Cambridge

IGCSE / O-Level

Accounting

(Code: 0452 / 7707)

Section 03

Chapter 8 Financial statements – Part A

8.1 Introduction

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

1. An income statement which consists of two sections:

• a trading section in which the gross profit of the business is calculated

• a profit and loss section in which the profit for the year of the business is calculated.

2. A statement of financial position shows the assets and liabilities of the business at a certain date. The statement of financial position is not part of the double entry system.

Every item in a trial balance appears once in a set of financial statements

Any notes to a trial balance are used twice in a set of financial statements

Walkthrough 8.1

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

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

Samir
Trial balance at 31 May 20–8

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

- The inventory at 31 May 20–8 was valued at $7 600.
- During the year ended 31 May 20–8, Samir took goods costing $300 for his own use. No entries have been made in the accounting records.

8.2 Trading section of the income statement

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

Gross profit = Selling price of goods – Cost of sales

The cost of sales is the total cost of goods sold, not necessarily the cost of goods purchased during the year and is calculated using a formula.

Cost of sales = Opening inventory + Purchases – Closing inventory

There are two ways in which a trading section of an income statement can be prepared – **horizontal and vertical.**

The **horizontal format** is similar to a traditional ledger account.

Walkthrough 8.2

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

Samir

Income statement (trading section) for the year ended 31 May 20–8

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

- As these items are entered in the trading section of the income statement, they should be ticked-off in the trial balance and accompanying notes.
- The gross profit is carried down to the profit and loss section (see Section 8.3).
- The first money column on each side has been used for adding and subtracting items and the final column had been used for the section total.

8.3 Profit and loss section of the income statement

The **profit and loss** section of an income statement is concerned with profits and losses, gains and expenses.

Its purpose is to calculate the final profit aft er all running expenses and other items of income. This is known as the **profit for the year**. The formula for calculating profit for the year is:

Profit for the year = Gross profit + Other income – Expenses

As with a trading section of an income statement, a profit and loss section can be prepared using either the **horizontal or the vertical method.**

The difference (or balance) between the two sides equals the **profit for the year** (if the credit side is the largest) or the **loss for the year** (if the debit side is the largest).

Walkthrough 8.5

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

Samir
Income statement (profit and loss section) for the year ended 31 May 20–8

	$	$	$
Gross profit			29 500
Add Discount received			400
			29 900
Less Discount allowed		900	
Wages		11 200	
General expenses		2 800	
Property tax		600	15 500
Profit from operations			14 400
Less Loan interest		500	
Profit for the year			13 900

- Using the vertical presentation it is easy to show the profit earned from the normal trading or operating activities and then final profit for the year after the deduction of any finance costs.

8.4 Transferring ledger account totals to the income statement

The income statement must have a double entry in another account, and credited items must be debited in the appropriate ledger account. Deductions from debit items in the income statement are equivalent to credit entries, necessitating a debit entry in the ledger.

Walkthrough 8.7

Using the income statement prepared for Samir in Walkthrough 8.6, prepare the following ledger accounts to show how **each** is closed by transfer to the income statement:

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

a

Samir
Nominal ledger
Purchases account

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

b

Purchases returns account

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

c

Discount received account

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

d

Wages account

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

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

8.5 Income statement of a service business

A **service business** is one which does not buy and sell goods, such as an accountant, an insurance company, a travel agent, a hairdresser and so on.

The statement of financial position is exactly the same as the statement of financial position of a **trading business.**

Walkthrough 8.10

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

	$
Property tax	6400
General expenses	8950
Insurance	2670
Printing and stationery	4560
Loan interest	1500
Wages	43500
Rent receivable	7300
Commissions received	92150

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

Anita
Income statement for the year ended 30 September 20–5

	$	$		$	$
Property tax		6400	Commissions received		92150
General expenses		8950	Rent receivable		7300
Insurance		2670			
Printing and stationery		4560			
Loan interest		1500			
Wages		43500			
Profit for the year		31870			
		99450			99450

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

Anita
Income statement for the year ended 30 September 20–5

	$	$	$
Commissions received			92150
Add Rent receivable			7300
			99450
Less Property tax		6400	
General expenses		8950	
Insurance		2670	
Printing and stationery		4560	
Wages		43500	66080
Profit from operations			33370
Less Loan interest			1500
Profit for the year			31870

You can now answer Question 6 at the end of this chapter.

Chapter 9 Financial statements – Part B

9.1 Introduction

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

A **statement of the financial position** shows the assets of a business (what the business owns and what is owing to the business) and the liabilities of a business (what the business owes) on a certain date.

9.2 Assets

Assets are divided into two types. These are:

1. Non-current assets

There are two types of non-current assets:

a Tangible non-current assets Tangible non-current assets are long-term assets which are obtained for use rather than for resale. They help the business earn revenue

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

b Intangible non-current assets Intangible non-current assets are long-term assets which do not have material substance (they cannot be seen or touched).

Examples of intangible non-current assets include **goodwill**, brand names and trademarks.

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

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

9.3 Liabilities

Liabilities are divided into three types. These are:

1 **Capital** - Capital represents the owner's investment in the business and is the amount owed by the business to the owner.

2 Non-current liabilities Non-current liabilities are amounts owed by the business which are not due for repayment within the next 12 months. Examples of non-current liabilities include long-term loan and mortgage.

3 Current liabilities Current liabilities are short-term liabilities. Since current liabilities, like current assets, arise from the normal trading activities of the business, their amounts are constantly changing.

There are two ways in which a statement of financial position can be prepared – **horizontal and vertical**. A **horizontal** statement of financial position is prepared in a two-sided format. It is usual for the assets to be listed on the left and the liabilities to be listed on the right.

Walkthrough 9.1

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

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

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

Samir Trial balance at 31 May 20–8	Dr $	Cr $
✓ Revenue (sales)		95 700
✓ Sales returns	1 000	
✓ Purchases	65 000	
✓ Purchases returns		500
✓ Carriage inwards	1 500	
✓ Inventory 1 Jun 20–8	7 100	
✓ Discount received		400
✓ Discount allowed	900	
✓ Wages	11 200	
✓ General expenses	2 800	
✓ Property tax	600	
✓ Loan interest	500	
Premises	80 000	
Fixtures and equipment	13 900	
Trade receivables	7 500	
Trade payables		7 800
Bank	3 300	
Cash	100	
Long-term loan		10 000
Capital		90 000
Drawings	9 000	
	204 400	204 400

- The inventory at 31 May 20–8 was valued at $7 600.
- During the year ended 31 May 20–8 Samir took goods costing $300 for his own use.
- No entries have been made in the accounting records.

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

Chapter 10 - Accounting rules

10.1 Introduction

Accounting rules are essential for recording financial information and comparing business results. Each business should apply these principles, including capital and revenue expenditure, receipts, and inventory valuation.

10.2 Accounting principles

Accounting principles are sometimes referred to as **concepts and conventions**. A **concept** is a rule which sets down how the financial activities of a business are recorded.

A **convention** is an acceptable method by which the rule is applied to a given situation

Business entity

The **business entity principle** is also known as the **accounting entity** principle. This means that the **business is treated as being completely separate from the owner of the business**.

Consistency

Where a choice of method is available, the one with the most realistic outcome should be selected. Once a method has been selected, **the method must be used consistently from one accounting period to the next.**

This is known as the **consistency principle**.

Duality

The **principle of duality** is also referred to as the **dual aspect** principle. It has been explained in Chapter 2 how **every transaction has two aspects – a giving and a receiving**. The term **double entry** is used to describe how these two aspects of a transaction are recorded in the accounting records.

Going concern

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

Historic cost

The **historic cost principle** requires that **all assets and expenses are initially recorded in the ledger accounts at their actual cost.**

Matching

The **matching principle** is also referred to as the **accruals principle**. This is an extension of the realisation principle to include other income and expenses. **The revenue of the accounting period is matched against the costs of the same period** (the timing of the actual receipts and payments is ignored).

Materiality

The materiality principle applies to items of very low value (items which are not 'material') which are not worth recording as separate items. Other principles can be ignored if the time and cost involved in recording such low value items far outweigh any benefits to be gained from the strict application of these principles

Money measurement

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

Prudence

The **prudence principle** is also known as the principle of **conservatism.**

Accountants should ensure that profits and assets are not overstated and that liabilities are not understated.

The phrase '**never anticipate a profit, but provide for all possible losses**' is oft en used to describe the principle of **prudence.**

Realisation

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

10.3 International accounting standards

International accounting standards ensure that financial statements are prepared using the same rules and guidelines internationally. Knowledge of the individual accounting standards is outside the scope of the syllabus.

Comparability

The information contained in financial statements can be useful if it can be compared with similar information about the same business for another accounting period or at another point in time

Relevance

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

Reliability

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

• capable of being depended upon by users as being a true representation of the underlying transactions and events which it is representing

• capable of being independently verified

• free from bias

• free from significant errors

• prepared with suitable caution being applied to any judgements and estimates which are necessary.

Understandability

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

10.4 Capital and revenue expenditure and receipts

Capital expenditure

Capital expenditure is money spent by a business on purchasing non-current assets and improving or extending non-current assets.

They should **not** be charged as expenses in the year of purchase as they benefit the business for several years.

This cost will be **matched** against the annual revenue which the non-current asset has helped the business to earn.

Revenue expenditure

Revenue expenditure is money spent on running a business on a day-to-day basis.

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

Capital receipt

A **capital receipt occurs when money is received other than from normal trading activities.** This includes the receipt of capital from the owner, the receipt of loans and the proceeds of sale of a non-current asset.

A capital receipt should **not** be entered in the income statement.

Revenue receipt

A **revenue receipt** is money received by a business from normal trading activities.

These include revenue from the sale of goods, fees from clients and other income such as rent received, commission received, discount received and so on.

10.5 Inventory valuation

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

Walkthrough 10.1

Dhaval sells two different types of goods (Type A and B). He provided the following information at 31 December 20–6:

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

The cost price per unit of Type A does not include carriage inwards of $1 per unit.

It will cost $0.50 per unit to bring Type A goods into a saleable condition

12 units of Type B were damaged and would only be able to be sold for $10 per unit.

Prepare a statement to show the value of the closing inventory at 31 December 20–6.

Dhaval Valuation of inventory at 31 December 20–6		
	$	$
Type A – 94 units at $17.50		1 645
Type B – 12 units at $10	120	
26 units at $15	390	510
		2 155

Calculations

Type A Cost $20 + Carriage $1 = $21
Net realisable value $18 – costs to complete $0.50 = $17.50
Valued at net realisable value as it is lower than cost

Type B 12 units Cost $15
Net realisable value $10
Valued at net realisable value as it is lower than cost
26 units Cost $15
Net realisable value $19
Valued at cost as it is lower than net realisable value

Walkthrough 10.2

After the preparation of his financial statements for the year ended 31 December 20–7 Dhaval discovered that he had over-valued his closing inventory by $50

Complete the following table by placing a tick in the correct columns to show the effect of this.

	Overstated	Understated	No effect
gross profit for the year ended 31 December 20–7	✓		
gross profit for the year ending 31 December 20–8		✓	

	Overstated	Understated	No effect
profit for the year ended 31 December 20–7	✓		
profit for the year ending 31 December 20–8		✓	
Dhaval's capital at 31 December 20–7	✓		
Dhaval's capital at 31 December 20–8			✓
current assets at 31 December 20–7	✓		
current assets at 31 December 20–8			✓

Over-valuing the inventory at 31 December 20–7 will affect the financial statements for that year because

- the cost of sales is under-stated so both the gross profit and the profit for the year will be overstated
- over-stating the profit for the year means that the balance of the capital account on 31 December 20–7 will also be over-stated
- the total of the current assets at 31 December 20–7 will be over-stated if the inventory at that date is over-valued.

Over-valuing the inventory at 31 December 20–7 will affect the financial statements for the year ending 31 December 20–8 because

- the cost of sales is over-stated so both the gross profit and the profit for the year will be under-stated
- under-stating the profit for the year means that the balance of the capital account on 31 December 20–7 will have been corrected at 31 December 20–8
- the total of the current assets at 31 December 20–8 will not be affected.

Chapter 11 - Other payables and other receivables

11.1 Introduction

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

An income statement is prepared for a definite period of time (the period of time covered by the statement being included as part of the statement heading).

This is a practical application of the **matching principle.**

It is necessary to adjust the items within an income statement for amounts **prepaid** or **accrued**.

11.2 Accrued and prepaid expenses

Accrued expenses

An **accrual** is an amount due in an accounting period which remains unpaid at the end of that accounting period.

To apply the **matching principle**, the amount transferred to the income statement should represent the expense for the accounting period covered by that account. **This means that any amount due but unpaid at the end of the financial year must be added to the amount paid** and the total expense relating to the accounting period transferred to the income statement.

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

Prepaid expenses

A **prepayment** is an amount that is paid in advance.

As with accrued expenses, the **matching principle** must be applied so that the amount transferred to the income statement represents the expense for the accounting period covered by that statement.

To complete the double entry, this **balance is brought down on the debit side of the ledger account**.

As the balance represents a short term benefit, which the business has paid for but which is not used up, it will be included as a **current asset** in the **statement of financial position.**

11.3 Opening balances on expense accounts

Walkthrough 11.4

Salman's financial year ends on 31 March.

He receives an invoice for telephone expenses quarterly in arrears.

On 1 April 20–8 the telephone expenses account in Salman's nominal ledger showed a credit balance of $59.

During the year ended 31 March 20–9 his payments for expenses included the following:

20–8	5 April	Telephone expenses paid in cash, $59
20–8	30 June	Telephone expenses paid by cheque, $60
	2 October	Telephone expenses paid by credit transfer, $48
	31 December	Telephone expenses paid by credit transfer, $56

An invoice for telephone expenses for $63 was received on 31 March 20–9. This was for telephone expenses up to the end of March, but was not paid until 2 April 20–9.

Write up the telephone expenses account in Salman's nominal ledger for the year ended 31 March 20–9.

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

The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to:

- deduct that portion of the $223 which falls outside the financial year ($59 was paid during this financial year but related to the previous accounting period)
- add the $63 owing at the end of present financial year.

Salman

Nominal ledger

Telephone expenses account

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

Walkthrough 11.5

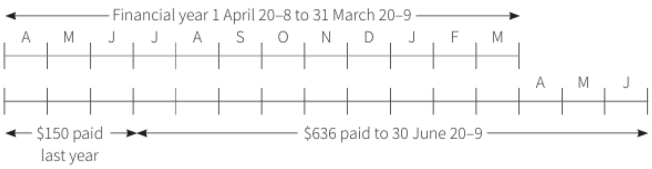
Salman's financial year ends on 31 March.

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

He paid $636 for one year's insurance on his premises by direct debit on 1 July 20–8.

Write up the insurance account in Salman's nominal ledger for the year ended 31 March 20–9.

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



The diagram shows that the expenses paid do not match the period covered by the financial year, so it is necessary to:

- deduct that portion of the $636 which falls outside the financial year (3 months/12 months or $\frac{1}{4}$ of $636 relates to the following financial year)
- add the $150 paid in the previous financial year as it falls within the present financial year.

Salman
Nominal ledger
Insurance account

Date	Details	Folio	$	Date	Details	Folio	$
20–8				20–9			
Apr 1	Balance	b/d	150	Mar 31	Income statement		627
Jul 1	Bank		636		Balance	c/d	159
			786				786
20–9							
Apr 1	Balance	b/d	159				

11.4 Combined expense accounts

Sometimes a business may use one ledger account for two different, but related, expenses. The same principles are applied as those used for an account containing a single expense. The only difference is that there may be two opening and closing balances.

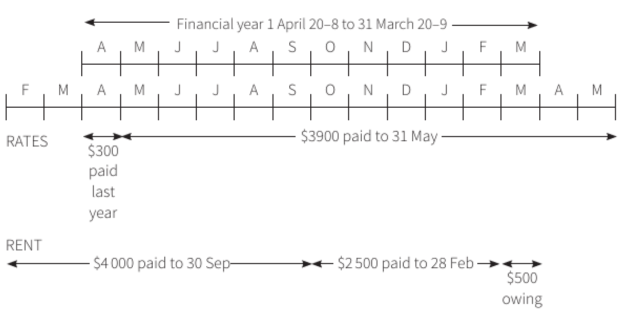
Walkthrough 11.6

Mary's financial year ends on 31 March. She maintains a combined account for rent and rates. On 1 April 20–8 Mary had prepaid one month's rates, $300, and owed two months' rent, $1 000. During the year ended 31 March 20–9 Mary made the following payments by cheque:

20–8		$
1 May	Rent for 8 months to 30 September 20–8	4 000
1 June	Rates for 13 months to 31 May 20–9	3 900
1 December	Rent for 5 months to 28 February 20–9	2 500

Write the rent and rates account in Mary's nominal ledger for the year ended 31 March 20–9.

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



Apply the same principles as used in **Walkthrough 11.4** and **11.5** by deducting anything which falls outside the financial year and adding anything which falls within the present financial year.

Mary
Nominal ledger
Rent and rates account

Date	Details	Folio	$	Date	Details	Folio	$
20–8				20–8			
Apr 1	Balance (rates)	b/d	300	Apr 1	Balance (rent)	b/d	1 000
May 1	Bank (rent)		4 000	20–9			
Jun 1	Bank (rates)		3 900	Mar 31	Income statement		
Dec 1	Bank (rent)		2 500		Rent 6 000		
20–9					Rates 3600		9 600
Mar 31	Balance (rent)	c/d	500		Balance (rates)	c/d	600
			11 200				11 200
20–9				20–9			
Apr 1	Balance (rates)	b/d	600	Apr 1	Balance (rent)	b/d	500

11.5 Accrued and prepaid income

Accrued income

Where **an item of income is accrued** it means that another person receiving a benefit or service from the business during the accounting period has not paid for that benefit or service by the end of the period.

The **matching principle** is applied to income in the same way as it is to expenses so that the amount transferred to the income statement represents the income for the accounting period covered by that statement. This means that **any amount due but not received at the end of the financial year must be added to the amount received** and the total income relating to the accounting period transferred to the income statement.

To complete the double entry, this **balance is brought down on the debit side of the ledger account**. As the balance represents an amount owing to the business, due to be received in the near future, it will be included as a **current asset** in the **statement of financial position.**

Prepaid income

Where **an item of income is prepaid**, it means that a person had paid for a benefit or service from the business, but this has not been provided by the business at the end of the financial year.

Once again, the **matching principle** must be applied so that the amount transferred to the income statement represents the income for the accounting period covered by that statement.

To complete the double entry, this **balance is brought down on the credit side of the ledger account**. This balance will be included as a **current liability** in the **statement of financial position** as the business has a liability to provide some service or benefit for which the business has already been paid.

11.6 Opening balances on income accounts

In the second and subsequent years of trading, a business may have opening balances on income accounts as well as opening balances on expense accounts. These must be considered when calculating the income relating to the particular financial year for which the accounts are prepared.

Walkthrough 11.9

Salman's financial year ends on 31 March.

He acts as an agent for Kohli & Company and is paid a commission six monthly in arrears on all goods sold for Kohli & Company.

On 1 April 20–8 the commission receivable account in Salman's nominal ledger showed a debit balance of $135.

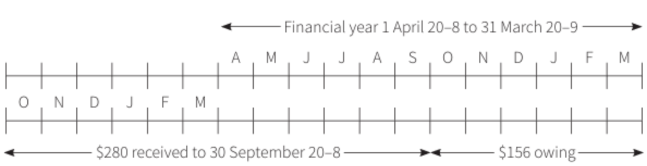
During the year ended 31 March 20–9 he received direct debits for commission as follows:

20–8	2 April	$135
	1 October	$145

At 31 March 20–9 commission due but not yet received amounted to $156.

Write up the commission receivable account in Salman's nominal ledger for the year ended 31 March 20–9.

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



The diagram shows that the income received does not match the period covered by the financial year, so it is necessary to:

- deduct that portion of the $280 which falls outside the financial year ($135 was received during this financial year but related to the previous accounting period)
- add the $156 owing at the end of present financial year.

Salman
Nominal ledger
Commission receivable account

Date	Details	Folio	$	Date	Details	Folio	$
20–8				20–8			
Apr 1	Balance	b/d	135	Apr 2	Bank		135
20–9				Oct 1	Bank		145
Mar 31	Income statement		301	20–9			
				Mar 31	Balance	c/d	156
			436				436
20–9							
Apr 1	Balance	b/d	156				

Walkthrough 11.10

Salman's financial year ends on 31 March.

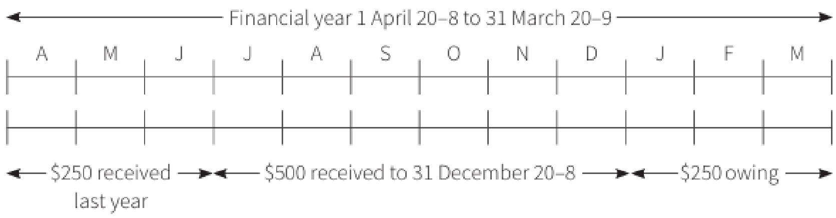
He rents part of his premises to another trader at an annual rent of $1 000, payable quarterly in advance.

On 1 April 20–8 the rent receivable account in Salman's nominal ledger showed a credit balance of $250.

The tenant paid rent of $250 by direct debit on 1 July 20–8 and 2 October 20–8. The rent due on 1 January 20–9 was not received until 2 April 20–9.

Write up the rent receivable account in Salman's nominal ledger for the year ended 31 March 20–9.

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



The diagram shows that the income received does not match the period covered by the financial year, so it is necessary to:

- add the $250 due but not received at the end of the financial year
- add the $250 received in the previous financial year as it falls within the present financial year.

Salman
Nominal ledger
Rent receivable account

Date	Details	Folio	$	Date	Details	Folio	$
20–8				20–8			
Mar 31	Income statement		1 000	Apr 1	Balance	b/d	250
				Jul 1	Bank		250
				Oct 2	Bank		250
				20–9			
				Mar 31	Balance	c/d	250
			1 000				1 000
20–9							
Apr 1	Balance	b/d	250				

Chapter 12 - Accounting for depreciation and disposal of non-current assets

12.1 Introduction

Depreciation is an estimate of the loss in value of a non-current asset over its expected working life. Most of the non-current assets of a business lose value over a period of time that they are used by the business

The records can only show an **estimate** of the loss in value of a non-current asset because of depreciation. The **exact** amount will only be known when the asset is disposed of or sold.

The purchase of a non-current asset is **capital expenditure**.

Matching the capital expenditure against the sales it has helped the business to earn is done by an annual charge for depreciation. **This means that the cost of the non-current asset is spread over the years which benefit from the use of that asset.**

The principle of prudence is also applied in the statement of financial position as the non current assets are recorded at a figure less than the cost price (this is known as the **net book value or the written down value)**. This overrides the **historic cost principle** as it ensures that the non-current assets are shown at more realistic values.

12.2 Causes of depreciation

The four main causes of depreciation are physical deterioration, economic reasons, passage of time and depletion.

Physical deterioration

This is the result of 'wear and tear' due to the normal usage of the non-current asset. It can also be because the asset falls into a poor physical state due to rust, rot, decay and so on.

Economic reasons

The non-current asset may become inadequate as it can no longer meet the needs of the business. It can also be because the non-current asset has become obsolete as newer and more eff icient assets are now available.

Passage of time

This arises where a non-current asset, for example a lease, has a fixed life of a set number of years

Depletion

This arises in connection with non-current assets such as wells and mines. The worth of the asset reduces as value is taken from the asset.

12.3 Methods of calculating depreciation

The method selected should be the one which spreads the cost of the asset as fairly as possible over the periods which benefit from its use. Once a method has been selected for a particular non-current asset, it should be applied each year. This is an application of the **principle of consistency**.

Straight line method of depreciation

This is also known as the **fixed instalment method**. The formula used for calculating the annual depreciation using this method is:

$$\frac{\text{Cost of asset}}{\text{Number of expected years of use}}$$

This method applies the **same amount of depreciation (or the same percentage rate of the cost price)** each year.

Walkthrough 12.1

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years.

Calculate the annual depreciation charge:

a as an amount of money

b as a percentage.

a $\frac{\$25\,000}{4 \text{ years}} = \$6\,250$

b $\frac{\$6\,250}{\$25\,000} = 25\%$

Reducing balance method of depreciation

As the name implies, the amount of depreciation reduces each year. **The same percentage rate is applied, but it is calculated on a different value each year.**

Where it is estimated that the asset will have some value at the end of its working life, this must be included in the calculation. Such a value is known as a **residual value**. The formula then becomes:

$$\frac{\text{Cost of asset} - \text{Residual value}}{\text{Number of expected years of use}}$$

Walkthrough 12.2

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for \$3 000.

Calculate the annual depreciation charge:

a as an amount of money

b as a percentage (based on the original cost).

a $\frac{\$25000 - \$3000}{4 \text{ years}} = \$5500$

b $\frac{\$5500}{\$25000} \times \frac{100}{1} = 22\%$

The figure of cost less depreciation is known as the **net book value** (or written down value) of the asset.

Walkthrough 12.3

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for \$3 000.

Calculate the depreciation for **each** of the four years of the fixtures' working life using the reducing balance method at the rate of 40% per annum.

	\$
Cost	25 000
Depreciation for year ended 30 June 20–4 at 40%	10 000
Book value at 1 July 20–4	15 000
Depreciation for year ended 30 June 20–5 at 40%	6 000
Book value at 1 July 20–5	9 000
Depreciation for year ended 30 June 20–6 at 40%	3 600
Book value at 1 July 20–6	5 400
Deprecation for year ended 30 June 20–7 at 40%	2 160
Book value at 1 July 20–7	3 240

Revaluation method of depreciation

The assets are valued at the end of each financial year. This value is compared with the value at the end of the previous financial year (or with the cost if it is the first year of ownership). The amount by which the value of the asset has fallen is the depreciation for the year.

Walkthrough 12.4

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing \$25 000 and paid by cheque. She decided to revalue the fixtures at the end of each year.

On 30 June 20–4 the fixtures were valued at \$20 500.

Calculate the depreciation for the year ended 30 June 20–4.

	\$
Cost of fixtures on 1 July 20–3	25 000
Value of fixtures on 30 June 20–4	20 500
Depreciation for the year ended 30 June 20–4	4 500

12.4 Recording depreciation in the ledger

Recording depreciation using the straight line method and the reducing balance method

The procedure for entering depreciation calculated using the straight line method and the reducing balance method is exactly the same. Each type of non-current asset has two ledger accounts:

- an account for recording the cost of the asset (the asset account)
- an account for recording the depreciation (the provision for depreciation of asset account).

The asset account always has a debit balance and the provision for depreciation always has a credit balance.

Walkthrough 12.5

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing $25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for $3 000.

Kavita decided to use the reducing balance method of depreciation at 40% per annum.

Make the entries in Kavita's nominal ledger accounts for **each** of the years ended 30 June 20–4, 20–5, 20–6 and 20–7.

Kavita
Nominal ledger
Fixtures account

Date	Details	Folio	$	Date	Details	Folio	$
20–3							
Jul 1	Bank		25 000				

Provision for depreciation of fixtures account

Date	Details	Folio	$	Date	Details	Folio	$
20–4				20–4			
Jun 30	Balance	c/d	10 000	Jun 30	Income statement		10 000
			10 000				10 000
20–5				20–4			
Jun 30	Balance	c/d	16 000	Jul 1	Balance	b/d	10 000
				20–5			
				Jun 30	Income statement		6 000
			16 000				16 000
20–6				20–5			
Jun 30	Balance	c/d	19 600	Jul 1	Balance	b/d	16 000
				20–6			
				June 30	Income statement		3 600
			19 600				19 600
20–7				20–6			
Jun 30	Balance	c/d	21 760	Jul 1	Balance	b/d	19 600
				20–7			
				June 30	Income statement		2 160
			21 760				21 760
				20–7			
				Jul 1	Balance	b/d	21 760

- The asset account was not balanced at the end of each year as there is only one entry in the account.
- Before the transfer to the income statement can be made each year it is necessary to calculate the depreciation for the year. The calculations have been shown in **Walkthrough 12.3**.
- The difference between the balance on the asset account and the balance on the provision for depreciation account on the same date represents the net book value of the fixtures on that date.
- If the straight line method of depreciation had been selected the entry in the fixtures account would be exactly the same.
- If the straight line method of depreciation had been selected the entries in the provision for depreciation of fixtures account would be very similar. The transfer to the income statement would be $5 500 each year, so the totals and balances on the account would differ to those shown earlier.

Recording depreciation using the revaluation method

The cost of the asset and the depreciation are recorded in the same account.

The entries are summarised as follows:

During the year – **when the asset is purchased**
debit the asset account and credit either the cash book or the supplier's account with the cost price.

At the year-end – credit the asset account with the value of the asset at that date and carry down as a debit balance
transfer the difference on the account to the income statement as this is the depreciation for the year.

Walkthrough 12.7

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing $25 000 and paid by cheque. She decided to revalue the fixtures at the end of each year.

On 30 June 20–4 the fixtures were valued at $20 500.

Make the entries in the fixtures account in the nominal ledger for the year ended 30 June 20–4.

Kavita
Nominal ledger
Fixtures account

Date	Details	Folio	$	Date	Details	Folio	$
20–3				20–4			
Jul 1	Bank		25 000	Jun 30	Balance	c/d	20 500
					Income statement		4 500
			25 000				25 000
20–4							
Jul 1	Balance	b/d	20 500				

12.5 Recording depreciation in the financial statements

Recording depreciation in the income statement

The depreciation for the year for each type of asset is credited to the provision for depreciation account in the nominal ledger and is debited to the income statement

Recording depreciation in the statement of financial position

It is usual to show the total cost of each type of non-current asset less the total depreciation written off up to the date of the statement of financial position (referred to as **accumulated depreciation or depreciation to date).** The difference between these figures is the net book value.

Walkthrough 12.8

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing $25 000 and paid by cheque. She estimated that she would be able to use the fixtures for four years and then be able to sell them for $3 000.

Kavita decided to use the reducing balance method of depreciation at 40% per annum.

a Prepare a relevant extract from Kavita's income statement for **each** of the years ended 30 June 20–4 and 30 June 20–5.

b Prepare a relevant extract from Kavita's statement of financial position at 30 June 20–4 and at 30 June 20–5.

a

Kavita
Extract from income statement for the year ended 30 June 20–4

	$
Expenses – Depreciation of fixtures	10 000

Kavita
Extract from income statement for the year ended 30 June 20–5

	$
Expenses – Depreciation of fixtures	6 000

b

Kavita
Extract from statement of financial position at 30 June 20–4

Non-current assets	$ Cost	$ Accumulated depreciation	$ Net book value
Fixtures	25 000	10 000	15 000

Kavita
Extract from statement of financial position at 30 June 20–5

Non-current assets	$ Cost	$ Accumulated depreciation	$ Net book value
Fixtures	25 000	16 000	9 000

Walkthrough 12.9

Kavita's financial year ends on 30 June.

She depreciates her fixtures using the reducing balance method of depreciation at 40% per annum.

Her trial balance drawn up on 30 June 20–6 included the following:

	Dr $	Cr $
Fixtures	25 000	
Provision for depreciation of fixtures		16 000

a Prepare a relevant extract from Kavita's income statement for the year ended 30 June 20–6.

b Prepare a relevant extract from Kavita's statement of financial position at 30 June 20–6.

a

Kavita
Extract from income statement for the year ended 30 June 20–6

	$
Expenses – Depreciation of fixtures	3 600

b

Kavita
Extract from statement of financial position at 30 June 20–6

Non-current assets	$ Cost	$ Accumulated depreciation	$ Net book value
Fixtures	25 000	19 600	5 400

12.6 Disposal of non-current assets

Walkthrough 12.10

Kavita's financial year ends on 30 June.

On 1 July 20–3 she purchased fixtures costing $25 000 and paid by cheque. She decided to depreciate the fixtures using the reducing balance method.

On 1 July 20–7 the provision for depreciation of fixtures account showed a credit balance of $21 760.

Kavita sold all the fixtures on credit to Traders Ltd for $3 100 on 1 July 20–7.

Make the entries in Kavita's nominal ledger accounts for the year ended 30 June 20–8.

Kavita
Nominal ledger
Fixtures account

Date	Details	Folio	$	Date	Details	Folio	$
20–3				20–7			
Jul 1	Bank		25 000	Jul 1	Disposal		25 000
			25 000				25 000

Provision for depreciation of fixtures account

Date	Details	Folio	$	Date	Details	Folio	$
20–7				20–7			
Jul 1	Disposal		21 760	Jul 1	Balance	b/d	21 760
			21 760				21 760

Disposal of fixtures account

Date	Details	Folio	$	Date	Details	Folio	$
20–7				20–7			
Jul 1	Fixtures		25 000	Jul 1	Provision for depreciation		21 760
					Traders Ltd		3 100
				20–8			
				Jun 30	Income statement		140
			25 000				25 000

- The difference on the disposal account remains in that account until the end of the financial year when it is transferred to the income statement.
- In this case the depreciation had been under-provided so there was a small loss of $140 to transfer to the income statement.
- If the total of the credit side of the account had exceeded the debit side, there would have been an over-provision of depreciation. The transfer to the income statement would have been shown on the debit of this account and on the credit of the income statement.

Because the purchase of a non-current asset is **capital expenditure** it is recorded in an account for the non-current asset rather than in the purchases account. When a non-current asset is sold it is a **capital receipt** and is recorded in a special account known as a **disposal of non-current asset account** rather than in the sales account

Chapter 13 - Irrecoverable debts and provisions for doubtful debts

13.1 Introduction

An **irrecoverable debt is an amount owing to a business which will not be paid by the credit customer**. This may be because the customer has disappeared, has gone out of business or because he is unable to pay. If all reasonable steps to obtain payment have failed the debt is **written off .**

13.2 Recovery of debts written off

A debt written off may be recovered if a credit customer pays some, or all, of the amount owed, aft er the amount was written off . As the account of the customer has been closed, the amount received is debited in the cash book and credited to a debts recovered account

Walkthrough 13.1

Sachin is a trader who sells goods on credit. He offers customers a cash discount of 2% if accounts are paid within 30 days.

Sachin's financial year ends on 31 December.

Sachin sold goods, $400, on credit to Bhuvan's Stores on 1 February 20–2. The account was settled by cheque on 28 February 20–2. On this date Bhuvan's Stores purchased further goods, $150, on credit. After many attempts to recover the amount due, Sachin wrote off Bhuvan's Stores account as an irrecoverable debt on 30 December 20–2.

Sachin received a cheque from Bhuvan's Stores for $150 on 31 October 20–3.

During the year ended 31 December 20–3 Sachin wrote off irrecoverable debts totalling $820.

Write up the following accounts in Sachin's ledgers for **each** of the years ended 31 December 20–2 and 20–3 – Bhuvan's Stores account, irrecoverable debts account and debts recovered account.

Sachin

Sales ledger

Bhuvan's Stores account

Date	Details	Folio	$	Date	Details	Folio	$
20–2				20–2			
Feb 1	Sales		400	Feb 28	Bank		392
28	Sales		150		Discount		8
				Dec 30	Irrecoverable debts		150
			550				550

Nominal ledger

Irrecoverable debts account

Date	Details	Folio	$	Date	Details	Folio	$
20–2				20–2			
Dec 30	Bhuvan's Stores		150	Dec 31	Income statement		150
			150				150
20–3				20–3			
Dec 31	Debtors written off		820	Dec 31	Income statement		820
			820				820

Debts recovered account							
Date	Details	Folio	$	Date	Details	Folio	$
20–3				20–3			
Dec 31	Income statement		150	Oct 31	Bank (Bhuvan's Stores)		150
			150				150

- The words 'debtors written off' have been used as no individual names, dates and amounts details have been provided.
- Alternatively, the debt could have been reinstated by debiting Bhuvan's Stores account and crediting debts recovered. The cheque would then be debited to the bank and credited to Bhuvan's Stores account.
- Alternatively, the debts recovered account could have been transferred to the credit of the irrecoverable debts account. This would result in $670 being transferred from irrecoverable debts to the income statement on 31 December 20–3.

13.3 Reducing the possibility of irrecoverable debts

A credit limit is usually fixed for each customer, which places an upper limit on the amount the customer can owe at any one time (this credit limit can be reviewed periodically). The establishing of a credit limit and the later monitoring of the customer's account is known as **credit control.**

13.4 Provision for doubtful debts

A provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of irrecoverable debts.

This is an application of the principle of prudence. By maintaining a provision for doubtful debts, a business also observes the principle of matching

In order to make a provision for doubtful debts, it is necessary to estimate the amount of irrecoverable debts. The amount of the provision may be established by:

• looking at each individual credit customer's account and estimating which ones will not be paid

• estimating, on the basis of past experience, the percentage of the total amount owing by credit customers that will not be paid

• considering the length of time debts have been outstanding by means of an ageing schedule. A provision of a higher percentage may be made on older debts (the longer a debt is outstanding the greater the risk it may become irrecoverable).

13.5 Creating a provision for doubtful debts

Once it is decided to create a provision for doubtful debts and the amount or percentage has been decided, this can be recorded in the books. These entries are made at the end of the financial year.

Walkthrough 13.2

Sachin's financial year ends on 31 December.

During the year ended 31 December 20–4 he wrote off irrecoverable debts totalling $950.

On 31 December his trade receivables amounted to $25 000. He decided to create a provision for doubtful debts of 4% of the trade receivables.

a Write up the irrecoverable debts account and the provision for doubtful debts account in Sachin's nominal ledger for the year ended 31 December 20–4.

b Prepare a relevant extract from Sachin's income statement for the year ended 31 December 20–4.

c Prepare a relevant extract from Sachin's statement of financial position at 31 December 20–4.

a

Sachin
Nominal ledger
Irrecoverable debts account

Date	Details	Folio	$	Date	Details	Folio	$
20–4				20–4			
Dec 31	Debtors written off		950	Dec 31	Income statement		950
			950				950

Provision for doubtful debts account

Date	Details	Folio	$	Date	Details	Folio	$
				20–4			
				Dec 31	Income statement		1 000

- The words 'debtors written off' have been used in the irrecoverable debts account as no individual names, dates and amounts have been provided.
- The provision has been calculated at 4% of $25 000.

b

Sachin
Extract from income statement for the year ended 31 December 20–4

	$
Expenses – Irrecoverable debts	950
Provision for doubtful debts	1 000

c

Sachin
Extract from statement of financial position at 31 December 20–4

	$	$
Current assets		
Trade receivables	25 000	
Less Provision for doubtful debts	1 000	24 000

- Only the amount which is actually expected to be received from the trade receivables is added to the other current assets in the statement of financial position.

13.6 Adjusting a provision for doubtful debts

In future years it may be decided to maintain the provision for doubtful debts using the same percentage of the trade receivables. If the amount owing has increased, the provision needs to be increased and vice versa

Walkthrough 13.3

Increasing a provision for doubtful debts

Sachin's financial year ends on 31 December.

On 31 December 20–4 Sachin created a provision for doubtful debts of $1 000.

During the year ended 31 December 20–5 Sachin wrote off debts totalling $990.

On 31 December 20–5 his trade receivables amounted to $28 000. He decided to maintain the provision for doubtful debts at the rate of 4% of the trade receivables.

a Write up the irrecoverable debts account and the provision for doubtful debts account in Sachin's nominal ledger for the year ended 31 December 20–5.

b Prepare a relevant extract from Sachin's income statement for the year ended 31 December 20–5.

c Prepare a relevant extract from Sachin's statement of financial position at 31 December 20–5.

a

Sachin
Nominal ledger
Irrecoverable debts account

Date	Details	Folio	$	Date	Details	Folio	$
20–5				20–5			
Dec 31	Debtors written off		990	Dec 31	Income statement		990
			990				990

Provision for doubtful debts account

Date	Details	Folio	$	Date	Details	Folio	$
20–5				20–4			
Dec 31	Balance statement	c/d	1 120	Dec 31	Income statement		1 000*
				20–5			
				Dec 31	Income statement		120
			1 120				1 120
				20–6			
				Jan 1	Balance	b/d	1 120

- The words 'debtors written off' have been used in the irrecoverable debts account as no individual names, dates and amounts have been provided.
- The item indicated with * was entered in the account on 31 December 20–4 at the end of the previous financial year.
- The new provision has been calculated at 4% of $28 000.

b

Sachin
Extract from income statement for the year ended 31 December 20–5

	$
Expenses – Irrecoverable debts	990
Provision for doubtful debts	120

- Only the amount by which the provision needs to be increased is included in the expenses in the income statement.

c

Sachin
Extract from statement of financial position at 31 December 20–5

	$	$
Current assets		
Trade receivables	28 000	
Less Provision for doubtful debts	1 120	26 880

- The amount of the provision for doubtful debts at 31 December 20–5 (the balance on the provision account) is deducted from the trade receivables to show the amount expected to be received.

Revision questions