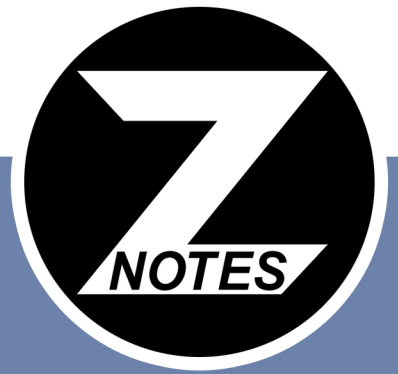


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# CIE IGCSE ACCOUNTING 0452

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SUMMARIZED NOTES ON THE SYLLABUS

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NOTES

**PREFACE:**

- The following are short forms used in the notes. Note that these short forms will not be accepted in examinations and no marks will be awarded for their usage:

Short Form	Full Form
SOFP/BS	Statement of financial position/ balance sheet
BRS	Bank reconciliation statement
PNL	Profit and loss a/c
IS	Income statement
Dep.	Depreciation
MCB	Main cash book
PCB	Petty cash book
TB	Trial balance
SPOG	Selling price of goods
COS	Cost of Sales
P	Purchases

- The only accepted short forms are:

A/C	Account
b/d	Brought down
c/d	Carried down.
C	Contra- only for use in ledgers- Not structured answers.

- References to tables and Images have been given as some may not fit into one column. These are included at the end of the document.
- Ticks refer to (optional, but recommended) markings a candidate will make to ensure the requirements of the question have been satisfied.
- If in the examination question, a folio column is not present, the contents of the folio column should be shown along with the details in the detail column
- Some of the accounts shown do not contain all the columns and details required in an examination. They just show relevant details. All details will be required in the question unless mentioned.
- Date should be written in full (including day, month and year) unless instructed otherwise.

**1. THE PURPOSE OF ACCOUNTING****1.1 Bookkeeping vs. Accounting:**

- Bookkeeping:** A process of detailed recording of all the financial transactions of a business.
- Accounting:** Accounting uses the bookkeeping records to prepare financial statements at regular intervals.

**2. SOURCES AND RECORDING OF DATA****2.1 Profits and losses:**

- The aim of business is to make a profit. This is calculated in the financial statements which are usually prepared at the end of a financial year.
- Profit = Income – Expenses**
- A business can also make a loss wherein the expenses are greater than the income. Loss= negative profit.
- By measuring the profit and loss of a business, one can:
  - Understand the progress of the business
  - Use ratios and compare the profit of a business to other figures in the financial statements to get a more comprehensive view of the business' progress.
  - Compare the progress of the business to the progress of similar businesses.
  - Comparing the business to itself from year to year.
  - Base the business' future and make decisions based of the profit/loss figure.

**2.2 Assets, Capital and Liabilities:**

- Profit is the return received by the owner for their investment of capital.
- Capital or Owner's Equity is the amount the business owes to its owner. When a business begins operation, the owner of the business invests capital, which can be any resource such as:
  - Cash
  - Bank or cash equivalents
  - Motor vehicles
  - Inventory (the stock of goods).
- Each investment of capital results in an increase in assets.
- Assets are things/resources the business owns or are owed to the business.

- At times a business can borrow money from an entity which is not the owner of the business. The business now has a liability and *is liable to pay for the item borrowed*.
- An increase in liabilities results in an increase in assets, for e.g. cash if borrowed increases the cash in hand, but also increases the amount the business owes to other entities.
- Thus, the accounting equation is derived:

$$ASSETS = CAPITAL + LIABILITIES$$

**2.3 Double Entry bookkeeping:**

- The double entry system of bookkeeping involves giving two effects to each business transaction, one which debits to the A/C receiving and the other which credits where the amount is being deducted.
- **The rules of double entry bookkeeping are:**
  - Debit the receiver, Credit the giver.
  - Debit what comes in, Credit what goes out.
  - Debit the expense, Credit the income.
- Day-to-day transactions are recorded using the double entry bookkeeping system.
- Ledgers are used to record financial transactions and their format is as follows: Ledger (T) Format: Date-Details-Folio-\$- Date-Details-Folio-\$- (Left = Dr, Right = Cr)

**T format:**

Dr				Cr			
Date	Details	F	\$	Date	Details	F	\$

- **Alternative running balance format:**
  - Three column running balance format (Ledger) = Date-Details-Folio-Dr (\$) - Cr (\$) - Balance (\$).
  - Advantage of Three column running balance format- Balance shown after each transaction (Lesser Errors)

Date	Details	F	Dr (\$)	Cr (\$)	Balance

**Example entries:**

- Sales, for cash \$100: Dr Cash A/C for \$100 (as cash is the receiving A/C) and Cr Sales A/C for \$100 (as sales is responsible for/giving the cash).
- Purchases of goods \$150 (on credit): Dr Purchases A/C for \$100 and Cr Seller's A/C for \$100.
  - Crediting the seller's A/C creates a liability as now the business has obligation to pay for the goods.
- Drawings (assets taken by the owner of a business for their personal use, out of the business) of goods \$50. Dr Drawings and Cr Purchases, both with \$50. The drawings increase and the goods decrease.
- Payment of \$150 (through bank) to Seller for goods bought earlier: Credit Bank A/C for \$150 and Dr Seller's A/C for \$ 150.
  - Now there is no outstanding balance on the seller's A/C, as the debit is equal to the credit.
- When an A/C of a person or another business is maintained, and has a Dr Balance, the business is owed money by that entity and vice versa as shown in the example.
  - Sales of \$60 to B dawg (on credit): Cr Sales A/C and Dr B Dawg A/C.
- An A/C which is a liability to the business due to regular trading is known as a trade creditor/trade payables/creditor.
- An A/C which is an asset (because the entity owes money to the business, it's almost as good as having the money) due to regular trading is known as a trade debtor/ trade receivables/Debtor.

- **Balancing a ledger at the end of the month:**
    - The debit and credit columns are individually totalled. The difference is noted. If the debit side is heavier than the credit side, then the difference is entered as a credit entry (Balance c/d) and vice versa for the credit side being heavier than the debit side.
    - Total the debit and credit columns and write them.
    - The totals of both columns will now tally.
    - If the balance c/d was Dr, then the balance b/d will be Cr, and vice versa.
    - Thus, the difference is now brought down.
    - The balance c/d entry is done on the last day of the month and the balance b/d entry is made on the first day of the next month.
- Refer to IMAGE 1

**2.4 The Trial Balance:**

- As mentioned, a transaction has one Dr effect and one Cr effect equal in amount, therefore all the total debits should equal the total credits. This is checked by the trial balance.
- The Trial Balance is a statement of ledger balances on a particular date
- **How A/C (s) are shown in the trial balance:**
  - If the debit side of an A/C has greater value than the credit side, then the difference is recorded as a debit balance
  - If the credit side of an A/C has greater value than the debit side, then the difference is recorded as a credit balance

<b>Accounts that normally have Dr balances (EAD)</b>	<b>Accounts that normally have Cr balances (CLIP)</b>
<b>Assets</b>	<b>Liabilities</b>
<b>Expenses</b>	<b>Incomes</b>
<b>Drawings</b>	<b>Capital</b>
<b>Sales Returns (E)</b>	<b>Purchase Returns</b>

- The trial balance is prepared to check the arithmetical accuracy of the double entry bookkeeping records. It shows that the total Dr balance = the total Cr balance.

- It is not a part of the double entry system. Heading = Trial Balance at <The date on which it is prepared>. Format = Details-Folio-Dr (\$)–Cr (\$). However, folio numbers don't always appear.
- The Trial balance is useful in locating arithmetic errors, but cannot guarantee an error free ledger. It is also useful in preparing financial statements. If the Dr & Cr columns totals tally, then the ledgers are arithmetically correct.

**Errors the trial balance cannot detect:**

<b>Name</b>	<b>Description of entries made</b>
<b>Error of commission</b>	Correct amount, correct side, but wrong A/C of correct class
<b>Error of complete reversal</b>	Correct amount, correct A/C, but wrong side of each A/C
<b>Error of omission</b>	Transaction completely omitted from the ledgers
<b>Error of original entry</b>	Incorrect figure used for both entries
<b>Error of Principle</b>	Correct amount, correct side, but wrong class of A/C
<b>Compensating errors</b>	Two or more errors cancel each other out

- A trial balance may not always tally. This might be because:
  - An error of addition within the TB
  - An error of addition in the ledger A/C s
  - Double entry figures differ
  - Only single entry made instead of a double entry
  - Both entries made in the same side of the ledger

**• To locate errors:**

- Check TB addition
- Check balance addition in the ledger A/C s
- Check that ledger A/C balance is entered on the correct side (Dr or Cr)
- Check that every ledger A/C balance is entered in the trial balance
- Look for a transaction equal to the difference in the totals of the TB & check for its double entry.
- Look for a transaction that is equal to half the difference & then check whether it has been entered on the same side twice.
- Check the double entry for each transaction after the previous trial balance was made (last resort).

**• Practical Tip:** If the difference in the totals of the TB is perfectly divisible by 9, then check if an amount has been entered without a zero (e.g. If 99 has been entered as debit instead of 990, the difference 891 can be divided by 9 perfectly giving 99. Thus, any transactions with the value 99 can be located and rectified)

**2.5 The Ledger**

• Ledgers are divided based on the types of accounts they contain, this is done so that several people can bookkeep simultaneously, i.e. Work can be distributed (the same applies for books of prime entries).

<b>Ledger</b>	<b>General Description/Contents</b>
<b>Sales Ledger</b>	Debtors Ledger
<b>Purchases Ledger</b>	Creditors Ledger
<b>Nominal Ledger</b>	Real A/C s (assets) & nominal A/C s (income, expenses & capital)
<b>Cash book</b>	MCB & PCB

• **Cash Book:** In practice, it is common to have the cash A/C & bank A/C shown side by side in what is called a cash book. This book is moved away from the ledger; however, this still follows the double entry system of bookkeeping. Certain businesses maintain a 3-column cash book where there is an added cash discount column on the Dr & the Cr side. They are both ledgers as well as prime books of entries<sup>1</sup>

<b>Cash Book</b>	<b>Format</b>
<b>2 column cash book</b>	Dr = Date-Details-Folio-Cash-Bank Cr = Date-Details-Folio-Cash-Bank
<b>3 column cash book</b>	Dr = Date-Details-Folio-Discout Allowed-Cash-Bank Cr = Date-Details-Folio-Discout Received-Cash-Bank

- **Contra Entries:** withdrawal of cash/deposition of cash. The folio column will have a 'C' in it. The Cash column can never have a Cr balance as it is a physical quantity, i.e. it can either be nil or it has a Dr Balance. However, the bank column can have a Cr balance; this is known as a bank overdraft wherein the bank allows one to pay more than their bank balance is & then charges interest on the sum (most of the times-in practicality). A Cr balance on the bank column of the cash book represents a liability.
- Discount allowed/Cash Discount (may not pertain to cash transactions)<sup>2</sup>: Discount a business allows to its Cr customers to encourage faster payment (within a set time span). This is an expense incurred by the business in-order to have debts settled promptly. However, this is not shown on the receipt.
- The discount columns are not a part of the double entry system, they are used for convenience. At the end of the trading periods, their totals are taken are carried to their respective A/C s (Dr Entries for discount allowed & Cr entries for discount received). This represents the double entry for all the individual debits in the creditors & credits in the debtors.
- If a cheque is dishonoured (There is a problem with the cheque {No signature, Amount In words & in numbers don't match} or there is an insufficient balance in the debtor's A/C, etc.), the reverse entry of that has to be made when the cheque was deposited & the debtor or payee will have to be informed that the amount is unpaid.

<sup>1</sup> See 2.7 Prime Books of entry

<sup>2</sup> Also, a method to decrease the value of bad debts See 3.5 Bad Debts and Provision for Doubtful Debts

**2.6 Business Documents:**

- Refer to TABLE 1 for business documents.

**2.7 Prime books of entry:**

- Businesses maintain a petty cash book (as to not record small cash payments (and sometimes receipts) in the cash book & ledgers, i.e. It reduces the amount of entries in the cash book & ledgers.) That records any low value transactions. It lists the transactions to be transferred to the ledger A/C & also acts as the ledger A/C for these petty cash transactions.
- **General working of a petty cash system:** A junior cashier is given a float amount so that the chief cashier focuses on more important transactions. They (chief cashier) regularly checks the work of the junior cashier. When some petty cash is to be obtained, a petty cash voucher is given to the petty cashier. (this show: purpose, date & signature of receiving person). These are used to check against the petty cash spent.
- **The imprest system:** Petty cash expenditure is made from the float/imprest amt. The imprest amount stays constant (but can be altered). After the balancing of the petty cash book, the chief cashier will restore the imprest. This enables the chief cashier to know exactly how much petty cash has been spent.
- **Layout/format:**
  - Vo no. = Voucher number.
  - Dr: Date-Details-Folio-Total received (\$)
  - Cr: Date-Details Vo. No.- Total paid (\$) - Analysis columns.

Dr				Cr			
Date	Details	F	Tr (\$)	Date	Details	F	Tr (\$)
							Analysis

- Tp= total paid, Tr= total received (do not use in the examination)
- Dr and Cr not required to be written on top
- The analysis columns contain the breakup of the total paid column, i.e. the sum of their totals should equal the total of the total paid column.
- The totals of the analysis columns should be debited in their respective expenses ledger A/C(S) in the nominal ledger.

- Prime books of entry are listing devices which help to remove a lot of detail from the ledgers. It also means that bookkeeping can be divided between several people.
- They are also called books of original entry/subsidiary books.
- Transactions are recorded here before being recorded in the ledgers.
- The cash book & the petty cash book are both ledgers & prime books of entries.
- Sales and Sales Returns Journals: TABLE 2
- Purchases and Purchases Returns Journal: TABLE 3
- Trade discount does not appear in the ledger A/C; it may be shown in the prime books. The value of the goods bought reduces.
- Any sales made on cash or for a cheque will be recorded in the cash book & then in the purchases A/C.
- Credit sales is recorded in the sales journal and debtor's A/C when the sale was made. The total is transferred to the sales A/C as total credit sales for month. The total of the cash sales is also transferred to the sales ledger from the cash book at the end of the month.
- Sales Returns if for cash are recorded in the sales A/C (end of month) and cash book during the transaction. Returns on goods bought for credit is entered in the sales returns journal and debtor's A/C at the date of the transaction and the total is posted to the sales returns A/C at the end of the month as "total credit sales returns of month"
- There will be 2 effects in the ledger from all the books of prime entry other than the cash book & petty cash book, where there will only be one effect (as they are also ledgers).

## 2.8 The General Journal

- The journal or general journal is used whatever is not entered into any other book of prime entry before they are recorded in the ledgers.
- **A journal entry shows:**
  - The date of the transaction
  - The A/C name to be debited and credited and the respective amounts
  - A narrative: a short description of what is being recorded and why it is being recorded. E.g. capital of \$1000 cash invested.
- A narrative is important as sometimes certain entries can be out of the ordinary for example: an inter ledger transfer from a supplier's A/C in the purchases ledger (who also happens to be a debtor) to their A/C in the sales ledger to set off the balances.
- When a business begins operation, or begins recording its financial transactions, there are opening journal entries that are made to record the investment of capital, any liabilities the business has etc. These items are then posted into the ledger accounts.
- **General Guidelines:**
  - Show the debit entries first.
  - Slightly indent credit entries in the details column.
  - Draw a line after each separate entry and its narrative if required (only in the details column)
  - At times a folio column is present to show where in the ledgers the postings have been made.
- The purchase and sales of non-current assets are not recorded in any other book of prime entry, so they are recorded in the general journal and then posted into the ledger A/C (s).
- All entries in the ledger must be routed through the books of prime entry; therefore, any entry which does not go in any of the other books of prime entry will be recorded in the general journal.

## 2.9 Correction of errors:

- If the trial balance does not tally, and not errors are immediately identifiable, a suspense A/C is prepared by making an entry to balance the trial balance (by inserting the difference). Thus, Draft financial statements can be prepared. As and when errors are found, they are corrected through journal entries.
- The correction of these errors is made through the general/nominal journal. E.g.

Cash Sales of \$50 was not credited in the cash book  
Entry in Journal (Made on 23/02/12)

Date	Details	Debit (\$)	Credit (\$)
23/02/12	Suspense A/C	50	
	Sales A/C		50
	Half entry made for sales, now corrected		

- Errors which do not affect the tallying of the trial balance (commission, compensating, complete reversal, original entry, omission and principle) are also corrected through the journal by making the appropriate debits and credits to reverse the error and make the correct entry. E.g.

Cash Sales of \$250 recorded as Credit sales for B Dawg.  
Correction would be (in journal):

*Debit- \$250- Cash book, Credit - \$250 B Dawg A/C*

*Narrative: Cash sales mistakenly recorded as credit sales, now rectified.*

In the exam, a full journal entry would have to be made like in the previous example.

- In the preparation of draft financial statements, if the difference on the suspense A/C is a debit balance, it is recorded in the SOFP<sup>3</sup> as an asset and a liability if the suspense A/C has a credit balance.
- As corrections are made, the profit might be affected. If any item affects the trading section of the IS, then both the gross and net profit are affected, but if an item affects only the PNL, it will affect only the Net Profit.

<sup>3</sup> See 4.3 Statement of Financial Position



- To amend the profits, a statement of corrected profit is made.
- If expenses have been omitted, profit for the year will decrease with the correction and vice versa for income.
- Correcting the profit for the year also means the SOFP is also altered. The needed changes will also have to be made to all appropriate sections of the SOFP. If the expenses have increased, then the profit will decrease etc. Basic concepts will have to be applied in correcting profit.

### **2.10 Bank Reconciliation**

- A bank statement is a statement of account equivalent (just to understand, do not write in the exam) issued by the bank to a business showing the bank transactions pertaining to a particular period. It is the opposite of the business' bank account in the business' ledger (debit will be credit and vice versa.) It's basically a copy of the customer's account in the bank's ledger.
- If the two balances (on the bank statement and the bank a/c) don't match, it is necessary to reconcile them to explain why there is difference.
- There is generally always a difference, as the business and the bank don't record transactions at the same time (difference due to the clearance period.) and certain other items are not included in certain A/C (s)

<b><i>Items in cash book not in bank statement:</i></b>	<b><i>Items in bank statement but not in cash book:</i></b>
<ul style="list-style-type: none"> <li>• Cheques not yet presented</li> <li>• Amounts not yet credited</li> <li>• Errors in cash book (to be corrected)</li> </ul>	<ul style="list-style-type: none"> <li>• Bank charges and bank interests</li> <li>• Dishonoured cheque(s)</li> <li>• Standing order<sup>4</sup></li> <li>• Credit transfer<sup>5</sup></li> <li>• Direct Debits<sup>6</sup></li> <li>• Errors in bank statement (to be corrected)</li> </ul>

<sup>4</sup> An instruction to a bank by an account holder to make regular fixed payments to a person or organisation

<sup>5</sup> A wire transfers.

<sup>6</sup> An arrangement made with a bank that allows a third party to transfer money from a person's account on agreed dates, typically to pay bills

- To compare the cash book with the bank statement, the credit side of the bank statement is compared to the debit side of the cash book, as these transactions are recorded from opposite points of views. A tick is placed against transactions that match up.
- The cash book is then updated with items not in it and in the bank statement (obviously excluding errors)

<b><i>Items debited in the bank statement but not credited in the cash book</i></b>	<b><i>Items credited on the bank statement but not debited in the cash book</i></b>
<b>Charges, credit transfers paid into the bank, standing orders, dishonoured cheques etc.</b>	Credit transfers and direct debits paid into the bank, etc.

#### **• Preparing a bank reconciliation statement:**

- Match up the debit side of the statement with the credit side of the bank account and credit side of the statement with the debit side of the bank account. CHECK FOR ANY TALLING ERRORS ETC.
- Correct any errors in the cash book and balance and carry down the balance (this balance should appear on the SOFP if it is the last day of the financial year and is the amount the bank statement's balance has to be reconciled to.
- Prepare the BRS
- USE PARENTHESIS OVER AMOUNTS THAT HAVE A CREDIT BALANCE, FOR BRS (ESPECIALLY WITH THOSE INVOLVING OVERDRAFT)
- CHECK THE STARTING BALANCES OF THE BANK STATEMENT AND BANK ACCOUNT FOR ANY DISCREPANCIES.
- If errors are present in the bank statement correct them in the BRS.

• **Advantages of Bank Reconciliation:**

- An accurate bank balance is obtained (after updating)
- Errors in the bank account and bank statement can be identified and corrected.
- Helps in discovering fraud and embezzlement (theft or misappropriation of funds placed in one's trust or belonging to one's employer).
- Amounts not credited and cheque(s) not yet presented can be identified.
- Any 'stale' cheque(s) can be identified (older than 6 months) and written back into the bank account.

**2.11 Control A/C(s)**

- Control A/C are ledger A/Cs that represent all the individual debtors' and creditors' A/Cs in a trade receivables control A/C and a trade payables control A/C.
- The trade receivables control A/C contains the total balance of trade payables at a given date.
- The trade receivables control A/C contains the total balance of trade receivables at a given date. This is checked about every month, and if it does not agree either there is an error in the control A/C or in the debtors'/creditors' A/C
- If the trial balance does not tally/balance, and errors are not readily located, the accounting records will have to be checked which is very time consuming. This process can be made faster if sales and purchases ledger control A/C(s) are prepared. They individually contain the total trade receivables and payables that are recorded from the prime books. They thus act as a check on these A/C (s)
- These however, can only check arithmetical accuracy. Errors of omission and commission will not be revealed.

- When a full set of accounting records are maintained, it is usual to also prepare a sales and purchases ledger control A/C for the following reasons:
  - Help with the locating of errors when the TB does not tally.
  - Proof of arithmetical accuracy of the ledgers they control.
  - Draft financial statements can quickly be prepared because these A/C(s) show the total amt. directly.
  - Help reduce fraud as the maker of these A/C(s) are not the same as the maker of the ledgers for the particular A/C (s)
  - They provide a summary of the transactions affecting the debtors and creditors for each period.
- Note: the control A/C(s) are not a part of the double entry system of bookkeeping.
- Purchases Ledger Control A/C = Total Trade Payables A/C
- Sales Ledger Control A/C = Total Trade Receivables A/C
- NOTE: Prime books of entry are used as a source of information for the control A/Cs. The ledgers cannot be used as then no errors would be identifiable.
- The sales ledger control A/C contains all the transactions involving all the debtors and the purchases ledger control A/C contains all the transactions involving all the creditors.
- These A/C(s) only show the debtors and creditors that arise from the regular trading of the business.
- Balances on both sides of a control A/C can be present if:
 

<ul style="list-style-type: none"> <li>• <b>Overpayment by a debtor</b></li> <li>• <b>Debtor returns good after paying the account</b></li> <li>• <b>Debtor pays in advance of the goods</b></li> <li>• <b>Cash discount not being informed of before payment was made and then full payment made.</b></li> </ul>	<ul style="list-style-type: none"> <li>• Overpayment to a creditor</li> <li>• Returning goods to the creditor after paying the A/C</li> <li>• Paying the creditor in advance for the goods</li> <li>• Cash discount not being informed about before payment being made.</li> </ul>
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- The opposite balances are not netted out. They are shown separately with the credit balance showing amounts owing to and debit balances showing amounts owed to the business.
- Both balances are carried down normally.
- **Contra entries in Control A/C(s):** Inter ledger transfers are made to show businesses setting off their debts in the case if both businesses trade with each other. There are 2 ledger A/C(s) made for such businesses one in the debtor's ledger and one in the creditors' ledger. Setting off their A/C (s) is preferred over both businesses sending a cheque to each other as now only one check is sent across
  - **E.g.** Trader A owes Trader B \$10, and Trader B owes Trader A \$5. Traders A and B will set off their A/C(s) and the net figure of \$5 is paid by Trader A

<b>Books of trader B</b>			
Sales Ledger Control A/C			
Balance b/d	10	Inter Ledger Transfer	C 5
		Bank A/C	5
	<u>10</u>		<u>10</u>
Purchases Ledger Control A/C			
Inter Ledger Transfer	C 5	Balance b/d	5
	<u>5</u>		<u>5</u>

### 3. ACCOUNTING PROCEDURES

#### 3.1 Capital and Revenue Expenditure:

- The purchase of a non-current asset is regarded as capital expenditure; thus, its cost is not recorded in the purchases ledger, but a non-current assets A/C. The entire cost of the non-current asset is not charged as an expense the year it is purchased, as it helps the business for several years. The capital expenditure is thus matched (by estimating) against the sales, i.e. the cost of the non-current asset is spread over the years which benefit from the use of that asset. This is known as depreciation and is revenue expenditure.
- **The capital expenditure includes:** The cost of the NCA, legal costs incurred for the purchase of the NCA, carriage on the NCA and installation fees.
- Similarly, the receipt from disposal of non-current assets is regarded as capital receipt; it is recorded in the disposal of non-current asset(s) A/C, not the sales A/C.
- Because the income statement is made including revenue expenditure, recording capital expenditure as revenue expenditure will understate the profit and understate the NCA (thus giving effect to the accounting equation) and vice versa.
- Revenue expenditure is the cost incurred by running the business on a day-to-day basis. E.g. repairs on any non-current asset, general expenses, cost of public transport, etc. These are matched against the revenue receipt in the income statement.

#### 3.2 Capital and Revenue Receipt:

- Capital receipt is the income from sales of NCA. This should not be entered in the IS, but any profit or loss incurred from the sale of an NCA should be included in the NCA.
- **Revenue receipt:** The income from the running of the business, such as commission received, rent received, sales, etc.

### **3.3 Depreciation:**

- Depreciation is a year-end adjustment that reduces the value of non-current assets with time, i.e. Depreciation is an estimate of the loss in value of a non-current asset over its expected working life.
  - Non-current/ fixed assets depreciate with time as they are used, and depreciation is the loss in their value, this is an application of the principle of prudence as showing these assets at their cost prices can be misleading and lead to overstating a businesses' profit which can lead to more being drawn by the owner than the business can afford.
  - Land does not generally depreciate unless it is a mine or a well wherein something is drawn from the land (it's then called Depletion), buildings do depreciate.
  - The purchase of a non-current asset is a part of capital expenditure, which is why the entire cost of the non-current asset is not charged as an expense the year it is purchase as it helps the business for several years. The capital expenditure is thus matched (by estimating) against the sales, i.e. the cost of the non-current asset is spread over the years which benefit from the use of that asset.
  - The principal of prudence is also applied where the non-current asset is shown at its net book value in the SOFP/BS, thus overriding the principle of historical cost.
  - As depreciation is a non-monetary expense (it does not involve the actual flow of cash), it is shown after the monetary expenses in the IS.
  - Depreciation can be caused by Physical deterioration (wear and tear by normal use, rust etc.) And/or Economic or other reasons (more efficient apparatus has come out, it becomes obsolete etc.) And/or the passage of time (a lease etc.)
  - There are several methods of depreciation, the most appropriate one (which spreads cost fairly) must be used, but used consistently. Refer to TABLE 4 for the different methods of depreciation.
- Factors to be considered when choosing a method of depreciation are:
    - Life expectancy
    - Residual value
    - Estimated benefit from the use of the asset.
  - The entries for entering depreciation in the ledger for the straight-line method and reducing balance method are exactly the same.
  - Each non-current asset has 2 ledger A/C s (the asset account where cost is recorded -will always have a debit balance) and a provision for recording depreciation (provision for depreciation on XYZ asset A/C- will always have a credit balance). The 2 A/C s must be considered together as their difference (on the same date) is equal to the NBV
  - **During the year:** When the asset is purchased, Dr asset A/C and Cr cash book or supplier with cost price (depending how it is bought)
  - **At the year-end:** Dr Income statement with dep. Amt. And credit provision for dep. A/C with dep. Value. Balance prov. for dep. A/C and bring down credit balance. Balance asset A/C only if any transaction made and bring down debit balance.
  - If the straight-line method of depreciation has been used, the dep. Amt. stays constant.
  - It is a business' choice whether to start depreciating the asset from the date of purchase, for example, only a proportion of the dep. may be charged ([annual dep. /12] \* months of ownership till financial year end) OR it may be decided to ignore the date of purchase and record a full year of depreciation or not depreciate it in the year of purchase at all. The same applies for the sale of a non-current asset.
  - When the revaluation method of depreciation is used, no provision for dep. A/C is created, the same (asset) A/C is used to calculate dep.
  - **During the year:** When the asset is purchased, debit asset a/c with cost price and credit supplier's A/C or cash book (depending on the method of purchase) with cost price.

- **During the year-end:** Cr asset A/C with NBV (as balance carried down) and Cr the difference (between Dr and Cr = the dep. For the year) to the income statement (in the asset A/C), and debit the IS with the differential (which is the dep. the year) figure. Bring down the NBV of the asset as balance brought down.
- Depreciation reduces the Net profit of the year when it is debited into the IS from the provision for dep. A/C or from the asset A/C in case of the revaluation method.
- If the depreciation of assets is on manufacturing apparatus it must be recorded by debiting the manufacturing A/C rather than the income statement which thus increases the cost of manufacturing and indirectly decreases the profit for the year.
- The balance on the provision for depreciation A/C does not mean anything in the trial balance other than the accumulated dep. / dep. to date.
- The depreciation to be recorded will be provided in the trial balance's/given information's accompanying notes. It will have 2 effects, one as an expense in the IS or Manufacturing A/C and the other in the balance sheet.
- Only the dep. Relating to the current financial year is included in the IS, not the accumulated dep.
- In the BS/SOFP the dep. to date (which is the accumulated dep. up till this financial year + depreciation for this year) is subtracted from the cost price to become the NBV (which thus reduces year by year).
- The following years' trial balance will show an increased value in the provision for dep. A/C
- The purchase of an asset is regarded as capital expenditure; thus, its cost is not recorded in the sales ledger, but a non-current assets A/C. Similarly, the disposal of non-current assets is regarded as capital receipt; it is recorded in the disposal of non-current asset(s) A/C, not the sales A/C.

- If a non-current asset is sold, its pertaining dep. and cost have to be removed from the ledgers (these are transferred to the disposal A/C. The proceeds from the sales have to be credited to this A/C to match up against the cost and with the dep.<sup>7</sup> This A/C will quite likely not balance as the estimated loss in value (dep.) generally doesn't align with the selling price. The difference will be equal to either the loss or profit (after dep.) On selling the non-current asset.
- **On the date of sale:**
  - Cr NCA A/C with original cost of asset sold and Dr Disposal
  - Dr Prov. For dep. (with total accumulated dep. Of the non-current asset being sold) and Cr disposal.
  - Cr Disposal and Dr Cash book/Debtor A/C (with the selling price of the NCA).
- **At the end of the year:**
  - Transfer any difference to the income statement from the disposal A/C to balance the disposal A/C.

Disposal of Non-Current Asset A/C

NCA A/C	Y	Provision for depreciation of NCA A/C	X
		Bank A/C	A
		Loss from sale*	B
	<u>Y</u>		<u>Y</u>

\*Assuming loss. Recorded on the last day on the financial year

- Just as entries are made in the ledger A/C s for depreciation and the sale of an NCA, the similar entries will be entered in the prime books (specifically the general/nominal journal)

### 3.4 Other payables and receivables:

- Often, adjustments are made in the financial statements to present a more accurate view of the profit/loss of a business, these adjustments are known as year-end adjustments.
- In practice, it is common to find expenses or income paid in one financial year, but which relates to other financial years.

<sup>7</sup> Certain businesses record dep. to the date of sales and some ignore depreciation for the year of sale, therefore the correct value must be taken to arrive at the correct gain/loss from the sale of the NCA

- Only items relating to the specified time-period should be included in the income statement: the timing of the actual receipts and payments is not relevant. This is a practical application of the accruals principle.
- It is necessary to adjust the income statement with regards to amounts prepaid or accrued. This results in a more accurate profit/loss figure and therefore more meaningful comparisons can be made between financial statements of different years and businesses
- Accrued: an amount due in an accounting period which remains unpaid till the end of that period
- When an expense is accrued, it means that some benefit or service has been received during the accounting period, but this benefit or service has not been paid for by the end of the period.
- The amounts transferred to the income statement from the expenses ledger A/C is always supposed to be the expense corresponding to only the particular accounting period. This means that any amount due but unpaid (Y) at the end of the financial year must be added to the amount paid (assuming no amount was prepaid for the previous financial year) and the total expense be transferred to the income statement. The amount due but not paid for (accrued) is shown on the SOFP as Other payables under the current liabilities section.

General expenses A/C

Debit		Credit	
Total to date	XXX	IS	XXX+Y
Balance c/d	Y		
	<u>XXX+Y</u>		<u>XXX+Y</u>
		Balance b/d	Y

- During the year: Dr the expenses A/C and Cr the cash book (Paid expenses)

- **At the end of the year:** Dr unpaid expenses Amount (as balance c/d) and Cr with the same amount as balance b/d after the totalling. Cr the expenses A/C and Dr the income statement for the total expenses for the trading period mentioned. The Cr balance on the expense A/C is included as a current liability on the SOFP as other payables.
- IMAGE 2 can be used to understand how expenses paid for and expenses not paid for are compared to the entire trading period:
- Therefore:

$$\frac{\$150}{15} = \text{Expense per month}$$

Therefore Expense for the financial year =

$$\$ \frac{150}{15} \times (15 - 3) = \$120$$

- Wherever several expenses are accrued, a collective figure is often showed in-place of posting individual figures.
- Prepaid expenses: A prepayment is an amount paid in advance. When an expense is prepaid, it means that a payment has been made during the financial year for some benefits or services to be received in a future accounting period.

General expenses A/C

Debit		Credit	
Total (Paid) to date	XXX+Y	IS	XXX
	<u>XXX+Y</u>	Balance c/d	Y
			<u>XXX+Y</u>
Balance b/d	Y		

- Any prepaid expenditure cannot be posted to the income statement of the accounting period of the year it is paid in (following the principle accruals), thus this Amount has to be deducted from the total paid, to transfer only the expenses for the corresponding year to the IS.
- The expenses A/C will be left with a Dr Balance and shown as a current asset in the BS as it is short term benefit (it is paid for, but not used up).

- The double entry of the carried down amount (Y) which is prepaid, is the Balance brought down (Y) thus implying an Amount Prepaid.
- During the year: Dr Expenses A/C and Cr cash book with Amount Paid.
- At the year-end: Cr expenses A/C with prepaid Amount and Dr IS with difference (expenses for the year). Bring the new debit balance down and include it as a current asset on the SOFP/BS as other receivables.
- The concept applied in making the previous diagram can also be used to understand how to break up a prepaid expense: where the expenses for April, May and June 2008 have been prepaid
- To find the expense for x months when given the annual expense, divide annual expense by 12 and then multiply ans. by x.
- Where several expenses have been prepaid for, they can be shown as a combined figure under other receivables.
- If a business has office stationary, inventory etc. These can also be considered as prepaid expenses as their benefits are yet to come, but have already been paid for.
- The expenses incurred for the corresponding trading period will be included in the IS as normal and other expenses / income will be included in the IS and SOFP (if accrued /prepaid) appropriately.
- Any stock of items that are not meant for resale such as stationary cannot be included in the stock for resale.
- The opening balances for prepaid expenses or expenses which have to be paid for have to be considered when calculating the expenses for the next financial year. The same applies for income.
- **For Expenses to be paid (due)/ Accrued expenses:** Total expenses incurred in the trading period (including ones not going to be paid for in this year, but have been incurred)- expenses to be paid for (opening Cr balance) = Amount To be transferred to IS.
- **For Prepaid expenses:** Initial prepaid expenses (a Dr Opening balance) +Total paid in this trading period-closing balance (Amount Prepaid for the next trading period) = Amount to be transferred to IS.

- **Accrued Income:** Where an item of income is accrued it means a person receiving a benefit or service from the business during the accounting period has not paid for it by the end of the period. The amount receivable (in this case commission) will be credited as balance c/d and then debited in the next trading period as balance b/d. The amount transferred to the IS (XX+Y) will be treated as other income (this amount is earned) (in the specific case for commission) and will be added to gross profit, and the amount not received is a current asset and will be shown under current assets in the balance sheet as Income accrued (Y) or as other receivables with a note providing an explanation/breakdown. For other cases, the adequate procedure will have to be followed

Commission received A/C

Debit		Credit	
IS	XX+Y	Bank	XX
		Balance c/d	Y
	<u>XX+Y</u>		<u>XX+Y</u>
Balance b/d	Y		

- A diagram like IMAGE 2 can also be used to help breakup income accrued.

- Prepaid income: Where an item of income is prepaid, it means that a person has paid for a benefit or service from the business, but this has not been provided by the business at the end of the financial year. The principle of accruals is applied to prepaid income, thus any amount for which the legal title of the goods or services have not been passed on to the buyer has to be deducted from the total income transferred to the IS and shown as a liability in the SOFP/BS.

Commission A/C

Debit		Credit	
Income Statement	Y	Cash	X + Y
Balance c/d	X		
	<u>X + Y</u>		<u>X + Y</u>
		Balance b/d	X

- The income A/c will thus show a credit amt. at the beginning of the next financial year as this amount has not yet been transferred to the IS (according to accruals) and is part of the income of the next (current) year anyways.
  - **During the year:** Cr income A/C and Dr Cash book with amt. Received (X+ Y)
  - **At the year-end:** Dr income A/C with prepaid income (X) as balance c/d and then in the next trading period, bring down this amt. (credit this amt.) (X) as balance b/d (This will be shown in the SOFP/BS as a current liability). The difference (the amount received where the goods/service have been delivered will be debited from the income A/C and credited in the IS (Y).
  - Once again, a diagram like IMAGE 2 can be used to breakdown the income received as prepaid or earned.
  - Only the amount earned will be added to the gross profit as it is (earlier) transferred to the IS as other income (specific to commission).
- The opening balances on expenses A/C s must be taken into consideration when calculating income and will have to be transferred to the IS whenever the services/ goods have been delivered or the period that they have been paid for has elapsed (e.g. Rent received).

### 3.5 Bad Debts and Provision for Doubtful

#### Debts:

- When goods are sold on credit, in real practice 100% of all these debts are not recovered. An amount not paid by the debtor is known as a bad debt. There is always a risk of this happening; this could be due the debtor being unable to pay, them dying etc. If all means of recovering the debt have been tried in vain, then the debt is written off. Their A/C is closed by crediting their A/C with the amount owing and debiting a bad debts A/C. At the end of the year, this amt. is transferred to the IS as a loss/expense.
- Writing off such debts is an application of prudence, thus not overstating one's profit (by not overestimating their assets).
- **Bad debts recovered:** If a debtor pays some/all of their debt after it is written off, the cash book is debited, and bad debts recovered A/C is credited with the amt. (s). Paid. Alternatively, the debt can be reinstated by reversing the entry when it was written off, and then debiting the cash book and crediting the debtor's A/C. Resulting in an advantage; all transactions relating to the debtors are in their A/C.
- If no names and dates have been provided, the entry in the bad debts A/C could be stated as "debtors written off" on the last day of the Accounting period.
- The bad debts recovered can be alternatively recorded by crediting the bad debts A/C, thus reducing the amt. representing bad debts.



- The only definite way of avoiding bad debts is by not selling goods on credit, which is not practical. Practical methods of reducing the chance of bad debts are: obtaining credit references from banks and other suppliers (before allowing any debt) for a potential debtor, fixing a credit limit (upper bound) per debtor (only a fixed amt. can be owed at a certain time). The debts are monitored over time. This is known as credit control. Invoices and month end statements should be issued along with letters to notify debtors of any amounts outstanding. Legal action can be taken, but is too expensive and does not justify the funds recoverable.
- Going by the principle of prudence, businesses estimate the amounts lost due to possible bad debts, which also aligns with the principle of accruals (estimated bad debts from sales, are recorded in the year the sales are made, rather than the year the debts are actually written off). This shows the assets of the business at a more realistic value.
- **The amount to be estimated can done so by:** estimating this amount per debtor based on their A/C's individual debts/transactions; estimating the amounts based on past experience of a debtor and devising a percentage of debts estimated which won't be paid; using an aging schedule and assigning a higher percentage on older debts and vice versa (based on the logic that older debts are more unlikely to be paid than newer ones. In totality, a percentage can be set too, for e.g. 5% of the total trade receivables). This is generally given in an examination.
- **Creating a provision for doubtful debts:**
  - Dr IS and Cr provision for doubtful debts A/C
  - In the BS/SOFP deduct the balance in the provision for doubtful debts A/C from the trade receivables.
- In the IS the bad debts are showed along with the provision for doubtful debts as expenses, and in the BS/SOFP the deduction of the provision for doubtful debts is shown (on the total trade receivables which is already less any bad debts)
- The provision for doubtful debts may have to be changed if for example (if a percentage of debts is taken) the debts have increased/decreased or if an amount has been set for whatsoever reason and has to be changed. This adjustment is made at the end of the financial year.
- **Adjusting a provision for doubtful debts:**
  - Dr provision for doubtful debts with the new provision as balance (c/d) and then after accounting for the difference (next step) bring down the new provision on the Cr side (as balance b/d).
  - If the provision has to be increased, then make a credit entry to the IS with the difference, and vice versa for a decrease.
  - In the BS/SOFP deduct the new provision for doubtful debts from the total trade receivables (which is less any bad debts [already accounted for])
  - Refer to IMAGE 3 to see a visual representation for increasing and decreasing provision for doubtful debts.
  - Only the amount increased or decreased (on the provision for doubtful debts) is shown in the IS as the rest has been accounted for in previous accounting years/periods. If the amount is decreased, then the difference is recorded in the Income Statement as decrease/reduction in provision for doubtful debts as a form of income and vice versa for an increase.

### 3.6 Inventory Valuation:

- Inventory must be valued at the end of the financial year. It is done at whichever is the lower between cost and net realisable value.
- **The cost of inventory includes:** Actual price + additional costs (like Carriage inwards or costs that bring the inventory to its current position)
- The net realisable value is the estimated receipt from the sale of the stock/inventory.
- Generally, the net realisable value > cost of inventory
- The examination will require a simple statement to be made from basic data like the one on the next page.

ABC business	
Valuation of inventory at DD/MM/YYYY	
	\$
Type X- 50 units at \$10 per unit	500
Type Y- 30 units at \$5 per unit	<u>150</u>
	<u>650</u>

## 4. FINANCIAL STATEMENTS

### 4.1 Financial Statements for different organisations:

- There are several different kinds of organisations that accounting may be done for and all of them require financial statements to be prepared for them. Mainly the format stays the same, but any other details, will be included in the accounting for financial statements section.

#### • Financial statements (generally):

Income Statement	Trading A/C (give gross profit) and Profit and Loss A/C (give net profit)
Balance Sheet/Statement of Financial Position	Show that ASSETS= CAPITAL + LIABILITIES

- Businesses can be trading and/ or manufacturing, and/or offering services. Businesses can be of several kinds:
  - Proprietorship
  - Partnership
  - Limited companies

### 4.2 Income Statements:

- The aim of business is to make a profit; this is calculated in the financial statements which are usually prepared at the end of a financial year.
- Financial statements are usually prepared from a trial balance, each item in a trial balance should have 1 tick (used once in the financial statements collectively) and any additional notes should have 2 ticks (used twice in the financial statements collectively, but can depend from note to note (sometimes half the effect is given etc.)). Ticks ensure no items have been overlooked.

- **Trading A/C:** concerned with buying and selling goods, calculates gross profit (SPOG- COS).
  - SPOG (of goods sold) = net sales (Sales less returns)
  - COS= total cost of goods only sold, i.e. Not always all the goods bought.
  - COS= OS+P (net purchases, less any additional purchases drawings and/or returns)– CS
  - P(net)= Purchases - Purchases Returns + Carriage inwards- goods for own use.

NOTE: Cash discount/discount allowed and discount received will not be included in the trading A/C as they arise from the early payment of debts, and are not sales related.

- The income statement (PNL and Trading A/C) should have a heading regarding the financial year/period covered and the name of the business trading.
- A trading A/C can be prepared using a horizontal format (similar to a T Ledger A/C) or a vertical format.
- The horizontal format has the incomes on the Cr side and the expenses on the Dr side, and the difference is the gross profit/loss.'
- The gross profit is carried down to the profit and loss A/C.
- The term 'revenue' is often used instead of 'sales' in the trial balance and IS.
- Most businesses prepare a trading A/C in the vertical format, which looks more like an arithmetic calculation.
- **Horizontal format:** Dr-\$-\$-Cr-\$-\$
- **Vertical format:** \_ \$-\$-\$
- **Heading:** Income Statement (Trading A/C section/Profit and loss A/C section) for the year ended <insert date>.
- The profit and loss A/C is concerned with profits, loss, gains and expenses and other income (e.g. commission)/expenses (running expenses). This gives you the profit for the year/ net profit (Gross profit + other income –other expenses)
- The profit and loss A/C can be shown in a horizontal format (Dr-\$-\$-Cr-\$-\$) (income on the Cr side and expenses on the Dr side. The balance = the net profit/loss) or a vertical format ( \_ \$-\$-\$)

- Most businesses use vertical format (also looks like an arithmetic calculation). The Trading A/C and PNL are usually collectively presented as an income statement (vertical format), and thus the gross profit need not be carried down. It is presented as:
  - Income Statement for the year ended DD M(words) YY-Y/YYYY
  - The date and time period it covers and the trading name of the business.
- The expenses/ income A/C have to be credited/debited (respectively) to be transferred to the IS
- **Only the expenses & income that pertain to the financial year end date have to be transferred to the income statement.**
- In the income/expenses A/C, whenever details are not given and only totals are given, they can be entered as 'totals to date'
- Other than the inventory, gross profit (transferred within IS from trading A/C to PNL A/C) and net profit, only one entry is made (IN THE INCOME STATEMENT) to transfer the balances to the IS.
- The income statement has 2 entries regarding the inventory A/C (IN THE INCOME STATEMENT), one to transfer the balance at the start of the year as the opening stock/inventory and at the end of the year from the income statement to the inventory A/C to show the closing stock/inventory (indirectly credited from IS as it is shown as a deduction from the expenses)
- The opening stock of one year is equivalent to the closing stock of the previous year.
- The net profit is the return received by the owner for their investment (increases amount owed to owner) and shall be debited from IS and credited to the capital A/C and vice versa for a net loss (as it reduces the amount owed to the owner.)
- The totals of the drawings A/C are also to be transferred to the capital A/C at the year-end (Cr drawings and Dr capital)

- The income statement of a service business (E.g.: accountant) (One who does not buy or sell goods) will not have a trading A/C as no goods are bought and sold/ Only a PNL is prepared, however the balance sheet stays the same. There will be only the titles of *Income* and *Expenses*

#### **4.3 Statement of Financial Position:**

- A balance sheet is the statement of financial position of a business on a certain date and shows the assets of a business (what the business owns/ its resources) as being equal to its capital (amount owed to the owner by the business/owner's investment/equity) plus any other liabilities (amount owed to any external entity other than the owner). I.e. The assets show how the resources are being used and the liabilities (including the capital-for this case) show where these resources come from.
- Non-current liabilities are those which are not due in the next 12 months (E.g.: long term loans)
- Current liabilities are short term ones (due within the next 12 months) and arise from the regular trading activities of the business whose values constantly change (E.g.: trade payables)

- Assets and liabilities are arranged in different groups:
  - Assets are divided into current (Values are constantly changing, short term assets which arise from the regular trading of the business, E.g.: Inventory) and non-current assets (long term assets which are not used for resale but help the business earn revenue. E.g.: Motor Vehicles)
    1. Non-current assets are listed in order of increasing liquidity (liquid= least permanent) (The ability to be converted into cash), typically: Land and buildings, Machinery, Fixtures and equipment and motor vehicles.
    2. Current assets are also listed in order of increasing liquidity (furthest away from cash shown first), typically: Inventory, Trade receivables, Other receivables, Bank, Cash. Trade receivables are said to be more liquid as compared to the inventory as they can be sold to other businesses.
    3. Current and Non-current liabilities appear in ascending order of which liability will have to be paid first. Note: Other payables will appear after trade payables.
- A SOFP should have the heading to the date to which it relates and must include the trading name of the business.
- SOFPs can be prepared in the horizontal (2 sided) (typically assets on the left and liabilities on the right, but reverse is acceptable) or a vertical format, which looks like an arithmetical calculation
- After all the financial statements are prepared every item on the trial balance must have one effect (either IS or SOFP) on the financial statements and additional notes will have 2 effects on the financial statements (one on the IS and the other on the SOFP)
- The balance of the capital A/C will increase in the SOFP if the business has made a profit or decrease if the business has made a loss.
- If a vertical format of a SOFP has been prepared, the liabilities are shown after the assets to show where the resources come from (reverse is OK).

- If more than one current liability is present it is listed in the first column and then totalled and taken to the second column.
- The main advantage of a vertical SOFP is that it shows the net current assets/working capital (current assets-current liabilities) which is very important<sup>8</sup>.
- The non-current liabilities can be listed before or after the capital.
- In the vertical format of SOFP, the Assets-Liabilities = Capital. Other formats keeping in line with the accounting equation are also acceptable.
- When the business makes a profit, it is added to the capital as the amount owed by the business increases and thus it can be concluded that a profit is an increase in net assets (capital)
- Amounts to be subtracted are be put in parenthesis to make sure they are not added.

#### **4.4 Incomplete Records:**

- Certain businesses do not maintain a full set of double entry bookkeeping records (for example small businesses). No trial balance can be drawn up for them and some preparatory calculations are required before they can start preparing their financial statements.
- When a list of assets and liabilities is prepared without any double entry bookkeeping, it is known as a statement of affairs which is like a balance sheet.
- To calculate profit, a capital A/C can be made to account for any changes in capital through (for example: drawings) and then the difference in capital is taken as either the profit or loss. Doing this however will not give any information about the gross profit, sales etc. No analysis can take place (Analysis will help with taking informed future decisions). So, this is one drawback involved.
- At times a business is able to provide some information about money received and paid etc. In addition to assets and liabilities which can make it possible to calculate sales, purchases and expenses. Therefore, a full set of financial statements can be made after some calculations.

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<sup>8</sup> See 6 Analysis 6.1 Analysis and Interpretation

- The amount paid to the creditors is not always going to be equal to the purchases figure and the same applies for the sales figure which relative to the amount received from debtors for obvious reasons such as goods being bought from the previous year, good that have not yet been paid for etc.
- If the opening balance (for the bank and/or cash A/C) and a summary of the receipts and payments are available, it is possible to arrive at the closing cash/bank balance(s).
- Certain questions require the preparation of a financial statement in a different year then which the ledgers or some information was given in. It is important to include other payables and receivables in the year they were actually due in (matching).
- **Note:** the allowance or receipt of trade discount affects the sales and purchases figures respectively.
- Margin and mark-up:
- **Mark – up** =  $\frac{\text{Gross Profit}}{\text{Cost of Sales}}$
- **Margin** =  $\frac{\text{Gross Profit}}{\text{Sales}}$
- **Gross Profit = Sales – COS**
- These figures can be used to calculate missing information and then prepare financial statements.
- The rate of inventory turnover is the number of times a business replaces its inventory in a given period of time and is also given by the formula:  $\frac{\text{Cost of sales}}{\text{Avg. Inventory}}$ , where average inventory is the mean of the opening and closing inventories.

- An additional account is made- the profit and loss appropriation A/C, which shows how the profit for the year or loss for the year is shared between the partners

**Advantages and disadvantages of a partnership business**

Advantages	Disadvantages
Additional finance	Profits have to shared
Additional knowledge, experience and skill	Decisions have to be recognized by all partners
Responsibilities are shared	One partner’s decision affects all other partners.
Discussions before decision	All partners responsible for the debts of the business

**5. ACCOUNTING FOR VARIOUS ORGANISATIONS:**

**5.1 Partnerships:**

- A partnership is a business in which 2 or more (max. 20 – normal) people come together and work with the view of making profits.
- Several professionals such as accountants and solicitors come together to form a partnership. This is common amongst family businesses. At times sole traders expand by amalgamating their businesses.

- Most partnerships draw up a partnership agreement. Not legally required, but it helps prevent misunderstandings and arguments in the future. It's clauses cover aspects of the business like : Capital invested per partner, sharing of profits or loss (possibly in the ratio of capital, but not necessarily), interest on capital invested (reward for investing- not required if all investments by all partners are equal, compensation for greater capital and thus risk) , salaries of partners (if one partner has more responsibilities than the other, for e.g.), possible upper limit on drawings, interest on drawings( discouragement to draw, especially in the initial years), interest on partners loan to company (compensation for possibly large gain if it was capital).
- Money is borrowed from a partner for a particular span of time if necessary; note this is NOT a part of capital. It is treated exactly like a normal loan, just that its interest (if accrued) can be recorded in the current A/C of the partner instead of a separate liability A/C. If the interest is paid it is recorded in a regular interest on loan A/C
- Profit and loss appropriation A/C: The profit for the year is taken, interest on drawings is added, and interest on capital is deducted, salaries to partners are deducted and any other items are included as appropriate. The final amount after the appropriation (residual profit) is shared.
- The capital A/C prepared in a partnership A/C can either have 2 or more sections for the partners, or several A/C(s) can be prepared. These capital A/Cs refer to fixed capital A/Cs. For other entries involving partners a separate current A/C and drawings A/C is made.
- This sample format is only for the debit side, the credit side looks exactly the same. The no. Of \$ columns depend on the number of partners. The current and drawings A/C follow the same format with a different heading. Optionally, separate A/Cs for each partner can be made, but this is not efficient.

Date	Details	F	Partner 1	Partner 2
			\$	\$

- The current A/C shows the salary received, interest on drawings, capital and even loans. A credit balance on this A/C represents an amount owed to the partner by the business and vice versa for a debit balance. If current A/C (s) are not maintained, all of the above is recorded in the capital A/C. Current A/Cs are maintained so each partner can view the amount owed by the business and the drawings pertaining to each other, apart from the capital. The capital A/C is only used to show permanent changes in capital when capital is officially pulled out from the business.
- A drawings A/C is maintained in which the drawings of each partner is maintained and then at the end of the financial year, transferred to the respective current A/C(s).
- It is time saving in an examination to show the current and capital A/C (s) side by side using 2 columns in one combined A/C separately. Thus reducing 4 A/Cs to 2 A/Cs
- The BS/SOFP of a partnership business has a different capital section where the individual partners' capital and current A/C closing balances are shown, and sometimes all the details pertaining to the current A/C balances (the calculation) can also be shown here instead of making all the entries in the current A/C (for examination purposes only)

**5.2 Limited Companies:**

- A limited company is a business which is a separate legal entity from its owners (shareholders) and whose liability for the company is limited to the value of shares they hold.
- A limited company can be formed as a new business or a sole trader or partnership can be converted into a limited company for expansion purposes.
- The capital of a limited company is divided into units called shares and the face value of the share(s) is the extent to which the shareholders are liable for the debts of the company.
- Through shares a large amount of capital can be raised.
- Profits are distributed as dividends which are stated as a percentage of the face values of the shares.

• There are 2 kinds of shares:

<b>Preference Shares</b>	<b>Ordinary/ Equity shares</b>
Fixed rate of dividend	Dividend depends on profit
Fixed rate and amount of dividend	Variable rate and amount of dividend
Dividend is always paid, but if profit does not allow, will be paid in the future when sufficient funds available.	Dividend can be paid. If profits allow for high dividend- paid, else even no dividend is possible
Payment Recorded in the Income Statement	Payment Recorded in the Statement of changes in equity
Preference is given to these shares when it comes to dividend payment	
Holders have minimal involvement in running of the company and are usually not entitled to vote at shareholder's meetings.	Holders have some involvement in the running of the business and can vote at shareholder's meetings at one vote paid share.
Included in the PNL (Income Statement)	Included in the profit and loss appropriation A/C

- The regulations for the formation and running of a limited company are many. For e.g. accounting records must be published annually.
- All the shareholders cannot be involved in the day-to-day decision making of a company, so a board of directors (elected), CEO Etc. are hired. Any legal action against the company is against the company itself and not its members.
- Earlier, when a business was formed a maximum (limit) of capital issued had to be stated- authorised share capital. This is not necessary now. Share capital issued is called issued share capital (this is the value of the shares issued). More can be issued at a later stage whenever required.
- A company may not require the full value of the called-up capital and may only require a fraction of it (if a share is worth \$1, the company may only call up \$0.50 per share). If more capital is required, it can be "called up". Since some shareholders may not pay the called-up

capital per share, the actual called up capital received is known as the paid-up capital.

- A company might raise additional funds by issuing debentures (loan capital) or loan notes, where through small loans, several thousands of dollars may be raised. They carry a fixed rate of interest and are given preference over all payments including the payment of dividends on preference shares. Interest on Debentures are included in the income statement. Debentures holders are not members of the company nor do they own any part of the company and do not have voting rights at shareholders meetings. If a company dissolves, the liabilities and debenture holders are repaid first, then the preference shareholders are paid after which ordinary shareholders are paid
- Limited companies are required to publish a statement of changes in equity, some may prepare a profit and loss appropriation A/C.
- A statement of changes in equity shows how the appropriation of profit (Profit for the year) affects the Share Capital, General Reserve and Retained Earnings.

	Ordinary Share Capital	General Reserve	Retained Earnings	Total
	\$	\$	\$	\$
Balance at year start	X	Y	Z	X + Y + Z
Profit for the year			A	A
Dividend paid (final- for previous year)			(B)	(B)
Dividend paid (interim)			(C)	(C)
Transfer to general reserve		D	(D)	-
Balance at year end	X	Y + D	Z + A - B - C - D	X + Y + Z + A - B - C

- The Profit for the year from the income statement is added to the general reserve and all payments are made out of it.
- Ordinary Share dividends declared but not paid are proposed.
- Proposed ordinary dividend are only included as a note in the financial statements. They are therefore not recorded as liabilities. The year in which these dividends are paid, is when they will be recorded.
- Interim ordinary dividend might be also be paid during the year (also called half way dividend), as this is paid, it is recorded in the statement of changes in equity.

- Preference share dividend will accrue, therefore the full amount will be shown in the IS.  
Mostly, all the profit made by a limited company is not given out as dividend, any even if it is intended to do so, it may not be possible, as not enough cash maybe in hand or assets in a liquid form etc.
- If any dividend or interest on debentures accrues, it is shown in the statement of financial position as a current liability.
- Whatever profit is not distributed and/or put into a general reserve (to plough back profits to aid further growth) will be transferred to the retained profit and is shown in the SOFP under reserves which is added to the share capital.
- The capital section of the statement of financial position of a limited company includes the share capital, reserves (e.g. general reserve, retained profits [refer to funds ploughed back over the years], etc) under the heading Capital and Reserves. The total of these values = Shareholder’s fund.

**5.3 Clubs and Societies:**

- Certain organisations are non-trading, such as clubs, or societies (golf club, scout groups etc.). Their main objective is not to make a profit, but to provide facilities to its members.
- Mostly, no double entry records are maintained. A record of money received and paid in kept (Receipts and payments A/C).
- The main source of income for these organisations is subscriptions (usually an annual payment to the organisation for the usage of facilities provided). A treasurer is assigned who manages all of this and pays the money owing to external entities and collects money owing to the organisation.

**Terminology in the Financial Statements and Accounting Records:**

<b>Business Terminology:</b>	<b>Clubs and Societies/ Non-Trading Organisations Terminology:</b>
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<b>Summary of cash and bank book</b>	Receipts and Payments A/C
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<b>Trading A/C</b>	Trading A/C
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<b>Profit and loss A/C</b>	Income and expenditure A/C <sup>9</sup>
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<b>Balance Sheet/SOFP</b>	Balance Sheet/SOFP
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<b>Profit for the year (Net profit)</b>	Surplus
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<b>Loss for the year (Net loss)</b>	Deficit
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- The receipts and payments A/C mostly does not differentiate between cash and bank transactions. For the most part it is exactly like a cash book. Note: The balances on the A/C can either mean just cash, just bank or both. A credit balance brought down means an overdraft.

Receipts	Payments

- The receipts and payments A/C only shows funds received or payed, it does not show the actual income or expenses for the financial period. These will have to be calculated with adequate information.
- Clubs and societies trade. Those that do, do not regard it as their main source of income. Those that do so (such as running a shop or café, etc.) maintain a separate income statement (only the trading A/C section) for each of these activities. The wages of shop attendants, depreciation on café equipment etc. Any profit or loss from these activities is transferred to the income and expenditure A/C under other income/ expenses.

<sup>9</sup> Will only have the contents: *Income and Expenditure*. There will be no other income/expenses here.



- A surplus is the excess of income over expenditure whereas a deficit is the excess of expenditure over income. The principles used to prepare a profit and loss A/C are like those applied when preparing an income and expenditure A/C.
- If any fund-raising activity like a competition is conducted, it is important to set off the income against the expenditure for that activity in the income and expenditure A/C.
- The balance sheet of a club or society is very similar to that of a business, however capital does not exist. This is because members of a club or society do not invest money and draw out funds the same way a proprietor of business does. Any surplus is accumulated to form the capital fund known as the accumulated fund. Similarly, a deficit decreases this fund.
- Subscriptions owing or prepaid can be included under other receivables and other payables respectively and an appropriate note should be included.
- To correctly match the expenses against the income (following accruals<sup>10</sup>), the subscriptions relating to a particular time frame must be included in the income and expenditure A/C for only that particular time frame. A subscription's A/C is prepared to calculate this figure. There could be 2 balances on this A/C as some members might have paid for their subscriptions in advance and some have not yet done so. They need to be kept a track of individually.
- As the accounts of a club or society are usually incomplete, a total trade receivables and payables A/C may need to be prepared to obtain the correct Amounts.
- Just as in a business  $\text{Assets} = \text{capital} + \text{liabilities}$ , in a club of society:  $\text{Assets} = \text{Accumulated funds} + \text{Liabilities}$ .

### **5.4 Manufacturing Businesses:**

- Certain businesses don't just buy and sell goods, there are also manufacturing businesses, like a textile manufacturer who make clothes.
- The double entry records for these businesses will be like that of a trading business. Additionally, there will be a manufacturing A/C, which is used to calculate the cost involved for the business to manufacture goods it has produced in a particular financial year.
- **Order of components in a manufacturing A/C**
- Raw material/Direct Material: wood for a furniture maker, etc. Many forms. Needed to make the finished goods.
- Add: Direct labour /Direct wages: Cost of the wages of people employed specifically for the manufacturing of goods
- Add: Direct Expenses: Expenses related to the product being manufactured; royalty, the cost of hiring a special piece of equipment to do a certain job.

THE ABOVE TOTAL = PRIME COST

- Add: Factory overhead: Expenses linked indirectly with the manufacturing of the product. Factory cleaning etc. Sometimes an expense associated with the entire business such as electricity can be partially assigned to the factory (for e.g. 1/3 of electricity and heating to be assigned to the factory). Depreciation on factory equipment is also allotted here
- THE ABOVE TOTAL = PRODUCTION COST OF GOODS
- Add: Opening work in progress
- Less: Closing Work in progress
- THE ABOVE TOTAL= PRODUCTION COST OF GOODS COMPLETED.

<sup>10</sup> See accounting principles

- After adding factory overheads, adjustments have to be made for opening and closing inventories of work in progress. This is because costs have been incurred in making them and they will be able to sell with time, so a value needs to be assigned to them. The same has to be done for the purchases of raw materials (in the manufacturing A/C:

Opening inventory of raw materials  
+ Purchases of raw materials  
+ Carriage inwards  
– Closing inventories of raw materials

- The final amount given in the manufacturing A/C is the production cost of goods completed. The production cost of goods sold is found in the IS by adding the opening inventory of finished goods and subtracting the closing inventory of finished goods. Note: The figures for finished goods represent the finished goods manufactured and also bought (if the manufacturer finds it cheaper to buy than make, if the manufacturer can't match the demand with supply, or when certain items cannot be made by the particular manufacturing business, etc.).
- Calculation of unit cost: if a manufacturer makes one identical product, its unit cost can be calculated by the formula:
- **Unit Cost** = 
$$\frac{\text{production cost of goods completed}}{\text{Number of units produced}}$$
- The Profit and loss section of the income statement for a manufacturing business is very similar to that of a retail business. Only administration, selling and other non-manufacturing expenses will appear here. The remaining of the partial expenses charged in the manufacturing A/C will also be shown here.
- The Statement of financial position of a manufacturing business is also very similar to that of a retail business, the difference being that there are 3 inventories: Raw materials, work in progress and finished goods.
- Year- end adjustments are treated as normal for manufacturing businesses

## 6. ANALYSIS AND INTERPRETATION

### 6.1 Accounting Ratios:

- Definitions:
  - Working Capital: Current Assets- Current Liabilities.
  - Capital Owned: Capital (in the accounting equation). Amount owed by a business to the owner of that business on a certain date
  - Capital Employed: Capital + Non- current liabilities (In the accounting equation). Total funds used by a business.

$$ASSETS = CAPITAL + LIABILITIES$$

$$Assets = Capital + CL^{11} + NCL^{12}$$

$$A = C^{13} + CL + NCL$$

$$A - CL = C + NCL = Capital Employed$$

- Refer to TABLE(s) 5 for Accounting Ratios.

<sup>11</sup> Current Liabilities

<sup>12</sup> Non-Current Liabilities

<sup>13</sup> Capital

**6.2 Inter firm comparisons:**

- Comparing the accounting ratios of one business to another gives valuable results, however, this has to be done carefully, as there are certain limitations.
- Businesses should compare themselves to other similar businesses.
- When making comparisons, remember that:
  - Businesses apply different accounting policies (e.g. depreciation)
  - Different operating policies may be in place, such as renting, funding from loans, etc. Which affect the SOFP and the Profit for the year.
  - Non-monetary information is not shown on the financial statements, (e.g. Staff expertise, skill of the labourers, etc.), but is very important.
  - Not all the information about a business can be found on the Financial statements (age of NCA, avg. inventory) these can also be used for comparisons, but are not on the financial statements.
  - Trends in the patterns of other businesses may not be observable, as the financial statements may not be available for other years.
  - Not all accounting years are typical.
  - Year-end dates for businesses vary, so influenced factors may be different (e.g. low inventory of air conditioners in the winter)
  - Accounting records are not altered with inflation.

**6.3 Users of Accounting Statements**

- Internal users
  - Owners: monitoring performance and progress. Gauge profitability.
    - Prospective shareholders will look at investment ratios (investment ratios not a part of the syllabus)
  - Managers: Same reasons as owners, just that the business is managed by an employee, not the owner.
- External users:
  - Bank manager: To know whether loans or overdrafts can be granted, to see if the business has enough funds to pay up.
  - Other Lenders: To see if repayment can be made.
  - Creditors/Trade payables (present and potential): To determine the credit limit allowed and the length of credit allowed. To know the liquidity position and the trade payables collection period.
  - Potential buyers and investors: To know the profitability of the business and market value of the assets.
  - Club members: To know if the club can continue to operate.
  - Other interested people: An examination question may require you to mention other interested parties, USE YOUR COMMON SENSE. It is not practical to cover all possible questions.
  - Customers (Minor point): ensuring the continuity of the supply of goods.
  - Employees and trade unions: to know if the business can continue to operate, thus providing jobs, paying adequate wages and possibly contributing to pension schemes.
  - Government Departments: Compiling business statistics and/or checking if correct tax is paid.

**6.4 Limitations of financial statements:**

- Accounting statements have their limitations, as they cannot comprehensively cover every aspect of a business. They are thus limited by:
  - Time (Historic Cost): The past cannot be used to properly predict the future. The financial position of the business changes from the time the accounting year ends to when financial statements are prepared (as it still operates)
  - Accounting policies: Different businesses use different accounting policies, so meaningful inter-firm comparisons are difficult to make. If the accounting policy is changed, then year to year comparisons will become difficult.
  - Difference in definition: Adjustments in profit from year to year and firm to firm vary, thus one should ensure only an apples to apples comparison is made.
  - Money Measurement: Non-monetary/ Non—financial factors often affect the financial position of a business, but these do not appear in the financial statements. E.g. morale of the workforce, adaption capability to changing market conditions, Gov. Policies, impact of new tech. etc.

**7. ACCOUNTING PRINCIPLES****7.1 Accounting Principles:**

- Refer to TABLE 6 for Accounting Principles

**7.2 Accounting Policies:**

- Policies set up by the IAS (International Accounting Standards) regulate how international accounting records are maintained.
- Accounting policies and principles are selected based on:
  - Relevance: financial information is relevant only if it affects the business decisions, as they are the base of further decisions that will be taken. Information in financial statements can be used to alter or reconfirm future expectations, set future goals etc and thus must be relevant
  - Reliability: financial information is reliable only if it can be depended upon to represent actual events and is free from error and bias. Financial statements must be capable of being independently verifiable and free from any significant errors. Whenever judgments or estimates are being made, suitable caution must be taken.
  - Understandability: financial reports must be capable of being understood by the users of that report (who are assumed to have basic accounting knowledge). No information should be omitted from the financial statements because it is thought to be too difficult to understand.
  - Comparability: a financial report can only be effectively compared with reports for other periods of the same or similar businesses if similarities and differences can be identified. The differences in policies must be identified to make valid comparisons

**8. IAS (INTERNATIONAL ACCOUNTING STANDARDS) TERMINOLOGY:**

Use the terms in the international usage column instead of the ones in the previous usage column. At times, marks are awarded for the usage of IAS terminology.

<b>International usage (terms to use in the examination):</b>	<b>Previous Cambridge/UK usage (use instead of):</b>
<b>Statement of financial position (balance sheet)</b>	Balance sheet
<b>Bank (and other) loans</b>	Loans repayable after 12 months
<b>Interest bearing loans and borrowing</b>	
<b>Bank overdrafts and loans</b>	Loans repayable within 12 months
<b>Interest bearing loans and borrowings</b>	
<b>Capital or equity/shareholders' equity</b>	Capital
<b>Cash (and cash equivalents)</b>	Bank and cash
<b>Cost of sales</b>	Cost of goods sold
<b>Current assets</b>	Current assets
<b>Current liabilities</b>	Current liabilities Creditors: amounts due within 12 months
<b>Finance costs</b>	Interest payable
<b>Finance income/investment revenues</b>	Interest receivable
<b>Financial statements</b>	Final accounts
<b>Gross profit</b>	Gross profit
<b>Income statement</b>	Trading and profit & loss account
<b>Intangible assets</b>	Goodwill, etc.
<b>Inventory/inventories (of raw materials and finished goods)</b>	Stock
<b>Investment property</b>	Investments
<b>Non-current assets</b>	Fixed assets
<b>Non-current liabilities</b>	Long-term liabilities Creditors: amounts falling due after more than one year
<b>Other operating expenses</b>	Sundry expenses (administration and distribution)
<b>Other operating income</b>	Sundry income
<b>Other payables</b>	Accruals
<b>Other receivables</b>	Prepayments
<b>Plant and equipment</b>	Plant and equipment
<b>Profit (before tax) for the year</b>	Net Profit
<b>Property</b>	Land and buildings
<b>Raw materials</b>	Purchases
<b>Ordinary goods purchased</b>	
<b>Revenue</b>	Sales
<b>Share capital</b>	Share capital
<b>Trade payables</b>	Creditors
<b>Trade receivables</b>	Debtors
<b>Work in progress</b>	Work in progress

**TABLES AND REFERENCES:**

**TABLE 1:**

<i><b>Business Document</b></i>	<i><b>Contents</b></i>	<i><b>Issued When:</b></i>	<i><b>Notes:</b></i>	<i><b>Uses:</b></i>
Invoice	The name & address of the supplier & customer, the date. Full details, quantities & the prices of goods sold	Goods sold on Cr Issued by the supplier  Can also be issued when goods are sold in for cheque/cash	Trade discount is show as being deducted whereas it is mentioned that cash discount is only allowed if the invoice is paid within a time limit.	Customer records Cr purchase & Supplier records Cr sales.
Dr Note	Name & address of supplier & customer, date, full details & quantities (sometimes prices) of goods returned or overcharged	Goods not satisfactory, Wrong goods etc.  Issued by the supplier or customer	Customer checks goods & invoice for overcharge/ Wrong goods, etc.  When the price is included, it is always less trade discount.	Communication medium.  No entries made  However, sometimes they are issued in-place of a rectified invoice
Cr Note	Name & address of the supplier & customer, date, full details, quantities & prices of goods returned or overcharged	Faulty goods/overcharged goods.  Issued by the supplier	Sometimes printed in red/any other colour to distinguish between an invoice	Customer records returns outwards & supplier record returns inwards.
Statement of A/C	Name & address of supplier & customer, date, balance owing at the start of the period, invoices & Cr notes issued, payments received, any cash discounts allowed, balance owing at the end of the period.	At the end of each month, by a supplier. Given to each customer.	Contains summary of all transactions.	No one makes any entries  Reminder to the customer of Amount Outstanding & can also be used to check for errors for both.

Cheque	Pre-printed details.  Date, amount & payee have to be filled.	Payment through bank.	Used to pay pre-stated sum to payee.  Comes in a book of pre-printed cheques (Issued by the bank)	Supplier: Counterfoil of <i>paying-in slip</i> used to make entry in cash book & for discount allowed.  Customer: Makes uses of the <i>cheque</i> counterfoil to make cash book entry & discount received.
Receipt		Goods sold by cash, and not when by cheque (the cheque acts as one)		Proof of payment

TABLE 2:

<b>Prime Book</b>	<b>General Description</b>	<b>Format</b>	<b>Notes:</b>
Sales Journal/Sales book/sales day book	A list of A/Cs to which <b>Cr</b> sales were made, their values & the dates	Date-Name-Invoice Number-Folio-Amount (\$)  The invoice number pertains to the invoice issued	The Dr entry is made in the debtor's ledger A/C as the sales are recorded in the journal with the total of the invoice At the end of the month, the sales A/C is credited with the total of the sales journal as total credit sales of month
Sales Returns>Returns inwards book/returns inwards journal	A list of the names of the businesses, the value of goods returned & date	Date-Name-Cr Note Number-Folio-Amount  The credit note number pertains to the credit note issued	Written up using copies of Cr notes The Cr entries are simultaneously made into the customer's A/C. At the end of the month, the totals will be posted to the sales returns A/C.

**TABLE 3:**

<b>Prime Book</b>	<b>General Description</b>	<b>Format</b>	<b>Notes:</b>
Purchases Journal/ Purchases book/ Purchases day book	A list of the names of businesses from which <b>Cr</b> purchases have been made, value & date.	Date-Name-Invoice no.- Folio-Amount  The invoice number pertains to the invoice received	Written up using invoices from suppliers. The supplier's A/C is simultaneously credited with invoice totals. The total is posted into the purchase A/C as total Cr purchases of month.
Purchases Returns Journal/Purchase returns book>Returns outwards book>Returns outwards journal	A list of names of businesses whom goods have been returned to, value & date	Date-Name-Cr Note Number-Folio-Amount  The credit note number pertains to the credit note received	Written up using Cr notes from suppliers. The Suppliers A/C is simultaneously debited with the total from the Cr note. At the end of the month, the total (from the journal) is posted in the purchases returns A/C.

**TABLE 4:**

<b>Method:</b>	<b>Formulae/ Additional info.</b>	<b>Notes:</b>
Straight line method of depreciation/ fixed instalment method.	$\frac{\text{Cost of asset} - \text{Residual value}}{\text{Number of expected years of use}}$	The formula gives us a constant vale that has to be deducted from the asset per annum. The depreciation value and percentage stays constant. The value of the asset can fall to nil if there is no estimated residual value.
Reducing Balance method of depreciation/ diminishing balance method of depreciation	This method is used when the greater benefits from the use of the asset have been gained in the earlier years of its life (the depreciation amount reduces). This method is used when assets become obsolete quickly. Any residual value is taken into consideration when the depreciation percentage is decided. The depreciation amounts are expressed in whole dollars and thus are rounded off.	The amount of depreciation reduces each year, but the percentage stays constant as depreciation is calculated on the net book value/ written down value. The value of the asset can never fall to nil as the depreciation is always calculated from the NBV
Revaluation method of depreciation	The assets are valued at the end of each financial year, and the amount is compared with the NBV of the previous financial year (or cost-if first year of ownership) The amount by which the value of the asset falls is the depreciation for that financial year	This method of depreciation is used when it is impractical/difficult to keep detailed records regarding certain non-current assets, e.g. Loose tools etc.



**TABLE(s) 5:**

Profitability Ratios:

<b>Ratio:</b>	<b>What it means:</b>	<b>Derivation/Notes:</b>	<b>How to improve:</b>	<b>Factors that make it worse:</b>
ROCE: Return on capital employed: $\frac{\text{Net profit (profit for the year)}}{\text{Capital employed}} * 100$	Relates profit for the year to the capital employed. Return on investments. Shows how efficiently capital is used.	Net profit as a percentage of the capital employed, therefore is comparison. Profit per \$100 (without percentage sign) invested	Increase selling price of goods. Buy cheaper goods. Invest lesser capital, or pull out unnecessary funds.	Increasing trade discount Selling goods at cheaper prices Not passing on increased costs to customers. Increased running costs
Gross profit margin: $\frac{\text{Gross profit}}{\text{Sales (Revenue)}} * 100$	Gross profit as a percentage of turnover. The higher the return the more profitable the business is.	Gross profit as a percentage of sales Gross profit / gain per \$100 of sales relative to only sales factors	Increase selling price of goods. Buy cheaper goods.	Increasing trade discount Selling goods at cheaper prices Not passing on increased costs to customers
Net profit margin: $\frac{\text{Net profit (profit for the year)}}{\text{Sales (Revenue)}} * 100$	Return on \$100 worth of sales. Indicates how well a business is controlling its expenses	Net profit as a percentage of sales. Represents what percentage of sales is being actually kept for the business. The actual return seen (in most cases) on \$100 worth of sales. Affected by change in gross profit margin	Increase selling price of goods. Buy cheaper goods. Reduce running expenses	Increasing trade discount Selling goods at cheaper prices Not passing on increased costs to customers. Increasing expenditure.

Liquidity Ratios:

<b>Ratio:</b>	<b>What it means:</b>	<b>Derivation/Notes:</b>	<b>How to improve:</b>	<b>Factors that make it worse:</b>
Current Ratio/ Working capital ratio: Current Assets : ( is to) current liabilities.	Compares relatively liquid assets that can be exchanged into cash within the next 12 months with the values of Liabilities which are due for short term payment.	Measures the ability of a business to meet its liabilities when due. Ratios between 1.5:1 to 2:1 are satisfactory. Having a lot of current assets as compared to current liabilities, for e.g. (14:1) can mean poor allocation of money. When a business doesn't have an adequate working capital, it generally cannot pay off due liabilities, has difficulties obtaining further credit supplies (due to low credit-worthiness), cannot take advantage of cash discounts or business opportunities when they arise.	Introduce more capital Obtain non-current loans Sell surplus NCA. Sell off goods (if at a profit) Reduce drawings by owner or reduce dividends.	Buying more goods on credit. Buying NCA
Quick ratio/ acid test ratio: Current Assets less inventory:( is to) current liabilities	Compares the current assets of a business minus its inventory to the current liabilities of the business. This is done as inventory is considered to not be liquid.	Compares the assets that can easily converted to cash to the liabilities of the business. Inventory is 2 stages away from being money, first it has to be sold, then the debt is to be collected. A ratio of 1:1 is regarded as satisfactory as all (current) liabilities can immediately be paid with liquid assets. Similar to current ratio. Higher than 1:1 is considered to be poor management of liquid assets.	Introduce more capital Obtain non-current loans Sell surplus NCA. Reduce drawings by owner or reduce dividends. Sell off inventory even if not profitable (if cash seriously required)	Buying more goods Buying NCA Buying goods for cash

Continuation of liquidity ratios:

<b>Ratio:</b>	<b>What it means:</b>	<b>Derivation/Notes:</b>	<b>How to improve:</b>	<b>Factors that make it worse:</b>
<p>Rate of inventory turnover/ inventory turn: <math>\frac{\text{Cost of sales}}{\text{Average inventory}} = \text{no. of times}</math> inventory is sold and replaced in the given period <math>\frac{\text{Average inventory}}{\text{Cost of sales}} * 365 = \text{no. of}</math> days on avg. inventory is held before being sold</p>	<p>The quicker the rate of inventory turnover, the lesser time funds are frozen in inventory, which is the least liquid CA.</p>	<p>If average inventory= COS, then it will take one year to sell these goods, so *365 days= 1 year. COS = total inventory sold in year, therefore it divided by avg. inventory gives no. of times inventory is replaced</p>	<p>Sell more goods.</p>	<p>Lower sales (higher inventory levels) Over- purchasing inventory, very high selling prices, falling demand, inefficiency and slowing activity.</p>
<p>Collection period for trade receivables: <math>\frac{\text{Trade receivables}}{\text{Credit sales}} * x,</math> Where x= 365 for CP in days, x= 52 for CP in weeks, x= 12 for CP in months Also called trade receivables/sales ratio</p>	<p>Trade receivables to sales ratio. Average time for debtors to pay their A/C(s)</p>	<p>If trade receivables = credit sales, then one year should be collection period as sales were made in one year. The length of time taken to actually pay should be compared to this. The longer a business will have to wait, the more likely it will become a bad debt. The collection period varies from year to year and a decrease means credit control works efficiently</p>	<p>Improve credit control policy Offer cash discount for early payment Charge interest on overdue A/C(s) Refuse to supply, until debt is paid. Invoice discounting or debt factoring can be done<sup>14</sup></p>	<p>Not following up on debt collection etc.</p>

<sup>14</sup> Factoring and Invoice Discounting are both financial services that can release the funds tied up in your unpaid invoices, involving a provider who agrees to advance money against outstanding debtor balances. A debt factor will maintain the sales ledger, collect debts and pay the business. They chase the debtors for repayment. A discounter will pay for certain debts in advance, but will not maintain the sales ledger. Both services are chargeable.

Payment period for trade payables: $\frac{\text{Trade payables}}{\text{Credit purchases}} * x$ Where x= 365 for PP in days, x= 52 for PP in weeks, x= 12 for PP in months Also called trade payables/ purchases ratio.	Average time taken to pay the creditors A/C(s)	Should be compared with the term of credit allowed by the creditors. If it increases, it means that the business is failing to pay/is short of immediate funds. If debtors are not settling their A/C(s) it can get difficult for the business to settle their own A/C(s).	<b>Additional information:</b> Taking longer to pay off one's debts means that one can use its funds for other purposes, but can also lead to the supplier refusing future credit and or goods, a lower credit score, loss of cash discount and damage to the existing relationship.
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**TABLE 6:**

<b>Principle:</b>	<b>Description:</b>	<b>Application:</b>	<b>Notes:</b>
Business Entity/Accounting entity and ownership	The owner of a business is regarded as being completely separate from the business and vice versa	The personal assets, spending, liabilities etc. Of the owner do not appear in the accounting records of the business and vice versa. Every (financial) transaction is recorded from the view point of the business	If a transaction involves both the owner and the business, it involves either the capital A/C or the drawings A/C or the current A/C
Duality/Dual aspect	Every (financial) transaction has 2 aspects- a giving and a receiving.	Applied in the double entry system of bookkeeping.	
Money measurement	Only info. Which can be expressed in terms of money can be recorded in the accounting records.	Several aspects of a business such as staff expertise, the morale of the workforce, the release of a competitor product etc. Will not be shown in the accounting records as its value cannot be given a concrete monetary value.	Money is a traditionally recognised unit of measuring the value of an item/ transaction. It is factual and not based on personal opinions
Realisation	A profit should not be recorded before it is earned, i.e. Profit is only recorded when the legal title of goods or services passes on from the seller to the buyer (who is obliged to pay for them).	The confirmation of the buying of goods doesn't really mean anything as the legal title of the goods hasn't yet changed from the seller to the buyer (No transfer of goods).	This principle is even followed if goods are sold on Cr and the customer hasn't made a payment- The transaction will still be recorded as income)
Going concern	It is assumed that the business will continue to operate for an indefinite period of time and that there is no intention to close down the business or reduce its size by a considerable amount	The accounting records of a business are always maintained on the basis of assumed continuity. Non-current assets will be shown at their NBV (cost less depreciation) and not a possibly quasi-realistic estimate. Inventory will be valued at a price lower than its cost / net realizable value.	If it is expected that the business will cease to operate in the near future, all asset values on SOFP can be adjusted towards their market values thus these values become more meaningful than their book values.

Historical cost	All assets and expenses are recorded in the ledger accounts at their actual cost.	At times a more prudent approach is taken whenever applying this Principle, thus depreciating the value of non-current assets thus bringing the value closer to a net realisable value	Applying this principle makes it difficult to compare financial transactions due to inflation. Prudence precedes Historical Cost, always.
Accounting period	Because reports are required at regular intervals, the life of a business is divided into accounting periods- usually years.	Useful comparisons can be made with the business itself over time. The total expenses of a period will be transferred to the income statement. Balances at the end of a trading period (amounts which do not pertain to the specific financial year) are carried down to become the opening balance of the next trading period.	According to going concern, the business should operate forever, so to prepare financial statements, it's lifetime is divided into years
Consistency	When a choice of method is available, if one is chosen (with the most realistic outcome), it must be followed throughout the coming accounting periods.	The reducing balance method of dep. For e.g. is consistently used to depreciate delivery vans	A comparison of financial statements from one accounting period to the next will be made difficult if this principle is not followed.
Accruals/ Matching	The revenue of a period is matched against the corresponding expenses pertaining to the period	Example: Insurance is prepaid for 2 months at the end of the accounting period (\$40 in total). At the start of the same accounting period insurance due = \$20, Insurance paid = \$300, Therefore insurance pertaining to the current accounting period= \$300(paid) - \$40 (prepaid) - \$20 (for the previous accounting period)	Extension of the principle of realisation; includes other expenses and other income.
Prudence	Ensures the accounting records present a realistic picture of the business.	Profits and assets should not be overstated. Liabilities and expenses should not be understated and all possible losses should be accounted for appropriately (provision for doubtful debts is maintained)  Profit should only be recognised once all possible losses are accounted for.	Prudence precedes all principles; bad debts are written off after a certain period, even though the income is realised Provisions are made for depreciation and possible bad debts.
Materiality:	Items of low value (low cost NCA or what comes under sundry expenses for e.g.) are either grouped or recorded in ways where other principles may be ignored	Immaterial non-current assets which cost more to account for spreading over their cost over their useful life are recorded as expenses.  e.g. Inventories of office supplies are not considered in the financial statements as they are considered immaterial	A large business which operates on a global scale might not record the purchase of a laptop as capital expenditure although it is clearly a NCA), but sole traders will.

IMAGE 1:

Date	Details	F	\$	Date	Details	F	\$
31/01/15	Balance	c/d	150	01/01/15	Balance	b/d	100
				15/01/15	Cash		50
			<u>150</u>				<u>150</u>
				01/01/18	Balance	b/d	150

IMAGE 2:

Expense of \$150 paid from January 2017 to March 2018

January	February	March	April	May	June	July	August	September	October	November	December	January	February	March
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Financial year: January 1st 2017 to December 31st 2017

January	February	March	April	May	June	July	August	September	October	November	December	January	February	March
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(- 3 Months)

IMAGE 2:

Date	Details	F	\$	Date	Details	F	\$
31/12/15	Income statement		10	01/01/15	Balance	b/d	100
31/12/15	Balance	c/d	90				
			<u>100</u>				<u>100</u>
31/12/16	Balance	c/d	110	01/01/16	Balance	b/d	90
				31/12/16	Income statement		20
			<u>110</u>				<u>110</u>
31/12/17	Balance	c/d	110	01/01/17	Balance	b/d	110
			<u>110</u>				<u>110</u>
				01/01/18	Balance	b/d	110

NOTES

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