the sales invoice number: a business should number its sales invoices sequentially.

Some invoices have a tear-off counterfoil or **remittance advice**, which the customer is asked to send with the payment. The counterfoil includes the customer's identity number, the invoice number and the total amount payable. A counterfoil helps a business to identify what payments are for when cheques are received through the post.

Transaction Documents-Sales

Statements: Some businesses also send statements to customers, as well as invoices. Statements may be used when a customer buys goods or services regularly. Typically, statements are sent to customers every month or perhaps every three months, listing:

- the amount still owed by the customer at the beginning of the statement period
- the amounts purchased by the customer in the period (each sale/purchase transaction is itemised separately)
- amounts paid by the customer in the period (each payment is itemised separately)
- the amount owed by the customer at the end of the statement period.

Transaction Documents -Sales

- **Sales returns and credit notes:** Sometimes a customer returns goods that have been sold to him. One reason for sales returns is that the goods might be in bad condition and of unsatisfactory quality. When a customer returns goods, having bought them on credit, it might seem that the logical thing to do is to re-issue an invoice for a smaller amount. In practice, this does not usually happen. Instead, the seller issues the customer with a **credit note**. Credit notes are, in effect, a reduction in an amount payable, documented as a separate transaction. For example, if there is an invoice to a customer for $200 and the business agrees to reduce the amount payable by $40 because some of the goods were of poor quality, a credit note is issued to the customer for $40. The customer is required to pay $160, which is the invoice for $200 less the credit note for $40.

Transaction Documentation-Sales

- **Sales transactions and accounting records:**
  - The data about sales transactions recorded in an accounting system comes from:
    - sales invoices
    - credit notes
    - payments by customers (e.g. cheque and remittance advice)
    - receipts (the seller's copy) in the case of cash sales.
  - Documents in a sales transaction that are not used to record data in the accounting system are
    - the sales order from the customer,
    - the delivery note or goods despatched note statements.

Transaction Documents - Purchases

- Purchase Transactions: 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.

Transaction Documents-Purchases

– **Quotation:** For large purchase transactions, or for contracts for the provision of services, a number of potential suppliers might be asked to provide a price quotation. The selected potential suppliers then submit a quotation (including other details, such as terms and conditions) and the buyer decides which one to accept. In many cases, the contract might be given to the supplier who quotes the lowest price.

Transaction Document –Purchase

- Purchase Order- For each purchase transaction, there should be a **purchase order**. A purchase order may be made verbally, but many businesses want documentary evidence of their purchase orders. So for each purchase transaction, there is a purchase order in writing.

Transaction Documents-Purchases

- **Goods received note:** When goods are purchased, the goods are delivered together with the supplier’s delivery note. The business might then make its own internal record of the goods received, and for each delivery note will prepare a **goods received note**. The goods received note will include details of the goods delivered by the supplier, with additional details such as the inventory code number of the purchased items.

Transaction Documents-Purchase

- Purchases Invoice: If the purchase is on credit (which is usual) the supplier sends an invoice. This is called a **purchase invoice**. A purchase invoice is the same as a sales invoice, except that it is originated by the supplier. Since they come from other business entities, purchase invoices all look different, because each has the letter heading and invoice design for the particular supplier. Because of this, it is usual for the purchaser to allocate his own sequential number to each suppliers invoice received. Purchase invoices should be paid by the latest date shown on the invoice. Regular suppliers might send monthly statements.

Transaction Documents-Purchases

- **Purchase returns:** When goods are returned to a supplier, for example because they are faulty, the supplier will issue a credit note. The buyer might also record details of the purchase returns in an internally-produced document, a **debit note**. The details in a debit note should match the details in the credit note that the supplier provides. Statements and credit notes from suppliers are similar to statements and credit notes sent to customers.

Transaction Documents-Purchases

- **Purchase transactions and accounting records:** The data about purchase transactions recorded in an accounting system comes from:
  - purchase invoices
  - credit notes from the supplier or debit notes produced internally
  - payments to suppliers
  - receipts (the purchaser's copy) in the case of cash purchases.

- Documents in a purchase transaction that are not used to record data in the accounting system are quotations, the purchase order, and statements received each month from the supplier. Goods received notes might be used to update inventory records, but not all business entities keep up-to-date inventory records.

From source documents to accounting records

Data in the documents described above are copied into the accounting records. Initially they are copied into 'books of prime entry' (i.e. books where an accounting entry is made for the first time). They are subsequently transferred to 'ledger accounts'. (Books of prime entry, ledgers and accounts in ledgers will be explained later).

Information for organisational policies and deadlines

In addition to allowing an entity to produce periodic financial statements, the accounting system also contributes to providing useful accounting information for management to run the business. For example, it will provide information on individual receivables which must be collected, individual payables which must be paid and it is also used to keep track of cash balances. Part of the management process will involve the setting of organisational objectives including deadlines for action. The accounting system provides information which allows management to see whether these are being achieved. Examples might include the following:

- Management might have a policy of allowing customers 30 days credit. The accounting system can be used to keep track of whether a customer pays within this period.
- Management might aim at a particular level of profit in a 3 month period. The accounting system provides information as to whether the target has been met.

END

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FINANCIAL ACCOUNTING 1

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THE ACCOUNTING EQUATION AND BUSINESS TRANSACTIONS

I. A simple representation of the statement of financial position
II. The effect of financial transactions on the accounting equation
III. Drawings
IV. Links between the statement of profit or loss and the statement of financial position
V. The business equation

THE ACCOUNTING EQUATION AND BUSINESS TRANSACTIONS

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:

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 and the business entity concept

The accounting equation, like the statement of financial position, 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.

For example, suppose that Greg sets up a business 'Greg's Security Services' and puts some capital into the business. The accounting system of the business would consider that 'Greg's Security Services' is an entity on its own, separate from Greg, and that Greg is an owner to which the business owes the capital.

THE ACCOUNTING EQUATION AND BUSINESS TRANSACTIONS

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 1: setting up a business by introducing capital

Costas has decided to set up in business selling football shirts from a stall in the market place. He begins by putting $3,000 into a bank account for the business. This transaction sets up the business, and it is recorded in the accounting equation as follows:

Assets		=	Equity		+	Liabilities
	$			$		$
Cash	3,000	=	Capital	3,000	+	0

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 $3,000.

Example 2: borrowing money

Costas then obtains a loan of $4,000 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. Assets and liabilities have both increased by $4,000.

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

Assets		=	**Equity**		+	**Liabilities**	
	$			$			$
Cash	3,000						
Van	4,000		Capital	3,000	+	Loan	4,000
	7,000	=		**3,000**	+		**4,000**

Example 3: paying cash to buy another asset

Costas buys a market stall and pays $500 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.

The accounting equation changes to:

Assets		=	**Equity**		+	**Liabilities**	
	$			$			$
Cash	2,500						
Stall	500						
Van	4,000		Capital	3,000	+	Loan	4,000
	7,000	=		**3,000**	+		**4,000**

Example 4: buying assets on credit

Costas now buys some football shirts for $1,800. 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.

The accounting equation changes to:

Assets		=	Equity		+	Liabilities	
	$			$			$
Cash	2,500						
Inventory	1,800						
Stall	500					Loan	4,000
Van	4,000		Capital	3,000	+	Trade payables	1,800
	8,800	=		**3,000**	+		**5,800**

Example 5: cash payment to settle a liability

Costas pays $1,000 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.

The accounting equation changes as follows:

Assets		=	Equity		+	Liabilities	
	$			$			$
Cash	1,500						
Inventory	1,800						
Stall	500					Loan	4,000
Van	4,000		Capital	3,000	+	Trade payables	800
	7,800	=		**3,000**	+		**4,800**

Example 6: cash sales, cost of sales and profit

Costas sells 50% of the shirts (cost = $900) for $1,200 in cash.

The business has sold assets that cost $900. It has received $1,200 in cash, and the difference is the profit on the sales. **Profit adds to the owner's capital**.

The accounting equation changes as follows:

Assets		=	Equity		+	Liabilities	
	$			$			$
Cash	2,700						
Inventory	900		Capital:				
Stall	500		Original	3,000		Loan	4,000
Van	4,000		Profit	300	+	Trade payables	800
	8,100	=		3,300	+		4,800

Example 7: credit sales, cost of sales and profit

Costas sells shirts for $900, to a shop owner in another town. These shirts originally cost $500. He sells the shirts on credit, giving the purchaser one month to pay.

The business has sold for $900 assets that cost $500. The difference is the profit of $400 on the sale. Profit adds to the owner's capital, taking the total profit earned so far from $300 to $700. 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.

The accounting equation changes to:

Assets		=	Equity		+	Liabilities	
	$			$			$
Cash	2,700						
Inventory	400						
Receivables	900		Capital:				
Stall	500		Original	3,000		Loan	4,000
Van	4,000		Profit	700	+	Trade payables	800
	8,500	=		**3,700**	+		**4,800**

THE ACCOUNTING EQUATION AND BUSINESS TRANSACTIONS

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.

I. Profits that are kept in the business are called retained earnings.

II. 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

Suppose that the accounting equation of Costas after several months is as follows.

Assets		=	**Equity**		+	**Liabilities**	
	$			$			$
Cash	7,700						
Inventory	2,300						
Receivables	1,500		Capital:				
Stall	500		Original	3,000		Loans	2,000
Van	4,000		Profit	9,600	+	Trade payables	1,400
	16,000	=		**12,600**	+		**3,400**

Costas decides to take $4,000 in cash out of his business, and he also takes inventory with a value of $200.

The assets of the business are reduced by $4,200 (cash + inventory), and capital is reduced by the same amount.

The accounting equation now changes as follows.

Assets		=	**Equity**		+	**Liabilities**	
	$			$			$
Cash	3,700						
Inventory	2,100		Capital:				
Receivables	1,500		Original	3,000			
Stall	500		Profit	9,600		Loans	2,000
Van	4,000		Drawings	(4,200)	+	Trade payables	1,400
	11,800	=		**8,400**	+		**3,400**

The drawings are $4,200 (cash $4,000 and inventory $200). The accumulated profits remaining in the business are reduced by the drawings from $9,600 to $5,400.

LINKS BETWEEN THE STATEMENT OF PROFIT OR LOSS AND THE STATEMENT OF FINANCIAL POSITION

A balance sheet shows the financial position of a business at a given point in time and is a representation of the accounting equation. A statement of profit or loss shows the profit or loss for a period of time. However, there are links between the two financial statements.

I. Profit affects the statement of financial position, by adding to the owner's capital.

II. Drawings out of profits also affect the statement of financial position, by reducing the owner's capital.

THE BUSINESS EQUATION

The accounting equation is:

Assets = Equity + Liabilities.

Re-arranging this equation, we get:

Assets – Liabilities = Equity (or Capital).

The term 'net assets' is sometimes used to mean 'assets minus liabilities'. So we can say that 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.

I. Profit adds to capital and losses reduce capital.

II. Drawings or (in the case of a company) dividends also reduce capital.

III. An owner might introduce new capital into the business, by providing it with additional cash (or other assets that previously 'belonged' to the owner and not the business)

From these observations, the following conclusions can be made about the change in net assets during a period of time, such as a financial year.

I. 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.

II. Opening net assets + Profit + Capital introduced – Drawings = Closing net assets.

THE BUSINESS EQUATION

This is called the business equation. From this formula, which contains 5 elements, if you are given the values of any four of the elements, you should be able to calculate the value of the fifth.

Example

Sonny operates a business as a sole trader. On 1 July 2018 the net assets of the business were $67,000. During the year to 30 June 2019, the business made a profit of $25,000 and Sonny took out $22,000 in drawings. Due to a shortage of cash in the business, he re-invested $4,000 in early June 2019.

The net assets of the business at 30 June 2019 can be calculated as follows.

I. Opening net assets + Profit + Capital introduced – Drawings = Closing net assets.
II. $67,000 + $25,000 + $4,000 – $22,000 = $74,000.

THE BUSINESS EQUATION

Example

Mavis operates a business as a sole trader. On 31 March 2019 the net assets of the business were \$95,000. During the year to 31 March 2019, the business made a loss of \$2,000 and Mavis took out \$15,000 in drawings during the year. She was also required to invest a further \$29,000 during the year. The opening net assets of the business at 1 April 2018 can be calculated as follows:

I. Opening net assets – Loss + Capital introduced – Drawings = Closing net assets.

II. Opening net assets – \$2,000 + \$29,000 – \$15,000 = \$95,000.

III. Opening net assets = \$95,000 + \$2,000 – \$29,000 + \$15,000 = \$83,000.

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

I. The dual nature of transactions
II. Bookkeeping
III. Accounts and ledgers
IV. Books of prime entry (books of original entry)
V. Posting transactions from the books of prime entry to the ledger accounts

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

The dual nature of transactions:

the duality concept The accounting equation, and the examples that have been used to describe the accounting equation, should illustrate an important concept in accounting and bookkeeping. This is the duality concept, that every transaction has two aspects, or a ‘dual nature’.

There is no exception to this rule. Every transaction that affects assets, liabilities, capital, income or expenses has an offsetting effect, so that the accounting equation always applies.

Double entry bookkeeping is based on this dual nature of transactions. It involves recording both aspects of the transaction.

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

Bookkeeping

Bookkeeping 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.

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

Accounts and ledgers

There are accounts for:

I. each type of asset, liability, income and expense, and accounts for the owners' capital

II. each customer who purchases goods or services on credit

III. each supplier from which goods or services are bought on credit.

Accounts are kept together in a ledger. A ledger is a term meaning a collection of related accounts. There are usually three ledgers in a financial accounting system:

I. The **main ledger**, usually called either the nominal ledger or the general ledger. This ledger contains the accounts for:
   - assets, liabilities and capital
   - income and expenses.

I. 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.

II. 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.

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

Books of prime entry (**books of original entry**) In a manual accounting system (a system that is not computerised) individual transactions are not recorded in the ledger accounts as they occur, because this would be too time-consuming. Instead, they are recorded initially in books of prime entry, or books of original entry. They are transferred at a later time from the books of prime entry to the accounts in the ledgers. The books of original entry are:

I. a sales day book, for recording sales on credit (receivables) from sales invoices
II. a sales returns day book, for recording items returned by credit customers (credit notes issued to customers)
III. a purchases day book, for recording purchases on credit from suppliers (trade payables) from purchase invoices
IV. a purchases returns day book for recording returns of purchases on credit
V. a cash book, for recording cash received into the business bank account and cash paid out of the bank account
VI. a petty cash book, for recording transactions relating to petty cash: petty cash consists of notes and coins held by a business to pay for small incidental expenses such as bus or taxi fares, or coffee and milk for the office
VII. a journal for recording transactions that are not recorded in any of the other books of original entry.

The books of prime entry are described in more detail later.

Posting transactions from the books of prime entry to the ledger accounts

The process of transferring the details of transactions from the books of prime entry to the accounts in the ledgers is sometimes called 'posting' the transactions. It is done as follows.

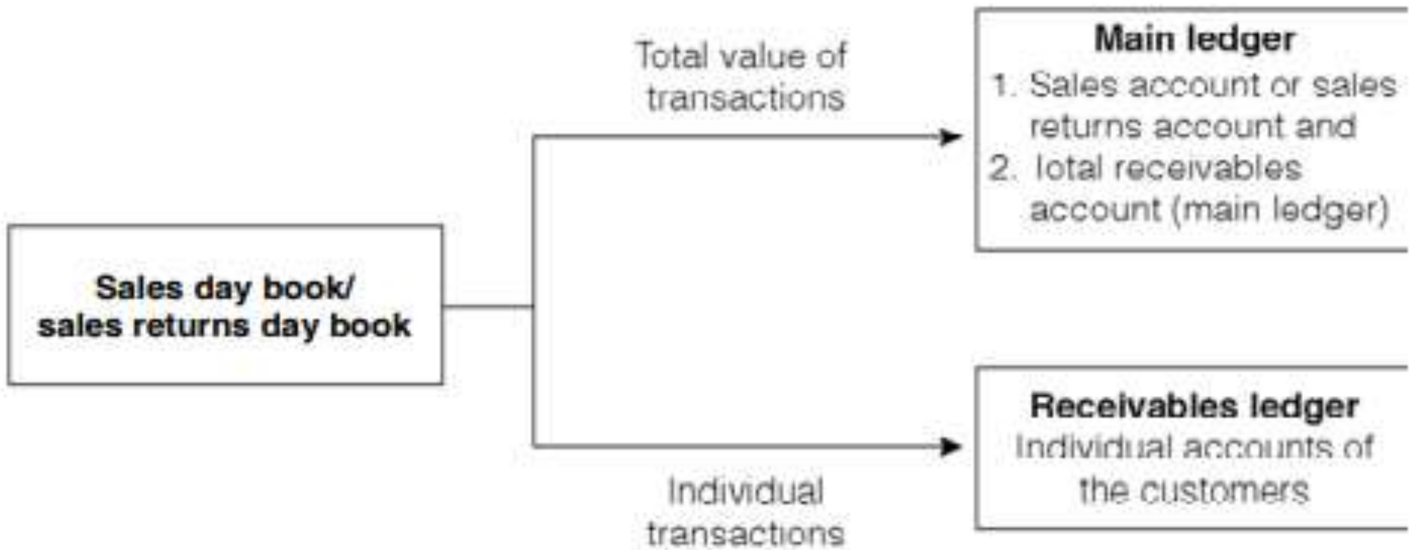
From the sales day book (or sales returns day book) to

(1) the main ledger and

(2) (2) the receivables ledger

Details of sales on credit (and also details of any credit notes for sales returns) are posted from the sales day book (or sales returns day book) to two ledgers. The total value of sales (or total value of sales returns) is recorded in the main ledger in two accounts, the sales account and the account for total receivables, to reflect the dual nature of the transaction. Details of each individual sales transaction with credit customers are also posted to the personal account for the customer, which is kept in the receivables ledger.

1. Sales on credit/sales returns



Example

Suppose that a sales day book contains the following three transactions that have not yet been posted to the ledger accounts.

Customer	Sale on credit/amount owed by customer
	$
Entity Green	250
P Rose	100
Yellow Company	400
	750

If these transactions are posted to the ledgers:

I. Sales of $750 will be recorded in the main ledger, both as $750 of sales (sales account) and $750 of money now owed by customers (trade receivables account).

II. In the receivables ledger, sales on credit of $250 will be recorded in the individual account for Entity Green, sales of $100 in the account for P Rose and sales of $400 in the account for Yellow Company.

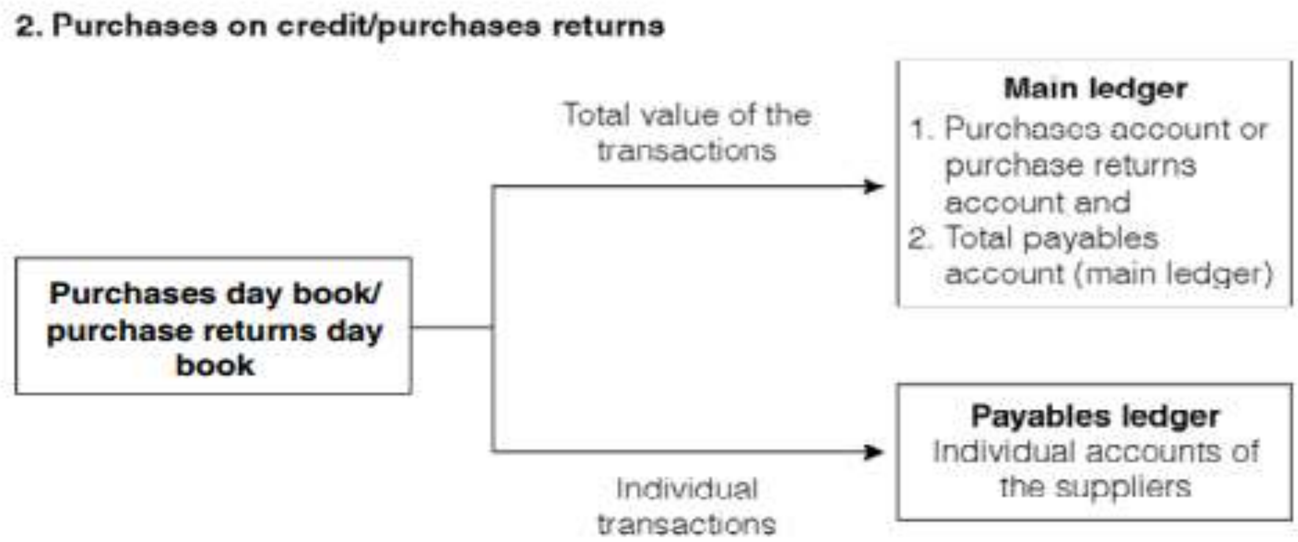
BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

From the purchases day book (or purchase returns day book) to

(1) the main ledger and

(2) (2) the payables ledger

Details of purchases of goods on credit (and also details of any credit notes from suppliers for purchase returns) are posted from the purchases day book (or purchase returns day book) to two ledgers. The total value of purchases (or total value of purchase returns) is recorded in the main ledger in two accounts, the purchases account and the account for total trade payables, to reflect the dual nature of the transaction. Details of each individual purchase transaction with suppliers are also posted to the personal account for the supplier, which is kept 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 of buildings or equipment, and invoices for telephone expenses and electricity and gas supplies. Details of these expenses are posted from the purchases ledger to the main ledger, and the accounts for:

I. the relevant expense, and
II. total trade payables.

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

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

From the cash book to

(1) the main ledger and

(2) the receivables or payables ledger

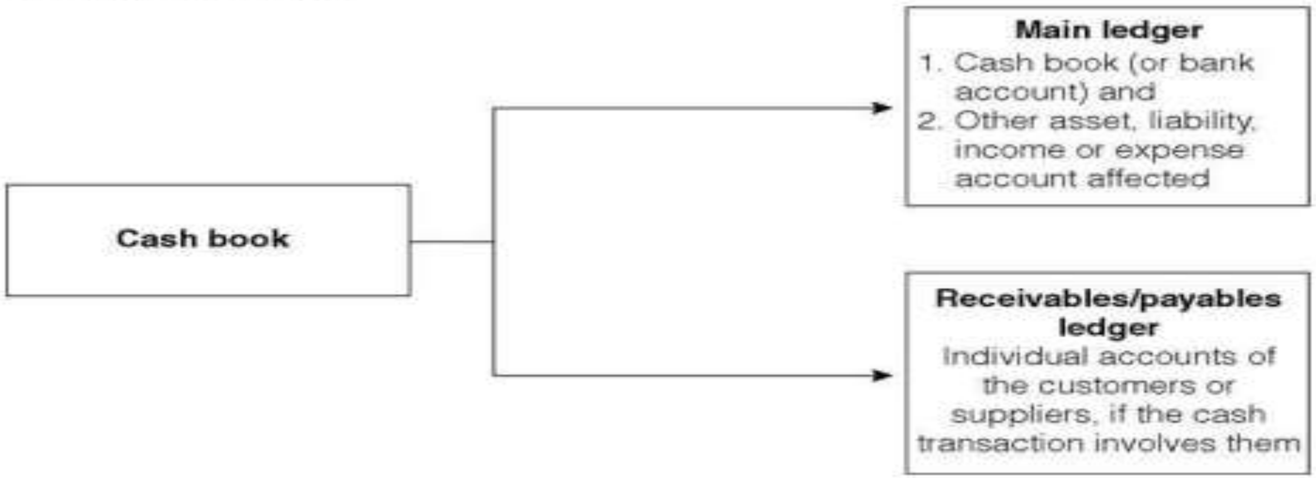
The cash book in a manual accounting system is often used as both a book of prime entry and as an account in the main ledger. However it might be convenient to think of the cash book as a book of prime entry and a different account, the bank account, as an account in the main ledger.

The cash book has two sides, a side for receipts of money and a side for payments.

Details of cash received are posted to the main ledger, where the dual nature of the transaction is recorded. For example money received from a credit customer is recorded as an addition to money in the bank and a reduction in trade receivables. Money received for a cash sale is recorded as an addition to money in the bank and an increase in total revenue from cash sales.

If the cash is received from a credit customer, the details of the money received are also recorded in the customer's personal account in the receivables ledger.

3. Cash received/paid



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

Example

Suppose that the cash book (payments side) contains the following transactions that have not yet been posted to the ledgers.

Supplier	Cash payment to the supplier
	$
Sepia Company	300
G Red	150
Blue Company	550
	1,000

BOOKKEEPING: ACCOUNTS, LEDGERS AND BOOKS OF PRIME ENTRY

These transactions are posted to the ledgers as follows:

I. Payments of $1,000 will be recorded in the main ledger, both as payments of $1,000 from the bank account and $1,000 of money paid to suppliers (trade payables).

II. In the payables ledger, a payment of $300 will be recorded in the individual account for Sepia Company, a payment of $150 in the account for G Red and a payment of $550 in the account for Blue Company.

BASIC RULES OF DOUBLE ENTRY BOOKKEEPING

I. Debit and credit entries, and T accounts
II. The rules of debits and credits
III. Double entry bookkeeping and the cash account
IV. Using journal entries to record transactions

BASIC RULES OF DOUBLE ENTRY BOOKKEEPING

Debit and credit entries, and T accounts Financial transactions are recorded in the accounts in accordance with a set of rules or conventions.

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

I. Every transaction is recorded twice, as a debit entry in one account and as a credit entry in another account.
II. 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 righthand side. By convention:

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

BASIC RULES OF DOUBLE ENTRY BOOKKEEPING

Account name

Debit side	$	Credit side	$
Debit transactions entered on this side	Amount	Credit transactions entered on this side	Amount
Enter reference to the account where the matching credit entry is made	XX	Enter reference to the account where the matching debit entry is made	XX

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.

Account	
Debit side	**Credit side**
Record as a debit entry: An **increase in an asset** (asset account) An **increase in an expense** (expense account)	**Record as a credit entry**: An **increase in a liability** (liability account) An **increase in income** (income account: for example, sales in the sales account) An **increase in capital** (capital account: for example, profit or new capital introduced to the business)
Record as a debit entry: A **reduction in a liability** (liability account) A **reduction in income** (for example, a debit in the sales returns account) A **reduction in capital** (drawings, losses)	**Record as a credit entry:** A **reduction in an asset** (asset account) A **reduction in an expense** (expense account: for example, purchases returns are a credit in the purchase returns account, because they reduce the cost of purchases)

THE RULES OF DEBITS AND CREDITS

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.

For example, if a purchase invoice is received for electricity charges for $2,300, the double entry is (ignoring sales tax):

I. Debit: Electricity charges (= increase in expense)

II. Credit: Total trade payables (= increase in liability)

The rules of double entry apply only to the main ledger and not to the receivables ledger or payables ledger, because there are accounts for total receivables and total payables in the main ledger. Transactions recorded in individual customer accounts in the receivables ledger or in individual supplier accounts in the payables ledger are entered in just one side of the appropriate individual customer or supplier account. The receivables ledger and the payables ledger are often called 'memorandum' records because they are outside the double-entry system.

Dr and Cr

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

DOUBLE ENTRY BOOKKEEPING AND THE CASH ACCOUNT

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

I. The Cash account, also called the Bank account, is an asset account (money in the bank is an asset).

II. Receipts of cash: These are recorded as a debit entry in the Cash account or Bank account, because receipts add to cash (an asset).

III. Payments of cash. Payments reduce cash, so these are recorded as a credit entry in the Cash account or Bank account.

Cash account (Bank account) in the main ledger

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

Example

Transaction 1: Sam sets up a business by putting $5,000 into a bank account.

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

Capital account

	$		$
		(1) Bank	5,000

Bank account

	$		$
(1) Capital	5,000		

Notes:

(a) The entry in each account shows the other account where the matching debit or credit entry appears.

(b) The numbers are included for illustrative purposes only, to help you to match the debit and credit entry for each transaction.

Transaction 2: Sam purchases goods for $4,000, paying $1,000 in cash and buying $3,000 of goods on credit.

Total purchases are an addition to expenses (purchases). The purchases reduce cash by $1,000 and increase trade payables by $3,000.

Bank account

	$		$
Capital	5,000	(2a) Purchases	1,000

Purchases account

	$		$
(2a) Bank	1,000		
(2b) Trade payables	3,000		

Trade payables account

	$		$
		(2b) Purchases	3,000

The purchases account is an expense account and the trade payables account is a liability account.

Note on purchases of inventory Notice that in this type of bookkeeping 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 the end of an accounting period, when it is counted and valued, and the value of the 'closing inventory' is entered in an inventory account.

Transaction 3. Sam sells goods for $6,000. $2,000 of these sales are in cash and the other $4,000 are on credit.

Total sales (income) are $6,000, and the sales result in an increase in total assets of $6,000, consisting of cash ($2,000) and trade receivables ($4,000).

Bank account

	$		$
Capital	5,000	Purchases	1,000
(3a) Sales	2,000		

Receivables account

	$		$
(3b) Sales	4,000		

Sales account

	$		$
		(3a) Bank	2,000
		(3b) Receivables	4,000

Transaction 4. Sam purchases some equipment for the business, costing \$3,000. He pays by cheque.

This transaction adds to the non-current assets of the business, and reduces cash. An increase in one asset (equipment) is therefore matched by a reduction in another asset (cash).

Bank account

	\$		\$
Capital	5,000	Purchases	1,000
Sales	2,000	(4) Equipment	3,000

Equipment account

	\$		\$
(4) Bank	3,000		

Transaction 5. Sam pays rent of $1,000 for six months, for office accommodation. Rent is an expense. The rental cost adds to expenses and reduces cash.

Bank account

	$		$
Capital	5,000	Purchases	1,000
Sales	2,000	Equipment	3,000
		(5) Rent	1,000

Rent account

	$		$
(5) Bank	1,000		

•

Exercise 2

Donald sets up a trading business, buying and selling goods. The following transactions occurred during his first month of trading.

Transaction	Details
1	Donald introduced $50,000 into the business by paying money into a business bank account.
2	The business bought a motor van for $6,000. Payment was by cheque.
3	The business bought some inventory for $3,000, paying by cheque.
4	All the inventory purchased (transaction 3) was sold for $5,000 in cash.
5	More inventory was purchased for $10,000. The purchase was on credit.
6	50% of the inventory purchased in transaction 5 was sold for $8,000. All these sales were on credit.
7	A payment of $3,000 was made to a supplier for some of the purchases.
8	A payment of $4,000 was received from a customer for some of the sales on credit.
9	Donald drew $1,000 from the bank account for his personal use.
10	Donald paid $200 for diesel for the motor van using a business cheque
11	The business paid $1,500 by cheque for the premium on an insurance policy.
12	The business received a bank loan of $10,000, repayable in two years.

Required

Record these transactions in the main ledger accounts of the business, using the following format.

Account name					
		$			$
Transaction number	Name of account containing the matching double entry	Amount	Transaction number	Name of account containing the matching double entry	Amount

Using journal entries to record transactions The journal is a book of prime entry that is used to record transactions that are not recorded in any other book of original entry.
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. The format of a journal entry is as follows:

	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

The narrative should give an accurate but brief explanation of the nature of the transaction. You might well be required to deal with an exam question that asks you to identify a journal entry where the narrative is incorrect for the given double entry.

Example

Prepare the journal entries for the following transactions:

(1) The owner of a business put $7,000 into the business bank account as new capital.

(2) Sales on credit were $25,000.

Answer

	Debit	Credit
(1)	$	$
Bank account	7,000	
Capital		7,000
Capital introduced into the business		
(2)		
Trade receivables	25,000	
Sales		25,000
Sales on credit		

Transactions recorded in the journal are posted to the main ledger accounts.

ACCOUNT BALANCES: OPENING AND CLOSING BALANCES

I. Account balances and a trial balance
II. Closing balance and opening balance
III. From trial balance to statement of profit or loss and statement of financial position – an example

ACCOUNT BALANCES AND A TRIAL BALANCE

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

I. If total debits exceed total credits, there is a debit balance

II. If total credits exceed total debits there is a credit balance.

In the previous example in paragraph 4.3, the debit and credit balances on the main ledger accounts are as follows, at the end of transaction number 5.

Debit balances	$	Credit balances	$
Bank	2,000	Capital	5,000
Purchases	4,000	Trade payables	3,000
Receivables	4,000	Sales	6,000
Equipment	3,000		
Rent	1,000		
	14,000		14,000

Total debit balances and total credit balances should always be equal. A list of the debit and credit balances in the main ledger accounts is called a **trial balance**.

At any time, it should be possible to 'extract' a trial balance from the main ledger, and prepare a list of debit balances and credit balances. If the accounts have been prepared correctly, total debit balances and total credit balances must be equal.

CLOSING OFF AN ACCOUNT AT THE END OF AN ACCOUNTING PERIOD

The debit or credit balance on an individual account at the end of an accounting period can be recorded by ‘closing off’ the account. The balance on the account is recorded as an ‘opening balance’ on the account at the start of the next period. This is explained in more detail below.

CLOSING BALANCE AND OPENING BALANCE

At the end of an accounting period, an account is closed off. On many accounts (particularly asset, liability and capital accounts), there will be a balance.

I. Balances on expense accounts and income accounts are transferred to the statement of profit or loss. (Note: There might be some accruals and prepayments on expense accounts.

II. 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.

To close off an account, the closing balance is entered in the T account so that total debits and total credits are equal. The debit and credit columns are then totalled and a line drawn underneath the entries. Below the line, the opening balance for the beginning of the next period is entered.

Example

Bank account

	$		$
Capital	5,000	Purchases	1,000
Sales	2,000	Equipment	3,000
		Rent	1,000
		Closing balance c/f	2,000
	7,000		7,000
Opening balance b/f	2,000		

In this example, there is a debit balance on the bank account at the end of the period. The closing balance to carry forward is entered on the credit side, so that total debits and total credits add up to $7,000. The debit balance of $2,000 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 $2,000.

NOTE

c/f stands for carried forward. You might also see:

I. c/fwd (for carried forward), or

II. c/d for 'carried down'.

Similarly,

I. b/f stands for brought forward. You might also see: b/fwd (for brought forward), or

II. b/d for 'brought down'.

A similar method of carrying forward the closing balance is used for liability accounts such as trade payables and the capital account. When the trade payables account below is balanced there is a closing balance of $1,500 indicating that $1,500 is payable to suppliers in total – this is a credit balance as it is a liability.

Trade payables account

	$		$
Bank	2,500	Purchases	3,000
Bank	5,000	Purchases	2,000
Balance c/d	1,500	Purchases	4,000
	9,000		9,000
		Balance b/d	1,500

Example

The following information has been extracted as account balances from the accounting records of Cane, after a first year of trading.
Trading began on 1 January Year 5.

	$ Debit	$ Credit
Sales		184,620
Purchases	146,290	
Salaries	21,500	
Motor expenses	5,200	
Rent	6,700	
Insurance	1,110	
General expenses	1,050	
Premises	15,000	
Motor vehicles	12,000	
Trade receivables	19,500	
Trade payables		15,380
Cash at bank	16,540	
Cash in hand	400	
Drawings	8,950	
Capital		54,240
	254,240	254240

Inventory as at 31st December Year 5 was $25,480.

Ignore depreciation of non-current assets and accruals and prepayments.

Required

Prepare

(a) a statement of profit or loss for the year ended 31 December Year 5 and

(b) a statement of financial position as at that date.

Answer

Statement of profit or loss

The statement of profit or loss is prepared using the format. An adjustment has to be made for inventory in order to calculate the cost of sales. The business only began trading on 1 January Year 5, so the opening inventory at 1 January is $0.

To prepare a statement of profit or loss, it is necessary to use the balances for the income and expense accounts in the trial balance.

The profit is the difference between sales income and expenses, and this profit in the statement of profit or loss is added to capital in the balance sheet.

Cane
Statement of profit or loss for the year to 31 December Year 5

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

STATEMENT OF FINANCIAL POSITION

Having calculated the profit, it is now possible to present the assets, capital (equity) and liabilities in a balance sheet.

The balances on the asset and liability accounts in the trial balance are used.

Note that the capital at the beginning of the year is adjusted for the profit and drawings during the year, to obtain the owner's capital at the end of the year. In the balance sheet below, cash in the bank and cash 'in hand' are added to make a single figure for cash, but this is not essential.

Cane
Statement of financial position as at 31 December Year 5

	$	$
Non-current assets:		
Premises		15,000
Motor vehicles		12,000
		27,000
Current assets:		
Inventory	25,480	
Trade receivables	19,500	
Cash at bank and in hand (16,540 + 400)	16,940	
		61,920
Total assets		88,920
Capital at 1 January Year 5		54,240
Net profit for the year		28,250
		82,490
Less: Drawings		(8,950)
Capital at 31 December Year 5		73,540
Current liabilities:		
Trade payables		15,380
Total capital and liabilities		88,920

END

ACF 255/DBA 239
FINANCIAL ACCOUNTING 1

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KSB
KNUST SCHOOL OF BUSINESS

RECORDING TRANSACTIONS: SALES, PURCHASES AND CASH

CONTENTS

INTRODUCTION TO BOOKS OF PRIME ENTRY

I. The role of books of prime entry
II. Posting transactions

INTRODUCTION TO BOOKS OF PRIME ENTRY

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:

INTRODUCTION TO BOOKS OF PRIME ENTRY

BOOK OF PRIME ENTRY	FUNCTION
Sales day book Sales returns day book	Records sales on credit (receivables) from sales invoices. Records items returned by credit customers (credit notes issued to customers).
Purchases day book Purchases returns day book	Records purchases on credit from suppliers (trade payables) from purchase invoices. 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.

INTRODUCTION TO BOOKS OF PRIME ENTRY

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

POSTING TRANSACTIONS

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 is an account which summarises a large number of transactions. (Examples include receivables control account, payables control account and payroll control account).

However, this creates 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).

POSTING TRANSACTIONS

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.

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.

ACCOUNTING FOR SALES

I. Recording sales
II. Recording sales returns
III. Discounts allowed
IV. Receivables control account
V. Terminology

ACCOUNTING FOR SALES

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.

I. 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:

II. 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.

ACCOUNTING FOR SALES

The entries are as follows:

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.

ACCOUNTING FOR SALES

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

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
TOTAL	75,000

ACCOUNTING FOR SALES

General ledger

Receivables control account

	$		$
Sales	75,000		

Sales

	$		$
		Receivables	75,000

Receivables ledger

Danish

	$		$
Sales	25,000		

Fahad

	$		$
Sales	10,000		

Hasan

	$		$
Sales	40,000		

ACCOUNTING FOR SALES

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

	Debit	Credit
	$	$
Receivables control account	75,000	
Sales		75,000

Being: Posting of sales from the sales day book.

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.

The entries are as follows:

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

RECORDING SALES RETURNS

Example

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

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

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

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

RECORDING SALES RETURNS

Example

General ledger

Receivables control account

	$		$
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

	$		$
		Receivables (1)	140,000

Sales returns

	$		$
Receivables (2)	5,000		

Bank

	$		$
Receivables (3)	60,000		

RECORDING SALES RETURNS

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

	Debit	Credit
	$	$
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		

RECEIVABLES LEDGER

Receivables ledger

Customer A

	$		$
(1a) Sales	40,000	(2a) Sales returns	5,000
		Balance c/d	35,000
	50,000		50,000
Balance c/d	35,000		

Customer B

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

Customer C

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

RECEIVABLES LEDGER

Customer D

	$		$
(1d) Sales	20,000		

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

	$
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.

DISCOUNTS ALLOWED

Discounts allowed

Businesses sometimes give discounts to customers. There are two main types of discount:

I. trade discount; and

II. 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 discount

A builders' merchant offers bags of cement for sale at $50 per bag. The price is reduced to $45 for any customer who buys 10 or more bags.

The reduction of $5 per bag is a trade discount.

Arif buys 20 bags off the building merchant.

If there were no discount Arif would have to pay $1000. However, because of the discount Arif has to pay only $900.

Note that from the builders' merchant's point of view this is a sale for $900. There is no special accounting needed for trade discounts.

DISCOUNT ALLOWED

Settlement discounts (prompt payment discounts)

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

Example: Settlement discount

A builders' 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.

B Builders buys goods worth $80,000. If B Builders pays within 30 days it need only pay $77,600. If B Builders does not pay within 30 days it must pay $80,000..

IFRS 15: Revenue from contracts with customers requires that revenue is recognised at the amount that the business making the sale expects to receive.

I. Revenue is recognised as the net amount (discount deducted) when a customer is expected to take advantage of a settlement discount.

II. Revenue is recognised as the gross amount (no deduction of the discount) when a customer is not expected to take advantage of a settlement discount.

DISCOUNT ALLOWED

Customer expected to take a discount

Example: Customer expected to take a discount

A offers a 3% settlement discount if payment is made within 30 days.

A has sold goods to B for $80,000. Based on previous experience, A expects B to take advantage of the settlement discount.

B pays within 30 days. A would recognise revenue as follows:

	Debit	Credit
At date of sale: Trade receivables	77,600	
Sales (97% x $80,000)		77,600
At date of payment (within 30 days)		
Bank	77,600	
Trade receivables		77,600

If a customer does not take a discount when expected to do so revenue is adjusted accordingly.

DISCOUNT ALLOWED

Example: Customer expected to take a discount but does not take it

A offers a 3% settlement discount if payment is made within 30 days.

A has sold goods to B for $80,000. Based on previous experience, A expects B to take advantage of the settlement discount.

B does not pay within 30 days.

A would recognise revenue as follows:

	Debit	Credit
At date of sale:		
Trade receivables	77,600	
Sales (97% x $80,000)		77,600
On day 30		
Trade receivables	2,400	
Revenue (3% x$80,000)		2,400
Date payment received		
Bank	80,000	
Trade receivables		80,000

DISCOUNT ALLOWED

Customer not expected to take a discount

Example: Customer not expected to take a discount

A offers a 3% settlement discount if payment is made within 30 days.

A has sold goods to B for $80,000. Based on previous experience, A does not expect B to take advantage of the settlement discount. B pays after 35 days.

A would recognise revenue as follows:

	Debit	Credit
At date of sale:		
Trade receivables	80,000	
Sales (97% ⍰ $80,000)		80,000
At date of payment (day 35)		
Bank	80,000	
Trade receivables		80,000

If a customer takes a discount when not expected to do so revenue is adjusted accordingly.

DISCOUNT ALLOWED

Example: Customer not expected to take a discount but does take it

A offers a 3% settlement discount if payment is made within 30 days. A has sold goods to B for $80,000. Based on previous experience, A does not expect B to take advantage of the settlement discount. B pays within 30 days.

A would recognise revenue as follows:

	Debit	Credit
At date of sale:		
Trade receivables	80,000	
Sales (97% x $80,000)		80,000
At date of payment (within 30 days)		
Bank (97% x$80,000)	77,600	
Trade receivables		77,600
Revenue (3% x$80,000)	2,400	
Trade receivables		2,400

REVENUE ADJUSTMENTS AND THE RECEIVABLES LEDGERS

Adjustments to revenue must also be recorded in the individual customer accounts in the receivables ledger.

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.

I. Debit entries in the receivables control account are transactions that add to the total amount of receivables.

II. Credit entries in the receivables ledger control account are transactions that reduce the total amount of receivables.

REVENUE ADJUSTMENTS AND THE RECEIVABLES LEDGERS

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
Revenue adjustment (Customer fails to take a discount when expected to do so)	X	Revenue adjustment (Customer takes a discount when not expected to do so)	X
		Bad debts written off (explained later in chapter 7).	X
		Contra entries (explained later in this chapter)	X
		Balance c/d	X
	X		X
Balance b/d	X		

DISHONOURED CHEQUES

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:

I. Cash sales (for which the entry is Dr Bank, Cr Sales);

II. 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.

TERMINOLOGY

This section 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.

	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

ACCOUNTING FOR PURCHASES

I. Recording purchases
II. Recording purchase returns
III. Discounts received
IV. Payables control account
V. Contra entries
VI. Terminology

ACCOUNTING FOR PURCHASES

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.

ACCOUNTING FOR PURCHASES

Details of each individual invoice are also posted to the account of the individual supplier in the payables ledger as follows:

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. The following illustrates the recording of purchases and the subsequent entries.

ACCOUNTING FOR PURCHASES

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

A journal can easily be constructed to effect the double entry

	Debit	Credit
	$	$
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

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:

I. debiting the total trade payables account

II. 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.

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

RECORDING PURCHASE RETURNS

Example

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

Purchases day book	$	
Supplier: A	30,000	
Supplier: B	60,000	
Supplier: C	20,000	
Supplier: D	70,000	
	180,000	(1)

Purchase returns day book	$	
Supplier: B	20,000	(2)

Cash paid to:	$	
Supplier: A	29,000	
Supplier: D	25,000	
	54,000	(3)

Discount received	$	
Supplier: A	1,000	(4)

RECORDING PURCHASE RETURNS

Example (continued): General ledger

Payables control account

	$		$
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

	$		$
Payables (1)	180,000		

Purchase returns

	$		$
		Payables (2)	20,000

Bank

	$		$
		Payables (3)	54,000

Discount received

	$		$
		Payables (4)	1,000

RECORDING PURCHASE RETURNS

Example (continued): General ledger

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

	Debit	Credit
	$	$
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		

RECORDING PURCHASE RETURNS

Example (continued): Payables ledger

Supplier A

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

Supplier B

	$		$
(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

	$		$
		(1c) Purchases	20,000

Supplier D

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

RECORDING PURCHASE RETURNS

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

	$
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.

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:

	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 profit or loss, 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

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

Example

A has sold goods to B for $80,000.

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

B pays in 19 days.

B 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

Discounts received and the payables ledgers

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

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 liabilities.

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.

I. Credit entries in the payables control account are transactions that add to the total amount of payables.

II. Debit entries in the payables ledger control account are transactions that reduce the total amount of payables.

DISCOUNTS RECEIVED

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.

DISCOUNTS RECEIVED

Exercise 1

Record the following transactions in both the payables ledger accounts for trade suppliers and also in the main ledger.

	$
Purchases on credit:	
Supplier W	3,000
Supplier X	6,000
Supplier Y	2,000
Supplier Z	7,000
	18,000
Purchase returns:	
Supplier X	2,000
Cash paid to:	
Supplier W	2,900
Supplier Z	2,500
	5,400
Early settlement discount received:	
Supplier W	100

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.

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	

CONTRA ENTRIES

A buys goods from Z, and also sells services to Z. A currently owes $120,000 to Z and is owed $50,000 by Z. A and Z might agree to offset these two debts, leaving A owing the net amount of $70,000 to Z.

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

Books of A:

	Debit	Credit
General ledger	$	$
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	

TERMINOLOGY

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

ACCOUNTING FOR SALES TAX

I. The nature of sales tax
II. The accounting treatment of sales tax
III. Note on the sales tax arithmetic
IV. Sales tax and discounts

ACCOUNTING FOR SALES TAX

The nature of sales tax

Many countries have a tax on sales, where the tax is collected for the government by the businesses that make the sales. In the UK, sales tax is called value added tax or VAT.

The rules relating to sales tax are similar for most countries, and accounting for sales tax is therefore also similar.

Business entities are required to register as sales tax collectors. A business that is registered for the sales tax:

I. must charge tax at the appropriate rate on the goods or services that it sells,

II. collects the tax for the government,

III. but can claim a repayment of the sales tax that it pays on its own purchases.

Since a registered business collects tax on its sales and reclaims the tax that it has paid, it is required to pay to the government only the difference between:

I. sales tax collected, and

II. sales tax paid.

Sales tax on goods or services sold	A
Less: Sales tax on purchases	B
Equals: Net payment of tax to the tax authorities	A – B

ACCOUNTING FOR SALES TAX

Example

Entity A operates a stone quarry, and sells a piece of stone to Entity B for $500 plus sales tax of 10%. Entity B specialises in making stone work surfaces for kitchens. It uses the stone it has bought to make a kitchen work surface that it sells to Entity C for $2,000 plus sales tax at 10%.

Entity C sells the work surface to a customer for $3,000 plus sales tax at 10%. Entities A, B and C are all registered as tax collectors.

In this simplified example, the payments of the sales tax are as follows:

	Entity A	Entity B	Entity C	Final customer
	$	$	$	$
Sales tax collected	50	200	300	0
Sales tax paid	0	50	200	300
Payment of tax to the government	50	150	100	-

ACCOUNTING FOR SALES TAX

This example should illustrate that all the sales tax is paid by the final customer for the finished consumer product. The tax on the final product is $300 (10% of $3,000). However, the tax is paid to the government at different stages in the 'supply chain', from the sale of the original raw materials to the sale of the final product. In this example, the total tax of $300 is paid in three stages, $50 by A, $150 by B and $100 by C.

Each business entity must record the sales tax that it collects, and the sales tax that it pays, and account to the government (tax authorities) for the difference.

The accounting treatment of sales tax

Sales tax charged on sales to customers is not a part of the sales revenue of a business. It is money payable to the government as tax.

Sales tax on purchases is not a part of the purchase costs or expenses of a business. It is a tax that is paid but then reclaimed from the government.

However, customers must pay the full sales price, including the sales tax. Similarly, amounts payable to a supplier include the sales tax payable.

The accounting treatment of sales tax is therefore as follows.

ACCOUNTING FOR SALES TAX

Sales tax and sales	Debit	Credit
Trade receivables (credit sales) or Bank (cash sales)	X	
This debit includes the sales tax in the total amount		
Sales (excluding sales tax)		X
Sales tax account (tax on the sales)		X

Sales tax and purchases	Debit	Credit
Purchases (excluding sales tax)	X	
Sales tax account (tax on the purchases)	X	
Trade payables (purchases on credit) or Bank (cash purchases)		X
This credit includes the sales tax in the total amount		

ACCOUNTING FOR SALES TAX

Example

A company sells goods for $10,000 plus sales tax of 18%. These transactions should be recorded in the main ledger as follows:

Sales account

	$		$
		Trade receivables	10,000

Sales tax account

	$		$
		Trade receivables	1,800

Trade receivables account

	$		$
Sales/ Sales tax	11,800		

SALES TAX ACCOUNT

The sales tax account is an asset/liability account. The balance on the account represents the difference between the sales tax on sales and the sales tax on purchases. The balance on this account is usually a credit balance, representing the net amount payable to the government.

When the tax is paid to the government, the accounting treatment is:

Payment of sales tax to the government	Debit	Credit
Sales tax account	X	
Bank account		X

Note on the sales tax arithmetic

If sales tax is X% of the basic price, and you are given the value of sales or purchases **including** the sales tax, you should calculate the sales price or purchase price **excluding** the sales tax as follows:

$$\text{Price excluding sales tax} = \text{Price including sales tax} \times \frac{100}{(100 + X)}$$

$$\text{Sales tax} = \text{Price including sales tax} \times \frac{X}{(100 + X)}$$

SALES TAX ACCOUNT

Example

A business is established and immediately registers for sales tax. During its first trading period, its sales excluding sales tax were $140,000 and its purchases including sales tax were $60,000. All sales and purchases are on credit. Sales tax is at the rate of 20%. At the end of the period, the business paid to the government all the sales tax payable for the period.

The accounting treatment of these transactions is as follows (in journal entry format):

	Debit	Credit
	$	$
Trade receivables	168,000	
Sales		140,000
Sales tax account		28,000
Being: Sales for the period		
Purchases	50,000	
Sales tax account	10,000	
Trade payables		60,000
Being: Purchases for the period		
Sales tax account	18,000	
Bank		18,000
Being Payment of sales tax to the government		

Note: The sales tax on purchases is $60,000 × 20/120. Purchases excluding sales tax are $60,000 × 100/120.

The sales tax account for the period is summarised as follows:

SALES TAX ACCOUNT

Sales tax account (Sales tax payable/receivable)

	$		$
Trade payables	10,000	Trade receivables	28,000
Bank	18,000		
	28,000		28,000

In practice, there is usually a balance on the sales tax account at the end of an accounting period. It is usually a credit balance, representing the net amount of tax that is currently payable to the government.

Exercise 2

A business has credit sales of $90,000 plus sales tax of 10%. It has purchases of $44,000, which include sales tax at 10%. Using T accounts show how these transactions would be recorded in the main ledger.

Exercise 3

A business has sales of $179,400, all on credit. These sales include sales tax at 15% of the basic price. In the same period, purchases were $95,450, including sales tax at 15%, and there were sundry expenses of $2,000 plus sales tax at 15%. (These sundry expenses have not yet been paid, and should be accounted for as payables). Required Enter these transactions in the accounts in the main ledger.

SALES TAX AND DISCOUNTS

On a sales invoice a customer could be allowed a trade discount which is usually given to long standing wholesale customers. There might also be a settlement discount offered for early payment.

These two types of discount have different effects when calculating the sales tax due

I. Trade discount – A trade discount is deducted from the list price, so the amount of sales tax payable, shown on the invoice, is calculated on the price after deducting the trade discount.

II. Settlement discount – A settlement discount is always deducted before calculation of sales tax. This is regardless of whether the customer is expected to take the discount or not.

Example

A business sells goods on credit for a list price of $100,000. A trade discount of 20% is given and a settlement discount of 4% has been offered for payment within 10 days. Sales tax is at the rate of 17.5%.

SALES TAX AND DISCOUNTS

The amount shown in the invoice as due from the customer is:

	Customer expected to take discount	Customer not expected to take discount
	$	$
List price	100,000	100,000
Less: trade discount	(20,000)	(20,000)
Net price	80,000	80,000
Less: settlement discount (4% × 80,000)	(3,200)	
	76,800	
Sales tax (17.5% of 76,800)	(13,440)	(13,440)
Total amount payable	90,240	93,440

This is the amount due from the customer for the goods. Note: If the customer pays outside the discount period so that no discount is taken the amount paid will be $93,440. However, no adjustment is made for the loss of sales tax.

ACCOUNTING FOR CASH

I. The cash book
II. Cash receipts
III. Cash payments

ACCOUNTING FOR CASH

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.

Cash receipts

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

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

Some businesses might choose to use a column in the cash receipts side of the cash book to record revenue adjustments for settlement discount taken when the original receivable did not anticipate that it would be. 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).

ACCOUNTING FOR CASH

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

Cash receipts

	Total	Receivables	Other receipts	Revenue adjustment (memo only)
	$	$	$	$
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
	$	$
Bank	183,500	
Receivables control account		177,500
Sale		1,000
Dividend income		5,000

And

Revenue	4,500	
Receivables control account		4,500

The cash received from individual customers and the revenue adjustment for 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. A business might choose to record discounts received in a memorandum column in the cash book.

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

Cash payments

	Total	Payables	Expenses	Discount received
	$	$	$	$
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
	$	$
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

I. Definition of petty cash

II. Recording petty cash transactions

PETTY CASH

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:

	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 $10,000). This set amount is called the imprest.

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

Example:

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

The imprest is set at $10,000.

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

An amount of $600 is paid to Lydia 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 $9,400 cash and an invoice from Lydia for $600. These two amounts add back to the imprest.

END