CORRECTION OF ERRORS AND THE SUSPENSE ACCOUNT

- Errors occurring in the preparation of accounts can be discussed and treated from two perspectives:
- Errors affecting the trial balance.
- Errors not affecting the trial balance

ERRORS NOT AFFECTING THE BALANCE SHEET

- Suppose we correctly entered cash sales GH¢70 to the debit of the Cash Book, but did not enter the GH¢70 to the credit of the sales account. If this were the only error in the books, the trial balance totals would differ by GH¢70. However, there are certain kinds of error which would not affect the agreement of the trial balance totals, and we will now consider these:

- **1 Errors of omission** – where a transaction is completely omitted from the books. If we sold GH¢90 goods to J Brewer, but did not enter it in either the sales or Brewer's personal account, the trial balance would still 'balance'.

- **2 Errors of commission** – this type of error occurs when the correct amount is entered but in the wrong person's account, e.g. where a sale of GH¢11 to C Green is entered in the account of K Green. It will be noted that the correct class of account was used, both the accounts concerned being personal accounts.

- **3 Errors of principle** – where an item is entered in the wrong class of account, e.g. if purchase of a fixed asset, such as a van, is debited to an expenses account, such as motor expenses account.

- **4 Compensating errors** – where errors cancel each other out. If the sales account was added up to be GH¢10 too much and the purchases account was also added up to be GH¢10 too much, then these two errors would cancel out in the trial balance. This is because the totals of both the debit side and the credit side of the trial balance will be GH¢10 too much.

- **5 Errors of original entry** – where the original figure is incorrect, yet double entry is still observed using this incorrect figure. An instance of this could be where there were sales of GH¢150 goods but an error is made in calculating the sales invoice. If it were calculated as GH¢130, and GH¢130 were credited as sales and GH¢130 were debited to the personal account of the customer, the trial balance would still balance.

- **6 Complete reversal of entries** – where the correct accounts are used but each item is shown on the wrong side of the account. Suppose we had paid a cheque to D Williams for GH¢200, the double entry of which is Cr Bank GH¢200, Dr D Williams GH¢200. In error it is entered as Cr D Williams GH¢200, Dr Bank GH¢200. The trial balance totals will still agree.

- **7 Transposition errors** – where the wrong sequence of the individual characters within a number was entered. For example, GH¢142 entered instead of GH¢124. This is quite a common error and is very difficult to spot when the error has occurred in both the debit and the credit entries, as the trial balance would still balance. (It is more common for this error to occur on one side of the double entry only.)

CORRECTION OF ERRORS

- We make corrections to double entry accounts by preparing journal entries. We should:

- **1** Show the corrections by means of journal entries, then

- **2** Show the corrections in the double entry set of accounts, by posting these journal entries to the ledger accounts affected.

ERROR OF OMMISSION

The sale of goods, £59 to E George, has been completely omitted from the books. We must correct this by entering the sale in the books. The journal entries for the correction are now shown:*

The Journal

	Dr	Cr
	£	£
E George	59	
Sales account		59

ERROR OF COMMISSION

A purchase of goods, £44 from C Simons, was entered in error in C Simpson's account.

C Simpson

20X5			£	20X5			£
Sept	30	C Simons: Error corrected	44	Sept	30	Purchases	44

C Simons

				20X5			£
				Sept	30	Purchases: Entered originally in C Simpson's account	44

The Journal entry will be:

The Journal

	Dr	*Cr*
	£	£
C Simpson	44	
C Simons		44
Purchase Invoice Number . . . entered in wrong personal account, now corrected		

ERROR OF PRINCIPLE

The purchase of a machine, £200, is debited to the purchases account instead of being debited to a machinery account. We therefore cancel the item out of the purchases account by crediting that account. It is then entered where it should be by debiting the machinery account.

The Journal

	Dr	*Cr*
	£	£
Machinery account	200	
Purchases account		200

Correction of error: purchase of fixed asset debited to purchases account

Compensating Error

The sales account is overcast by £200, as also is the wages account. The trial balance therefore still balances. This assumes that these are the only two errors found in the books.

The Journal

	Dr	*Cr*
	£	£
Sales account	200	
Wages account		200

Correction of overcasts of £200 each in the sales account and the wages account which compensated for each other

Error of original entry

A sale of £38 to A Smailes was entered in the books as £28. It needs another £10 of sales entering now.

The Journal

	Dr	Cr
	£	£
A Smailes	10	
Sales account		10
Correction of error whereby sales were understated by £10		

COMPLETE REVERSAL OF ENTRIES

A payment of cash of £16 to M Dickson was entered on the receipts side of the Cash Book in error and credited to M Dickson’s account. This is somewhat more difficult to adjust. First must come the amount needed to cancel the error, then comes the actual entry itself. Because of this, the correcting entry is double the actual amount first recorded.

Cash

	£		£
		M Dickson	16

M Dickson

	£		£
Cash	16		

was entered wrongly as:

Cash

	£		£
M Dickson	16		

M Dickson

	£		£
		Cash	16

Cash

	£		£
M Dickson	16	M Dickson (error corrected)	32

M Dickson

	£		£
Cash (error corrected)	32	M Dickson	16

The Journal entry appears:

The Journal

	Dr	Cr
	£	£
M Dickson	32	
Cash		32

Payment of cash £16 debited to cash and credited to
M Dickson in error on . . . Error now corrected

TRANSPOSITION ERROR

A credit purchase from P Maclaran costing £56 was entered in the books as £65. The £9 error needs to be removed.

The Journal

	Dr	*Cr*
	£	£
P Maclaran	9	
Purchases account		9

Correction of error whereby purchases were overstated by £9

ERRORS AFFECTING THE TRIAL BALANCE

- Incorrect additions in any account.
- Making an entry on only one side of the accounts, e.g. a debit but no credit; a credit but no debit.
- Entering a different amount on the debit side from the amount on the credit side.

- We should try very hard to find errors when the trial balance totals are not equal. When they cannot be found, the trial balance totals can be made to agree with each other by inserting the amount of the difference between the two sides in a **suspense account.**

- A suspense account is an account in the general journal that temporarily carries any transactions for which there are doubts about the account in which they should be recorded.

Exhibit 33.1

Trial Balance as at 31 December 20X5

	Dr	*Cr*
	£	£
Totals after all the accounts have been listed	100,000	99,960
Suspense		40
	100,000	100,000

To make the two totals the same, a figure of GH¢40 for the suspense account has been shown on the credit side of the trial balance. A suspense account is opened and the GH¢40 difference is also shown there on the credit side:

Suspense

			20X5			£
			Dec	31	Difference per trial balance	40

Suspense account and the balance sheet

- If the errors are not found before the financial statements are prepared, the suspense account balance will be included in the balance sheet.

- Where the balance is a credit balance, it should be included on the capital and liabilities side of the balance sheet.

- When the balance is a debit balance it should be shown on the assets side of the balance sheet.

Corrections of errors affecting the trial balance

- When the errors are found they must be corrected, using double entry. Each correction must first have an entry in the journal describing it, and then be posted to the accounts concerned.

Example 1

- Assume that the error of £40 as shown in Exhibit 33.1 is found in the following year on 31 March 20X6. The error was that the sales account was under cast by £40. The action taken to correct this is:
- Debit suspense account to close it: £40.
- Credit sales account to show item where it should have been: £40.

EXAMPLE

- The trial balance on 31 December 20X6 had a difference of £168. It was a shortage on the debit side.
- A suspense account is opened, and the difference of £168 is entered on the debit side. On 31 May 20X7 the error was found.
- We had made a payment of £168 to K Leek to close his account. It was correctly entered in the Cash Book, but was not entered in K Leek’s account.

Exhibit 33.3

K Leek

20X7				£	20X7				£
May	31	Bank	**(A)**	168	Jan	1	Balance b/d		168

The account of K Leek is now correct.

Suspense

20X7				£	20X7				£
Jan	1	Difference per trial balance		168	May	31	K Leek	**(B)**	168

The Journal entry is:

The Journal

			Dr	*Cr*
20X7			£	£
May	31	K Leek	168	
		Suspense		168
		Correction of non-entry of payment last year in K Leek's account		

More than one error

- The trial balance at 31 December 20X7 showed a difference of £77, being a shortage on the debit side. A suspense account is opened, and the difference of £77 is entered on the debit side of the account.

- On 28 February 20X8 all the errors from the previous year were found.

- (A) A cheque of £150 paid to L Kent had been correctly entered in the Cash Book, but had not been entered in Kent's account.
- (B) The purchases account had been under cast by £20.
- (C) A cheque of £93 received from K Sand had been correctly entered in the Cash Book, but had not been entered in Sand's account.
- These three errors resulted in a net error of £77, shown by a debit of £77 on the debit side of the suspense account.

Exhibit 33.4

L Kent

20X8				£						
Feb	28	Suspense	(A)	150						

Purchases

20X8				£						
Feb	28	Suspense	(B)	20						

K Sand

					20X8				£	
					Feb	28	Suspense	(C)	93	

Suspense

20X8				£	20X8				£
Jan	1	Balance b/d		77	Feb	28	L Kent	(A)	150
Feb	28	K Sand	(C)	93	Feb	28	Purchases	(B)	20
				170					170

The Journal

			Dr	*Cr*
20X8			£	£
Feb	28	L Kent	150	
		Suspense		150
		Cheque paid omitted from Kent's account		
Feb	28	Purchases	20	
		Suspense		20
		Undercasting of purchases by £20 in last year's accounts		
Feb	28	Suspense	93	
		K Sand		93
		Cheque received omitted from Sand's account		

ERRORS AND THE FINANCIAL STATEMENTS

Some of the errors will have meant that original profits calculated will be wrong. Other errors will have no effect upon profits. We will use Exhibit 33.5 to illustrate the different kinds of errors. Exhibit 33.5 shows a set of financial statements in which errors have been made.

Exhibit 33.5

K Davis
Trading and Profit and Loss Account for the year ending 31 December 20X5

		£	£
Sales			180,000
Less	Cost of goods sold:		
	Opening stock	15,000	
	Add Purchases	92,000	
		107,000	
	Less Closing stock	(18,000)	
			(89,000)
Gross profit			91,000
Add Discounts received			1,400
			92,400
Less	Expenses:		
	Rent	8,400	
	Insurance	1,850	
	Lighting	1,920	
	Depreciation	28,200	
			(40,370)
Net profit			52,030

Balance Sheet as at 31 December 20X5

	£	£
Fixed assets		
Equipment at cost		62,000
Less Depreciation to date		(41,500)
		20,500
Current assets		
Stock	18,000	
Debtors	23,000	
Bank	19,000	
	60,000	
Less Current liabilities		
Creditors	(14,000)	
		46,000
Suspense account		80
		66,580
Capital		
Balance as at 1.1.20X5		46,250
Add Net profit		52,030
		98,280
Less Drawings		(31,700)
		66,580

Errors which do not affect profit calculations

- If an error affects items only in the balance sheet, then the original calculated profit will not need altering. Example 1 shows this.
- Assume that in Exhibit 33.5 the £80 debit balance on the suspense account was because of the following error:

- On 1 November 20X5 we paid £80 to a creditor T Monk. It was correctly entered in the Cash Book. It was not entered anywhere else. The error was found on 1 June 20X6.

The journal entries to correct it will be:

The Journal

			Dr	*Cr*
20X6			£	£
June	1	T Monk	80	
		Suspense		80
		Payment to T Monk on 1 November 20X5 not entered in his account. Correction now made.		

Both of these accounts appeared in the balance sheet only with T Monk as part of creditors. The net profit of £52,030 does not have to be changed.

Errors which affect profit calculations

- If the error is in one of the figures shown in the trading and profit and loss account, then the original profit will need altering. Example 2 shows this.

- Assume that in Exhibit 33.5 the £80 debit balance was because the rent account was added up incorrectly. It should be shown as £8,480 instead of £8,400. The error was found on 1 June 20X6.

The Journal

			Dr	Cr
20X6			£	£
Jun	1	Rent	80	
		Suspense		80
		Correction of rent undercast last year		

Rent last year should have been increased by £80. This would have reduced net profit by £80. A statement of corrected profit for the year is now shown.

K Davis
Statement of Corrected Net Profit for the year ended 31 December 20X5

	£
Net profit per the financial statements	52,030
Less Rent understated	(80)
Corrected net profit for the year	51,950

Where there have been several errors

- If in Exhibit 33.5 there had been four errors in the ledger accounts of K Davis, found on 31 March 20X6, their correction can now be seen. Assume that the net difference had also been £80.
- (A) Sales overcast by £90
- (B) Insurance under cast by £40
- (C) Cash received from a debtor entered in the Cash Book only £50
- (D) A purchase of £59 is entered in the books, debit and credit entries as £95

The entries in the suspense account and the journal entries will be as follows:

Suspense Account

20X6				£	20X6				£
Jan	1	Balance b/d		80	Mar	31	Sales	(A)	90
Mar	31	Debtor	(C)	50	"	31	Insurance	(B)	40
				130					130

The Journal

20X6				Dr £	Cr £
1	Mar	31	Sales	90	
			Suspense		90
			Sales overcast of £90 in 20X5		
2	Mar	31	Insurance	40	
			Suspense		40
			Insurance expense undercast by £40 in 20X5		
3	Mar	31	Suspense	50	
			Debtor's account		50
			Cash received omitted from debtor's account in 20X5		
4	Mar	31	Creditor's account	36	
			Purchases		36
			Credit purchase of £59 entered both as debit and credit as £95 in 20X5		

Note: In (D), the correction of the overstatement of purchases does *not* pass through the suspense account.

Now we can calculate the corrected net profit for the year 20X5. Only items (A), (B) and (D) affect figures in the trading and profit and loss account. These are the only adjustments to be made to profit.

K Davis
Statement of Corrected Net Profit for the year ended 31 December 20X5

			£
Net profit per the financial statements			52,030
Add Purchases overstated	(D)		36
			52,066
Less Sales overcast	(A)	90	
Insurance undercast	(B)	40	
			(130)
Corrected net profit for the year			51,936

Error (C), the cash not posted to a debtor's account, did not affect profit calculations.

- Thank you

BANK RECONCILIATION STATEMENT

Completing entries in the cash book

In the books of a business, funds paid into and out of the bank are entered into the bank columns of the Cash Book. At the same time, the bank will also be recording the flows of funds into and out of the business bank account.

If all the items entered in the Cash Book were the same as those entered in the records held by the bank, the balance on the business bank account as shown in the Cash Book and the balance on the account as shown by the bank's records would be the same.

Unfortunately, it isn't usually that simple, particularly in the case of a current account. There may be items paid into or out of the business bank account which have not been recorded in the Cash Book.

And there may be items entered in the Cash Book that have not yet been entered in the bank's records of the account. To see if any of these things have happened, the Cash Book entries need to be compared to the record of the account held by the bank.

Banks usually send a copy of that record, called a bank statement, to their customers on a regular basis, but a bank statement can be requested by a customer of the bank at any time.

Bank statements should always be checked against the Cash Book entries!

Exhibit 30.1

Cash Book (bank columns only: *before* balancing on 31.12.20X8)

20X8				£	20X8				£
Dec	1	Balance b/d	✔	250	Dec	5	J Gordon	✔	65
"	20	P Thomas	✔	100	"	27	K Hughes	✔	175
"	28	D Jones	✔	190					

Bank Statement

				Withdrawals	*Deposits*	*Balance*
20X8				£	£	£
Dec	1	Balance b/d	✔			250
"	8	10625 (Note 1)	✔	65		185
"	21	Deposit	✔		100	285
"	28	Deposit	✔		190	475
"	29	10626 (Note 1)	✔	175		300
"	30	Bank Giro credit: P Smith			70	370
"	31	Bank charges		50		320

Note 1: 10625 and 10626 refer to the serial numbers on the cheques paid out.

It is now possible to see that the two items not shown in our Cash Book are:

Bank Giro credit: P Smith £70

Bank charges £50

P Smith had paid £70 but, instead of sending a cheque, he paid the money by bank giro credit transfer direct into the business bank account. The business did not know of this until it received the bank statement.

The other item was in respect of bank charges. The bank has charged £50 for keeping the bank account and all the work connected with it. Instead of sending an invoice, the bank has simply taken the money out of the bank account.

As we have now identified the items missing from the Cash Book, we can now complete writing it up by entering the two items we have identified:

Cash Book (bank columns only: after balancing on 31.12.20X8)

20X8			£	20X8			£
Dec	1	Balance b/d	250	Dec	5	J Gordon	65
"	20	P Thomas	100	"	27	K Hughes	175
"	28	D Jones	190	"	31	Bank charges	50
"	30	P Smith	70	"	31	Balance c/d	320
			610				610
20X9							
Jan	1	Balance b/d	320				

Where closing balances differ

Although a cash book may be kept up to date by a business, it obviously cannot alter the bank’s own records.

Even after writing up entries in the Cash Book, there may still be a difference between the Cash Book balance and the balance on the bank statement. Exhibit 30.2 shows such a case.

Exhibit 30.2

Cash Book (after being completed to date)

20X9			£	20X9			£
Jan	1	Balance b/d	320	Jan	10	C Morgan	110
"	16	R Lomas	160	"	20	M McCarthy	90
"	24	V Verity	140	"	28	Cheshire CC rates	180
"	31	J Soames	470	"	30	M Peck	200
"	31	R Johnson	90	"	31	Balance c/d	600
			1,180				1,180
Feb	1	Balance b/d	600				

Bank Statement

20X9			*Withdrawals* £	*Deposits* £	*Balance* £
Jan	1	Balance b/d			320
"	12	10627	110		210
"	16	Deposit		160	370
"	23	10628	90		280
"	24	Deposit		140	420
"	28	Direct debit: Cheshire CC	180		240
"	31	Bank Giro credit: R Johnson		90	330

You can see that two items are in the Cash Book but are not shown on the bank statement.

These are:

(i) A cheque had been paid to M Peck on January 30. He deposited it in his bank on January 31 but his bank didn’t collect the money from the business’s bank until February 2. This is known as an unpresented cheque.

(ii) Although a cheque for £470 was received from J Soames on January 31 and the business deposited it with the bank on that date, the bank did not receive the funds from Soames’ bank until February. This is known as a ‘bank lodgement not yet credited’ to the business bank account.

The cash book balance on January 31 was £600, whereas the bank statement shows a balance of £330. To prove that although the balances are different they can be 'reconciled' (i.e. made to agree) with each other, a bank reconciliation statement is prepared.

It will either start with the bank statement balance and then reconcile it to the Cash Book balance, or it will start with the Cash Book balance and then reconcile it to the bank statement balance. If the second approach is adopted, it would appear as:

Bank Reconciliation Statement as at 31 December 20X8

	£
Balance as per cash book	600
Add Unpresented cheque (i)	200
	800
Less Bank lodgement not on statement (ii)	(470)
Balance per bank statement	330

If the two balances cannot be reconciled then there will be an error somewhere. This will have to be located and then corrected.

This reconciliation technique is also used when dealing with other statements drawn up outside the firm: for example, when reconciling purchase ledger accounts to suppliers' statements.

An alternative approach to bank reconciliations

In order to avoid the confusion that may arise concerning what figure to include in the balance sheet, many accountants use a slightly different form of bank reconciliation. In this approach, you take the balance as shown on the bank statement and the balance in the Cash Book before making any adjustments that are identified when it is compared to the bank statement. You then reconcile each of them in turn to arrive at the balance that should appear in the balance sheet.

Having completed the reconciliation, you then update the Cash Book so that it balances at the correct amount, i.e. the amount that will be shown in the balance sheet. An example is shown in Exhibit 30.3.

Exhibit 30.3

Exhibit 30.3

Cash Book (bank columns only: *before* balancing on 31.12.20X8)

20X8				£	20X8				£
Dec	1	Balance b/d	✔	160	Dec	8	V O'Connor	✔	115
"	12	D Tyrrall	✔	80	"	21	G Francis	✔	35
"	23	P McCarthy	✔	130	"	31	D Barnes		25
"	31	S Aisbitt		72					

Bank Statement

20X8				*Withdrawals* £	*Deposits* £	*Balance* £
Dec	1	Balance b/d	✔			160
"	11	24621	✔	115		45
"	14	Deposit	✔		80	125
"	23	24622	✔	35		90
"	29	Deposit	✔		130	220
"	30	Bank Giro credit: A Parkinson			24	244
"	31	Bank charges		40		204

You can see that the following are missing from the Cash Book:

(a) A bank giro credit of £24 made on December 30 by A Parkinson.

(b) Bank charges of £40.

And you can see that the following are missing from the bank statement:

(c) A cheque paid to D Barnes for £25 on December 31 has not yet been presented.

(d) A bank lodgement has not yet been credited – the cheque for £72 received from S Aisbitt on 31 December.

The bank reconciliation statement would be:

Bank Reconciliation Statement as at 31 December 20X8

		£
Balance as per cash book		267
Add Bank giro credit not yet entered	(a)	24
		291
Less Bank lodgement not on balance sheet	(b)	(40)
Balance in balance sheet		251
Add Cheque not yet presented	(c)	25
		276
Less Bank lodgement not on statement	(d)	(72)
Balance per bank statement		204

When you have adjustments to make to both the Cash Book and the bank account balances in order to reconcile them, this form of bank reconciliation statement is more useful than one that simply shows that you know why their balances are different (which is all the bank reconciliation statement in Section 30.2 shows).

An alternative approach that is often used in practice is to start with the balance as per the Cash Book and adjust it to arrive at the balance per the balance sheet (i.e. the same as in the first half of the bank reconciliation statement shown above).

You then have a second section that starts with the balance as per the bank statement and adjust it to once again to arrive at the balance per the balance sheet. Either of these two approaches is perfectly acceptable and both provide the same information.

Other terms used in banking

1 **Standing Orders.** A firm can instruct its bank to pay regular amounts of money at stated dates to persons or firms. For instance, you may ask your bank to pay £200 a month to a building society to repay a mortgage.

2 **Direct Debits.** These are payments which have to be made, such as gas bills, electricity bills, telephone bills, rates, and insurance premiums. Instead of asking the bank to pay the money, as with standing orders, you give permission to the creditor to obtain the money directly from your bank account. This is particularly useful if the amounts payable may vary from time to time, as it is the creditor who changes the payments, not you. With standing orders, if the amount is ever to be changed, you have to inform the bank. With direct debits it is the creditor who informs the bank. Just as with anything else omitted from the Cash Book, items of these types need to be included in the reconciliation and entered in the Cash Book before balancing it off at the end of the period.

Bank overdrafts

The adjustment needed to reconcile a bank overdraft according to the firm’s books (shown by a credit balance in the Cash Book) with that shown in the bank’s records are the same as those needed when the account is not overdrawn.

Exhibit 30.4

Cash Book

20X8				£	20X8				£
Dec	5	I Howe		308	Dec	1	Balance b/d		709
"	24	L Mason		120	"	9	P Davies		140
"	29	K King		124	"	27	J Kelly	(B)	63
"	31	G Cumberbatch	(A)	106	"	29	United Trust		77
"	31	Balance c/d		380	"	31	Bank charges		49
				1,038					1,038

Bank Statement

			Dr	*Cr*	*Balance*
20X8			£	£	£
Dec	1	Balance b/d			709 O/D
"	5	Cheque		308	401 O/D
"	14	P Davies	140		541 O/D
"	24	Cheque		120	421 O/D
"	29	K King: Credit transfer		124	297 O/D
"	29	United Trust: Standing order	77		374 O/D
"	31	Bank charges	49		423 O/D

Bank Reconciliation Statement as at 31 December 20X8

	£
Overdraft as per cash book	(380)
Add Unpresented cheque	63
	(317)
Less Bank lodgement not on bank statement	(106)
Overdraft per bank statement	(423)

Note: You may find it confusing looking at this bank reconciliation statement because the opening entry is an overdraft, i.e. a negative number. Don't be, the adjusting entries are the same as those you make when it is positive:

- Exhibit 30.4 is of a Cash Book and a bank statement both showing an overdraft. Only the cheque for G Cumberbatch (A) £106 and the cheque paid to J Kelly (B) £63 need adjusting. Work through the reconciliation statement and then see the note after it.
- Because the balance shown by the Cash Book is correct (and, therefore, the balance that will appear in the balance sheet), you can use the form of bank reconciliation statement shown in Section 30.2.

	£
Balance/overdraft per cash book	xxxx
<u>Adjustments</u>	
Unpresented cheque	Plus
Bank lodgement not on bank statement	<u>Less</u>
Balance/overdraft per bank statement	<u>xxxx</u>

Dishonoured cheques

When a cheque is received from a customer and paid into the bank, it is recorded on the debit side of the Cash Book. It is also shown on the bank statement as a deposit increasing the balance on the account.

However, at a later date it may be found that the customer's bank will not pay the amount due on the cheque. The customer's bank has failed to 'honour' the cheque. The cheque is described as a dishonoured cheque.

There are several possible reasons for this. Imagine that K King paid a business with a cheque for £5,000 on 20 May 20X9. The business deposits it at the bank but, a few days later, the bank contacts the business and informs it that the cheque has been dishonoured. Typical reasons are:

1. King had put £5,000 in figures on the cheque, but had written it in words as ‘five thousand five hundred pounds’. A new cheque correctly completed will need to be provided by King.

2. Normally cheques are considered stale six months after the date on the cheque. In other words, banks will not honour cheques over six months old. If King had put the year 20X8 on the cheque instead of 20X9, then King’s bank would dishonour the cheque and King would need to be asked for a correctly dated replacement.

3. King simply did not have sufficient funds in her bank account. Suppose she had previously a balance of only £2,000 and yet she has made out a cheque for £5,000. Her bank has not allowed her an overdraft in order to honour the cheque. As a result, the cheque has been dishonoured. The bank inform the business that this has happened and the business would have to contact King, explain what has happened and ask for valid payment of the account.

In all of these cases, the bank would record the original entry in its records as being reversed. This is shown on the bank statement, for example, by the entry ‘dishonoured cheque £5,000’. The business then makes the equivalent credit entry in the Cash Book while, at the same time, debiting King’s account by the same amount.

When King originally paid the £5,000 the accounts in the ledger and Cash Book would have appeared as:

K King

20X9	£	20X9	£
May 1 Balance b/d	5,000	May 20 Bank	5,000

Bank Account

20X9	£		
May 20 K King	5,000		

After recording the dishonoured cheque, the accounts would be:

K King

20X9	£	20X9	£
May 1 Balance b/d	5,000	May 20 Bank	5,000
May 25 Bank: cheque dishonoured	5,000		

Bank Account

20X9	£	20X9	£
May 20 K King	5,000	May 25 K King: cheque dishonoured	5,000

In other words, King is once again shown as owing the business £5,000.

- You have been preparing the accounts for another client, John Mensah. John has commented that the bank balance in his accounts is always different from the balance as per bank statement.
- In your working papers for John, you noted that:
  - The reconciled bank balance at his last statement of financial position date was GHS2,573.
  - The total value of cheque recorded for the accounting period in the cheque journal was GHS147,684.
  - The total value of lodgments recorded for the accounting period in the cash book was GHS146,925.
  - A cheque has been incorrectly recorded in the cheque journal with a value of GHS1,765. The correct value of GHS1,675 had been debited on the bank statement.
  - Standing orders totaling GHS3,600 had been debited by the bank, but had not been recorded in the cheque journal.
  - During the year, John had a short term surplus of cash and GHS40,000 was transferred to a deposit account for a period of six weeks. When the deposit had matured, the original amount of GHS40,000 together with the interest earned (GHS312) was credited by the bank to the current account. None of these transactions had been recorded in Johns books.
  - Bank charges of GHS563 had been debited by the bank, but had not been recorded in John's books
  - A lodgment of GHS12,386 had been entered in the cash book on the last day of the accounting period. This had not been credited on the bank statement until the second working day of the next month.

- The following cheques were issued during the accounting period but were not debited on the bank statement until after the end of the accounting period:
- Cheque Number GHS
- 789256 1,425
- 789233 824
- 789241 681
- 789245 2,643
- The closing balance on the bank statement was GHS8,760 overdrawn.

Activities

1. What might cause the two balances to be different?

2. With the current increase in electronic banking where customers have access to all their bank account transactions, is the preparation of the bank reconciliation still necessary?

Manufacturing accounts

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Learning objectives

After you have studied this chapter, you should be able to:

- Calculate prime cost and production cost of goods manufactured
- Draw up a manufacturing account and income statement
- Adjust the manufacturing account in respect of work-in-progress

Manufacturing accounts

- Manufacturing businesses prepare a manufacturing account, in addition to the income statement, that is for internal use only.
- Instead of a figure for purchases, the trading account will contain the cost of manufacturing the goods that were manufactured during the period.
- The manufacturing account is used to calculate and show the cost of manufacturing those goods – the production cost.

Divisions of costs

In a manufacturing business, costs are divided into two types:

Exhibit 37.1

Direct materials			
Direct labour	**Prime cost**		
Direct expenses		**Production cost**	
Plus			
Indirect manufacturing costs			**Total cost**
Plus			
Administration expenses			
Selling and distribution expenses			
Financial charges			

It is the prime and production cost items that feature in the manufacturing account.

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Direct and indirect costs

- Any direct costs can be traced to an item being manufactured.
- The sum of the direct costs is the prime cost.
- If a cost cannot be directly traced to the manufactured product, it is considered an indirect cost.
- Indirect costs are considered factory overheads
- The prime cost plus indirect costs is the production cost.

Other costs

There are other cost classifications in manufacturing accounts.

- Administration expenses are any managerial or office related expenses.
- Selling and distribution expenses are any sales, marketing or advertising expenses.
- Financial charges are any bank related charges and the cost of discounts allowed.

The format of the financial statements

- The manufacturing account contains all direct and indirect costs.
- The trading account follows the usual format with the inclusion of the production cost of goods completed.
- The profit and loss account contains all administration expenses, selling and distribution expenses and financial charges.

The financial statements

Exhibit 37.2

Manufacturing Account

	£
Production costs for the period:	
Direct materials	xxx
Direct labour	xxx
Direct expenses	xxx
Prime cost	xxx
Indirect manufacturing costs	xxx
Production cost of goods completed c/d to trading account	xxx

Trading Account

		£	£
Sales			xxx
Less Production cost of goods sold:			
Opening inventory of finished goods	**(A)**	xxx	
Add Production costs of goods completed b/d		xxx	
		xxx	
Less Closing inventory of finished goods	**(B)**	(xxx)	
			(xxx)
Gross profit			xxx

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Example of a manufacturing account

Exhibit 37.3

Details of production costs for the year ended 31 December 2010:

	£
1 January 2010, inventory of raw materials	5,000
31 December 2010, inventory of raw materials	7,000
Raw materials purchased	80,000
Manufacturing (direct) wages	210,000
Royalties	1,500
Indirect wages	90,000
Rent of factory – excluding administration and selling and distribution blocks	4,400
Depreciation of plant and machinery in factory	4,000
General indirect expenses	3,100

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Example of a manufacturing account (Continued)

Manufacturing Account for the year ending 31 December 2010

	£	£
Inventory of raw materials 1.1.2010		5,000
Add Purchases		80,000
		85,000
Less Inventory of raw materials 31.12.2010		(7,000)
Cost of raw materials consumed		78,000
Manufacturing wages		210,000
Royalties		1,500
Prime cost		289,500
Indirect manufacturing costs		
Rent	4,400	
Indirect wages	90,000	
General expenses	3,100	
Depreciation of plant and machinery	4,000	
		101,500
Production cost of goods completed c/d		391,000

Sometimes, if a business has produced less than the customers have demanded, it may buy in some finished goods. In this case, the trading account will have both a figure for purchases of finished goods and a figure for production cost of goods completed.

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Work-in-progress

- The production cost carried down to the trading account is that of the production cost of goods completed during the period.
- If any items have not been completed, they cannot be sold and so should not appear in the trading account.
- Therefore a calculation is needed to decide on the transfer to the trading account:

Work-in-progress (Continued)

	£
Total production costs expended during the year	50,000
Production costs last year on goods not completed last year, but completed in this year (work-in-progress)	3,000
Production costs this year on goods which were not completed by the year end (work-in-progress)	4,400

The calculation is:

Total production costs expended this year	50,000
Add Costs from last year, in respect of goods completed in this year (work-in-progress)	3,000
	53,000
Less Costs in this year, for goods to be completed next year (work-in-progress)	(4,400)
Production costs expended on goods completed this year	48,600

Activity

Exhibit 37.4

	£
1 January 2010, Inventory of raw materials	8,000
31 December 2010, Inventory of raw materials	10,500
1 January 2010, Work-in-progress	3,500
31 December 2010, Work-in-progress	4,200
Year to 31 December 2010:	
Wages: Direct	39,600
Indirect	25,500
Purchase of raw materials	87,000
Fuel and power	9,900
Direct expenses	1,400
Lubricants	3,000
Carriage inwards on raw materials	2,000
Rent of factory	7,200
Depreciation of factory plant and machinery	4,200
Internal transport expenses	1,800
Insurance of factory buildings and plant	1,500
General factory expenses	3,300

Activity (Continued)

This information produces the following manufacturing account:

Manufacturing Account for the year ending 31 December 2010

	£	£
Inventory of raw materials 1.1.2010		8,000
Add Purchases		87,000
Carriage inwards		2,000
		97,000
Less Inventory of raw materials 31.12.2010		(10,500)
Cost of raw materials consumed		86,500
Direct wages		39,600
Direct expenses		1,400
Prime cost		127,500
Indirect manufacturing costs:		
Fuel and power	9,900	
Indirect wages	25,500	
Lubricants	3,000	
Rent	7,200	
Depreciation of plant and machinery	4,200	
Internal transport expenses	1,800	
Insurance	1,500	
General factory expenses	3,300	
		56,400
		183,900
Add Work-in-progress 1.1.2010		3,500
		187,400
Less Work-in-progress 31.12.2010		(4,200)
Production cost of goods completed c/d		**183,200**

Activity (Continued)

Trading Account for the year ending 31 December 2010

	£	£
Sales		250,000
Less Cost of goods sold:		
Inventory of finished goods 1.1.2010	3,500	
Add **Production cost of goods completed b/d**	**183,200**	
	186,700	
Less Inventory of finished goods 31.12.2010	(4,400)	
		182,300
Gross profit c/d		67,700

The profit and loss section is then constructed in the normal way.

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Apportionment of expenses

- Sometimes expenses will have to be split between indirect manufacturing costs and one of the profit and loss account expenses such as administration or selling expenses.
- In this situation, a method of apportionment must be used to split the expense.
- An example could be rent, which would be apportioned using floor area.

Learning outcomes

You should have now learnt:

1. Why manufacturing accounts are used
2. How to prepare a manufacturing account and income statement
3. That the trading account section of the income statement is used for calculating the gross profit made by selling the goods manufactured

Learning outcomes (Continued)

4. That the profit and loss account section of the income statement shows as net profit what is left of gross profit after all administration, selling and distribution and finance costs incurred have been deducted
5. That work-in-progress, both at the start and the close of a period, must be adjusted so as to identify the production costs of goods completed in the period

CORRECTION OF ERRORS AND THE SUSPENSE ACCOUNT

- Errors occurring in the preparation of accounts can be discussed and treated from two perspectives:
- Errors affecting the trial balance.
- Errors not affecting the trial balance

ERRORS NOT AFFECTING THE BALANCE SHEET

- Suppose we correctly entered cash sales GH¢70 to the debit of the Cash Book, but did not enter the GH¢70 to the credit of the sales account. If this were the only error in the books, the trial balance totals would differ by GH¢70. However, there are certain kinds of error which would not affect the agreement of the trial balance totals, and we will now consider these:

- **1 Errors of omission** – where a transaction is completely omitted from the books. If we sold GH¢90 goods to J Brewer, but did not enter it in either the sales or Brewer’s personal account, the trial balance would still ‘balance’.

- **2 Errors of commission** – this type of error occurs when the correct amount is entered but in the wrong person’s account, e.g. where a sale of GH¢11 to C Green is entered in the account of K Green. It will be noted that the correct class of account was used, both the accounts concerned being personal accounts.

- **3 Errors of principle** – where an item is entered in the wrong class of account, e.g. if purchase of a fixed asset, such as a van, is debited to an expenses account, such as motor expenses account.

- **4 Compensating errors** – where errors cancel each other out. If the sales account was added up to be GH¢10 too much and the purchases account was also added up to be GH¢10 too much, then these two errors would cancel out in the trial balance. This is because the totals of both the debit side and the credit side of the trial balance will be GH¢10 too much.

- **5 Errors of original entry** – where the original figure is incorrect, yet double entry is still observed using this incorrect figure. An instance of this could be where there were sales of GH¢150 goods but an error is made in calculating the sales invoice. If it were calculated as GH¢130, and GH¢130 were credited as sales and GH¢130 were debited to the personal account of the customer, the trial balance would still balance.

- **6 Complete reversal of entries** – where the correct accounts are used but each item is shown on the wrong side of the account. Suppose we had paid a cheque to D Williams for GH¢200, the double entry of which is Cr Bank GH¢200, Dr D Williams GH¢200. In error it is entered as Cr D Williams GH¢200, Dr Bank GH¢200. The trial balance totals will still agree.

- **7 Transposition errors** – where the wrong sequence of the individual characters within a number was entered. For example, GH¢142 entered instead of GH¢124. This is quite a common error and is very difficult to spot when the error has occurred in both the debit and the credit entries, as the trial balance would still balance. (It is more common for this error to occur on one side of the double entry only.)

CORRECTION OF ERRORS

- We make corrections to double entry accounts by preparing journal entries. We should:

- **1** Show the corrections by means of journal entries, then

- **2** Show the corrections in the double entry set of accounts, by posting these journal entries to the ledger accounts affected.

ERROR OF OMMISSION

The sale of goods, £59 to E George, has been completely omitted from the books. We must correct this by entering the sale in the books. The journal entries for the correction are now shown:*

The Journal

	Dr	Cr
	£	£
E George	59	
Sales account		59

ERROR OF COMMISSION

A purchase of goods, £44 from C Simons, was entered in error in C Simpson’s account.

C Simpson

20X5			£	20X5			£
Sept	30	C Simons: Error corrected	44	Sept	30	Purchases	44

C Simons

				20X5			£
				Sept	30	Purchases: Entered originally in C Simpson’s account	44

The Journal entry will be:

The Journal

	Dr	*Cr*
	£	£
C Simpson	44	
C Simons		44
Purchase Invoice Number . . . entered in wrong personal account, now corrected		

ERROR OF PRINCIPLE

The purchase of a machine, £200, is debited to the purchases account instead of being debited to a machinery account. We therefore cancel the item out of the purchases account by crediting that account. It is then entered where it should be by debiting the machinery account.

The Journal

	Dr	*Cr*
	£	£
Machinery account	200	
Purchases account		200

Correction of error: purchase of fixed asset debited to purchases account

Compensating Error

The sales account is overcast by £200, as also is the wages account. The trial balance therefore still balances. This assumes that these are the only two errors found in the books.

The Journal

	Dr	*Cr*
	£	£
Sales account	200	
Wages account		200

Correction of overcasts of £200 each in the sales account and the wages account which compensated for each other

Error of original entry

A sale of £38 to A Smailes was entered in the books as £28. It needs another £10 of sales entering now.

The Journal

	Dr	Cr
	£	£
A Smailes	10	
Sales account		10
Correction of error whereby sales were understated by £10		

COMPLETE REVERSAL OF ENTRIES

A payment of cash of £16 to M Dickson was entered on the receipts side of the Cash Book in error and credited to M Dickson's account. This is somewhat more difficult to adjust. First must come the amount needed to cancel the error, then comes the actual entry itself. Because of this, the correcting entry is double the actual amount first recorded.

Cash

			£
		M Dickson	16

M Dickson

	£		
Cash	16		

was entered wrongly as:

Cash

	£		
M Dickson	16		

M Dickson

			£
		Cash	16

Cash

	£		£
M Dickson	16	M Dickson (error corrected)	32

M Dickson

	£		£
Cash (error corrected)	32	M Dickson	16

The Journal entry appears:

The Journal

	Dr	*Cr*
	£	£
M Dickson	32	
Cash		32

Payment of cash £16 debited to cash and credited to
M Dickson in error on . . . Error now corrected

TRANSPOSITION ERROR

A credit purchase from P Maclaran costing £56 was entered in the books as £65. The £9 error needs to be removed.

The Journal

	Dr	*Cr*
	£	£
P Maclaran	9	
Purchases account		9

Correction of error whereby purchases were overstated by £9

ERRORS AFFECTING THE TRIAL BALANCE

- Incorrect additions in any account.
- Making an entry on only one side of the accounts, e.g. a debit but no credit; a credit but no debit.
- Entering a different amount on the debit side from the amount on the credit side.

- We should try very hard to find errors when the trial balance totals are not equal. When they cannot be found, the trial balance totals can be made to agree with each other by inserting the amount of the difference between the two sides in a **suspense account.**

- A suspense account is an account in the general journal that temporarily carries any transactions for which there are doubts about the account in which they should be recorded.

Exhibit 33.1

Trial Balance as at 31 December 20X5

	Dr	*Cr*
	£	£
Totals after all the accounts have been listed	100,000	99,960
Suspense		40
	100,000	100,000

To make the two totals the same, a figure of GH¢40 for the suspense account has been shown on the credit side of the trial balance. A suspense account is opened and the GH¢40 difference is also shown there on the credit side:

Suspense

	20X5			£
	Dec	31	Difference per trial balance	40

Suspense account and the balance sheet

- If the errors are not found before the financial statements are prepared, the suspense account balance will be included in the balance sheet.

- Where the balance is a credit balance, it should be included on the capital and liabilities side of the balance sheet.

- When the balance is a debit balance it should be shown on the assets side of the balance sheet.

Corrections of errors affecting the trial balance

- When the errors are found they must be corrected, using double entry. Each correction must first have an entry in the journal describing it, and then be posted to the accounts concerned.

Example 1

- Assume that the error of £40 as shown in Exhibit 33.1 is found in the following year on 31 March 20X6. The error was that the sales account was under cast by £40. The action taken to correct this is:
- Debit suspense account to close it: £40.
- Credit sales account to show item where it should have been: £40.

EXAMPLE

- The trial balance on 31 December 20X6 had a difference of £168. It was a shortage on the debit side.
- A suspense account is opened, and the difference of £168 is entered on the debit side. On 31 May 20X7 the error was found.
- We had made a payment of £168 to K Leek to close his account. It was correctly entered in the Cash Book, but was not entered in K Leek's account.

Exhibit 33.3

K Leek

20X7				£	20X7				£
May	31	Bank	**(A)**	168	Jan	1	Balance b/d		168

The account of K Leek is now correct.

Suspense

20X7				£	20X7				£
Jan	1	Difference per trial balance		168	May	31	K Leek	**(B)**	168

The Journal entry is:

The Journal

			Dr	*Cr*
20X7			£	£
May	31	K Leek	168	
		Suspense		168
		Correction of non-entry of payment last year in K Leek's account		

More than one error

- The trial balance at 31 December 20X7 showed a difference of £77, being a shortage on the debit side. A suspense account is opened, and the difference of £77 is entered on the debit side of the account.

- On 28 February 20X8 all the errors from the previous year were found.

- (A) A cheque of £150 paid to L Kent had been correctly entered in the Cash Book, but had not been entered in Kent's account.
- (B) The purchases account had been under cast by £20.
- (C) A cheque of £93 received from K Sand had been correctly entered in the Cash Book, but had not been entered in Sand's account.
- These three errors resulted in a net error of £77, shown by a debit of £77 on the debit side of the suspense account.

Exhibit 33.4

L Kent

20X8				£					
Feb	28	Suspense	(A)	150					

Purchases

20X8				£					
Feb	28	Suspense	(B)	20					

K Sand

					20X8				£
					Feb	28	Suspense	(C)	93

Suspense

20X8				£	20X8				£
Jan	1	Balance b/d		77	Feb	28	L Kent	(A)	150
Feb	28	K Sand	(C)	93	Feb	28	Purchases	(B)	20
				170					170

The Journal

			Dr	*Cr*
20X8			£	£
Feb	28	L Kent	150	
		Suspense		150
		Cheque paid omitted from Kent's account		
Feb	28	Purchases	20	
		Suspense		20
		Undercasting of purchases by £20 in last year's accounts		
Feb	28	Suspense	93	
		K Sand		93
		Cheque received omitted from Sand's account		

ERRORS AND THE FINANCIAL STATEMENTS

Some of the errors will have meant that original profits calculated will be wrong. Other errors will have no effect upon profits. We will use Exhibit 33.5 to illustrate the different kinds of errors. Exhibit 33.5 shows a set of financial statements in which errors have been made.

Exhibit 33.5

K Davis
Trading and Profit and Loss Account for the year ending 31 December 20X5

		£	£
Sales			180,000
Less	Cost of goods sold:		
	Opening stock	15,000	
	Add Purchases	92,000	
		107,000	
	Less Closing stock	(18,000)	
			(89,000)
Gross profit			91,000
Add Discounts received			1,400
			92,400
Less	Expenses:		
	Rent	8,400	
	Insurance	1,850	
	Lighting	1,920	
	Depreciation	28,200	
			(40,370)
Net profit			52,030

Balance Sheet as at 31 December 20X5

	£	£
Fixed assets		
Equipment at cost		62,000
Less Depreciation to date		(41,500)
		20,500
Current assets		
Stock	18,000	
Debtors	23,000	
Bank	19,000	
	60,000	
Less Current liabilities		
Creditors	(14,000)	
		46,000
Suspense account		80
		66,580
Capital		
Balance as at 1.1.20X5		46,250
Add Net profit		52,030
		98,280
Less Drawings		(31,700)
		66,580

Errors which do not affect profit calculations

- If an error affects items only in the balance sheet, then the original calculated profit will not need altering. Example 1 shows this.
- Assume that in Exhibit 33.5 the £80 debit balance on the suspense account was because of the following error:

- On 1 November 20X5 we paid £80 to a creditor T Monk. It was correctly entered in the Cash Book. It was not entered anywhere else. The error was found on 1 June 20X6.

The journal entries to correct it will be:

The Journal

			Dr	*Cr*
20X6			£	£
June	1	T Monk	80	
		Suspense		80
		Payment to T Monk on 1 November 20X5 not entered in his account. Correction now made.		

Both of these accounts appeared in the balance sheet only with T Monk as part of creditors. The net profit of £52,030 does not have to be changed.

Errors which affect profit calculations

- If the error is in one of the figures shown in the trading and profit and loss account, then the original profit will need altering. Example 2 shows this.

- Assume that in Exhibit 33.5 the £80 debit balance was because the rent account was added up incorrectly. It should be shown as £8,480 instead of £8,400. The error was found on 1 June 20X6.

The Journal

			Dr	*Cr*
20X6			£	£
Jun	1	Rent	80	
		Suspense		80
		Correction of rent undercast last year		

Rent last year should have been increased by £80. This would have reduced net profit by £80. A statement of corrected profit for the year is now shown.

K Davis
Statement of Corrected Net Profit for the year ended 31 December 20X5

	£
Net profit per the financial statements	52,030
Less Rent understated	(80)
Corrected net profit for the year	51,950

Where there have been several errors

- If in Exhibit 33.5 there had been four errors in the ledger accounts of K Davis, found on 31 March 20X6, their correction can now be seen. Assume that the net difference had also been £80.
- (A) Sales overcast by £90
- (B) Insurance under cast by £40
- (C) Cash received from a debtor entered in the Cash Book only £50
- (D) A purchase of £59 is entered in the books, debit and credit entries as £95

The entries in the suspense account and the journal entries will be as follows:

Suspense Account

20X6				£	20X6				£
Jan	1	Balance b/d		80	Mar	31	Sales	(A)	90
Mar	31	Debtor	(C)	50	''	31	Insurance	(B)	40
				130					130

The Journal

				Dr	*Cr*
20X6				£	£
1	Mar	31	Sales	90	
			Suspense		90
			Sales overcast of £90 in 20X5		
2	Mar	31	Insurance	40	
			Suspense		40
			Insurance expense undercast by £40 in 20X5		
3	Mar	31	Suspense	50	
			Debtor's account		50
			Cash received omitted from debtor's account in 20X5		
4	Mar	31	Creditor's account	36	
			Purchases		36
			Credit purchase of £59 entered both as debit and credit as £95 in 20X5		

Note: In (D), the correction of the overstatement of purchases does *not* pass through the suspense account.

Now we can calculate the corrected net profit for the year 20X5. Only items (A), (B) and (D) affect figures in the trading and profit and loss account. These are the only adjustments to be made to profit.

K Davis
Statement of Corrected Net Profit for the year ended 31 December 20X5

			£
Net profit per the financial statements			52,030
Add Purchases overstated	(D)		36
			52,066
Less Sales overcast	(A)	90	
Insurance undercast	(B)	40	
			(130)
Corrected net profit for the year			51,936

Error (C), the cash not posted to a debtor's account, did not affect profit calculations.

- Thank you

Single entry and incomplete records

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Learning objectives

After you have studied this chapter, you should be able to:

- Deduce the figure of profits where only the increase in capital and details of drawings are known
- Draw up an income statement and statement of financial position from records not kept on a double entry system

Learning objectives (Continued)

- Deduce the figure for cash drawings when all other cash receipts and cash payments are known
- Deduce the figures of sales and purchases from incomplete records

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Why double entry is not used

- Many small business owners keep their records by using a single entry system comprising a cash book and a list of debtors and creditors.
- This may be because they simply do not know double entry bookkeeping.
- However, they will have to prepare their financial statements each year.

Profit as an increase in capital

- If you know the capital figure at the start and end of a period, you can work out the profit figure for the year:

Net profit = This year's capital – Last year's capital

- If there are drawings, this would be worked out as:

Last year's capital + profits – drawings = This year's capital

Activity

The following example shows the various stages of drawing up financial statements from a single entry set of records.

The accountant has found the following details of transactions for J. Frank's shop for the year ended 31 December 2011.

(*a*) The sales are mostly on credit. No record of sales has been kept, but £61,500 has been received from persons to whom goods have been sold – £48,000 by cheque and £13,500 in cash.

(*b*) Amount paid by cheque to suppliers during the year = £31,600.

(*c*) Expenses paid during the year: by cheque: Rent £3,800; General Expenses £310; by cash: Rent £400.

(*d*) J. Frank took £250 cash per week (for 52 weeks) as drawings.

(*e*) Other information is available:

	At 31.12.2010	*At 31.12.2011*
	£	£
Accounts receivable	5,500	6,600
Accounts payable for goods	1,600	2,600
Rent owing	–	350
Bank balance	5,650	17,940
Cash balance	320	420
Inventory	6,360	6,800

(*f*) The only non-current asset consists of fixtures which were valued at 31 December 2010 at £3,300. These are to be depreciated at 10 per cent per annum.

We'll now prepare the financial statements in five stages.

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Activity (Continued)

Stage 1

Draw up a Statement of Affairs on the closing day of the earlier accounting period.

Activity (Continued)

J. Frank
Statement of Affairs as at 31 December 2010

	£	£
Non-current assets		
Fixtures		3,300
Current assets		
Inventory	6,360	
Accounts receivable	5,500	
Bank	5,650	
Cash	320	
		17,830
Total assets		21,130
Current liabilities		
Accounts payable		(1,600)
Net assets		19,530
Financed by:		
Capital (difference)		**19,530**

Activity (Continued)

Stage 2

Prepare a cash and bank summary, showing the totals of each separate item, plus opening and closing balances.

Activity (Continued)

	Cash	Bank		Cash	Bank
	£	£		£	£
Balances 31.12.2010	320	5,650	Suppliers		31,600
Receipts from debtors	13,500	48,000	Rent	400	3,800
			General expenses		310
			Drawings	13,000	
			Balances 31.12.2011	420	17,940
	13,820	53,650		13,820	53,650

Activity (Continued)

Stage 3

Calculate the figures for purchases and sales to be shown in the trading account. Remember that the figures needed are the same as those which would have been found if double entry records had been kept.

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Activity (Continued)

Total Accounts Payable

	£		£
Cash paid to suppliers	31,600	Balances b/d	1,600
Balances c/d	2,600	**Purchases (missing figure)**	**32,600**
	34,200		34,200

Activity (Continued)

Total Accounts Receivable

	£		£
Balances b/d	5,500	Receipts: Cash	13,500
Sales (missing figure)	**62,600**	Cheque	48,000
		Balances c/d	6,600
	68,100		68,100

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Activity (Continued)

Stage 4

Where there are no accruals or prepayments either at the beginning or end of the period, then the expenses paid will be the income statement figure. However, where accruals or prepayments exist, an expense account should be drawn up for that particular item.

Activity (Continued)

Rent

	£		£
Bank	3,800	**Profit and loss (missing figure)**	**4,550**
Cash	400		
Accrued c/d	350		
	4,550		4,550

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Activity (Continued)

Stage 5

Now draw up the financial statements.

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Activity (Continued)

J. Frank
Income Statement for the year ending 31 December 2011

	£	£
Sales (stage 3)		**62,600**
Less Cost of goods sold:		
Inventory at 1.1.2011	6,360	
***Add* Purchases (stage 3)**	**32,600**	
	38,960	
Less Inventory at 31.12.2011	(6,800)	
		(32,160)
Gross profit		30,440
Less Expenses:		
Rent (stage 4)	**4,550**	
General expenses	310	
Depreciation: Fixtures	330	
		(5,190)
Net profit		25,250

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Activity (Continued)

Statement of Financial Position as at 31 December 2011

	£	£
Non-current assets		
Fixtures at 1.1.2011		3,300
Less Depreciation		(330)
		2,970
Current assets		
Inventory	6,800	
Accounts receivable	6,600	
Bank	17,940	
Cash	420	
		31,760
Total assets		34,730
Current liabilities		
Accounts payable	2,600	
Rent owing	350	
Total liabilities		(2,950)
Net assets		31,780
Financed by:		
Capital		
Balance 1.1.2011 (per Opening Statement of Affairs)		19,530
Add Net profit		25,250
		44,780
Less Drawings		(13,000)
Total capital		31,780

Dealing with missing figures

- Often there is missing information relating to cash receipts or payments.
- If the missing information is one type of payment, then it is normal to assume that the missing figure is the amount required to make both totals agree in the cash column of the cash book.

Activity

Exhibit 35.2

The following information on cash and bank receipts and payments is available:

	Cash	*Bank*
	£	£
Cash paid into the bank during the year	35,500	
Receipts from debtors	47,250	46,800
Paid to suppliers	1,320	44,930
Drawings during the year	**?**	–
Expenses paid	150	3,900
Balances at 1.1.2010	235	11,200
Balances at 31.12.2010	250	44,670

Now, you need to enter this information in a cash book:

Activity (Continued)

	Cash	Bank		Cash	Bank
	£	£		£	£
Balances 1.1.2010	235	11,200	Bank ¢	35,500	
Received from debtors	47,250	46,800	Suppliers	1,320	44,930
Cash ¢		35,500	Expenses	150	3,900
			Drawings	?	
			Balances 31.12.2010	250	44,670
	47,485	93,500		47,485	93,500

The amount needed to make the two sides of the cash columns agree is £10,265, i.e. £47,485 minus £(35,500 + 1,320 + 150 + 250). This is the figure for drawings.

Activity (Continued)

Exhibit 35.3

Information on cash and bank transactions is available as follows:

	Cash	*Bank*
	£	£
Receipts from debtors	**?**	**78,080**
Cash withdrawn from the bank for business use (this is the amount which is used besides cash receipts from debtors to pay drawings and expenses)		10,920
Paid to suppliers	–	65,800
Expenses paid	640	2,230
Drawings	21,180	315
Balances at 1.1.2010	40	1,560
Balances at 31.12.2010	70	375

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Activity (Continued)

	Cash	Bank		Cash	Bank
	£	£		£	£
Balances 1.1.2010	40	1,560	Suppliers		65,800
Received from debtors	**?**	78,080	Expenses	640	2,230
Withdrawn from Bank ¢	10,920		Withdrawn from Bank ¢		10,920
			Drawings	21,180	315
			Balances 31.12.2010	70	375
	21,890	79,640		21,890	79,640

As it is the only missing item, receipts from debtors is, therefore, the amount needed to make each side of the cash column agree, £10,930, i.e. £21,890 minus £(10,920 + 40).

Learning outcomes

You should have now learnt:

1. The difference between a single entry system and a double entry system.
2. How to calculate net profit for a small trader when you know the changes in capital over a period and the amount of drawings during the period.

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Learning outcomes (Continued)

3. How to prepare an income statement and statement of financial position from records not kept on a double entry system.
4. How to deduce the figures for purchases and sales from a total accounts payable account and a total accounts receivable account.

Receipts and payments accounts and income and expenditure accounts

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the main differences between the financial statements of non-profit-oriented organisations and those of profit-oriented organisations
- Prepare receipts and payments account

Learning objectives (Continued)

- Prepare income and expenditure accounts and statements of financial position for non-profit-oriented organisations
- Calculate profits and losses from special activities and incorporate them into the financial statements
- Make appropriate entries relating to subscriptions, life membership and donations

Non-profit-oriented organisations

- When an accountant talks about non-profit-oriented organisations, they mean charities, clubs and associations.

- These are organisations run for the benefit of their members.

- Rather than producing income statements, they prepare receipts and payments accounts.

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Receipts and payments accounts

- Receipts and payments accounts are a summary of the cash book for the period.
- They can reveal everything that has happened financially during the period.

A receipts and payments account

Exhibit 36.1

Haven Running Club
Receipts and Payments Account for the year ended 31 December 2011

Receipts	£	*Payments*	£
Bank balance at 1.1.2011	2,360	Groundsman's wages	7,280
Subscriptions received in 2011	11,480	Sports ground rental	2,960
Rent received	1,160	Committee expenses	580
		Printing and stationery	330
		Bank balance at 31.12.2011	3,850
	15,000		15,000

Income and expenditure accounts

Where there are assets and/or liabilities within the organisation, the following statements are also required:

- A statement of financial position detailing the assets, liabilities and accumulated fund (capital).
- An income and expenditure account shows either a surplus of income over expenditure (profit), or a deficit of income over expenditure (loss), and may include other trading accounts for activities designed to make a profit.

Terms used

- An income and expenditure account follows the same rules as a trading and profit and loss account.
- The only differences are the terms used

Profit-oriented organisation	Non-profit-oriented organisation
1 Trading and Profit and Loss Account	1 Income and Expenditure Account
2 Net Profit	2 Surplus of Income over Expenditure
3 Net Loss	3 Deficit of Income over Expenditure

Activity

Exhibit 36.2

The treasurer of the Long Lane Football Club has prepared a receipts and payments account, but members have complained about the inadequacy of such an account. She therefore asks an accountant to prepare a trading account for the bar, and an income and expenditure account and a statement of financial position. The treasurer gives the accountant a copy of the receipts and payments account together with information on assets and liabilities at the beginning and end of the year:

Long Lane Football Club
Receipts and Payments Account for the year ended 31 December 2012

Receipts	£	*Payments*	£
Bank balance at 1.1.2012	524	Payment for bar supplies	38,620
Subscriptions received for		Wages:	
2011 (arrears)	1,400	Groundsman and assistant	19,939
2012	14,350	Barman	8,624
2013 (in advance)	1,200	Bar expenses	234
Bar sales	61,280	Repairs to stands	740
Donations received	800	Ground upkeep	1,829
		Secretary's expenses	938
		Transport costs	2,420
		Bank balance at 31.12.2012	6,210
	79,554		79,554

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Additional information:

1	*31.12.20X5*	*31.12.20X6*
	£	£
Stocks in the bar – at cost	4,496	5,558
Owing for bar supplies	3,294	4,340
Bar expenses owing	225	336
Transport costs	–	265

2 The land and football stands were valued at 31 December 20X5 at: land £40,000; football stands £20,000; the stands are to be depreciated by 10 per cent per annum.

3 The equipment at 31 December 20X5 was valued at £2,500, and is to be depreciated at 20 per cent per annum.

4 Subscriptions owing by members amounted to £1,400 on 31 December 20X5, and £1,750 on 31 December 20X6.

Activity (Continued)

Stage 1

Draw up a Statement of Affairs at the end of the previous period in order to identify the balance on the Accumulated Fund brought forward.

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Activity (Continued)

Statement of Affairs as at 31 December 2011

	£	£
Non-current assets		
Land		40,000
Stands		20,000
Equipment		2,500
		62,500
Current assets		
Inventory in bar	4,496	
Accounts receivable for subscriptions	1,400	
Cash at bank	524	
		6,420
Total assets		71,920
Current liabilities		
Accounts payable	3,294	
Bar expenses owing	225	
Total liabilities		(3,519)
Net assets		65,401
Accumulated fund (difference)		**65,401**

Activity (Continued)

Stage 2

Draw up a bar trading account.

Note – you will need to draft T-accounts to calculate the figure for creditors and the figure for bar expenses.

Activity (Continued)

Long Lane Football Club
Bar Trading Account for the year ending 31 December 2012

	£	£
Sales		
Less Cost of goods sold:		61,280
Inventory 1.1.2012	4,496	
Add **Purchases** (Note 1)	**39,666**	
	44,162	
Less Inventory 31.12.2012	(5,558)	
		(38,604)
Gross profit		22,676
Less **Bar expenses** (Note 2)	**345**	
Barman's wages	8,624	
		(8,969)
Net profit to income and expenditure account		13,707

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Activity (Continued)

Notes:

1 **Purchases Control**

	£		£
Cash	38,620	Balances (creditors) b/d	3,294
Balances c/d	4,340	**Trading account (difference)**	**39,666**
	42,960		42,960

2 **Bar Expenses**

	£		£
Cash	234	Balance b/d	225
Balance c/d	336	**Trading account (difference)**	**345**
	570		570

Activity (Continued)

Stage 3

Draw up the financial statements.

Note – you will have to draft T-accounts to calculate the figures for subscriptions received and transport costs.

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Activity (Continued)

Notes:

1 Subscriptions Received

	£		£
Balance (accounts receivable) b/d	1,400	Cash 2011	1,400
Income and expenditure (difference)	16,100	2012	14,350
		2013	1,200
Balance (in advance) c/d	1,200	Balance (accounts receivable) c/d	1,750
	18,700		18,700

2 Transport Costs

	£		£
Cash	2,420	Income and expenditure (difference)	2,685
Accrued c/d	265		
	2,685		2,685

Note that subscriptions received in advance are carried down as a credit balance to the following period.

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Activity (Continued)

Long Lane Football Club
Income and Expenditure Account for the year ending 31 December 2012

Income	£	£	£
Subscriptions for 2012(Note 1)			**16,100**
Profit from the bar			13,707
Donations received			800
			30,607
Less Expenditure			
Wages – Groundsman and assistant		19,939	
Repairs to stands		740	
Ground upkeep		1,829	
Secretary's expenses		938	
Transport costs(Note 2)		**2,685**	
Depreciation			
Stands	2,000		
Equipment	500		
		2,500	
			(28,631)
Surplus of income over expenditure			1,976

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Activity (Continued)

Long Lane Football Club
Statement of Financial Position as at 31 December 2012

	£	£
Non-current assets		
Land at valuation		40,000
Football stands at valuation	20,000	
Less Depreciation	(2,000)	
		18,000
Equipment at valuation	2,500	
Less Depreciation	(500)	
		2,000
Current assets		60,000
Inventory of bar supplies	5,558	
Accounts receivable for subscriptions	1,750	
Cash at bank	6,210	
		13,518
Total assets		73,518
Current liabilities		
Accounts payable for bar supplies	4,340	
Bar expenses owing	336	
Transport costs owing	265	
Subscriptions received in advance	1,200	
Total liabilities		(6,141)
Net assets		67,377
Accumulated fund		
Balance as at 1.1.2012		65,401
Add Surplus of income over expenditure		1,976
		67,377

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Accounting for subscriptions

Exhibit 36.3

An amateur theatrical group charges its members an annual subscription of £20 per member. It accrues for subscriptions owing at the end of each year and also adjusts for subscriptions received in advance.

(A) On 1 January 2013, 18 members had not yet paid their subscriptions for the year 2012.
(B) In December 2012, 4 members paid £80 for the year 2013.
(C) During the year 2013 it received £7,420 in cash for subscriptions:

	£
For 2012	360
For 2013	6,920
For 2014	140
	7,420

Accounting for subscriptions (Continued)

Subscriptions

				£					£
2013					2013				
Jan	1	Owing b/d	**(A)**	360	Jan	1	Prepaid b/d	**(B)**	80
Dec	**31**	**Income and expenditure***		**7,220**	Dec	31	Bank	**(C)**	7,420
	31	Prepaid c/d	**(C)**	140		31	Owing c/d	**(D)**	220
				7,720					7,720
2014					2014				
Jan	1	Owing b/d	**(D)**	220	Jan	1	Prepaid b/d	**(C)**	140

***This is the difference between the two sides of the account.**

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Dealing with subscriptions

- Many subscriptions owing are never paid, so many clubs do not include unpaid subs as an asset in the statement of financial position.
- Many clubs accept a life membership charge which entails a one-off payment. This payment is credited to a life membership account and transferred into the income and expenditure account over a suitable period.
- Donations and entrance fees for new members are shown as income in the year that they are received.

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Learning outcomes

You should have now learnt:

1. That a receipts and payments account does not show the full financial position of an organisation, except for one where the only asset is cash and there are no liabilities
2. That an income and expenditure account is drawn up to show either the surplus of income over expenditure or the excess of expenditure over income. These are the same as ‘profit’ or ‘loss’ in a profit-oriented organisation

Learning outcomes (Continued)

3. That the accumulated fund is basically the same as a capital account
4. That although the main object of the organisation is non-profit-oriented, certain activities may be run at a profit (or lose money) in order to help finance the main objectives of the organisation
5. That in an examination you should treat subscriptions owing at the end of a period in the same way as accounts receivable, unless told otherwise

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Learning outcomes (Continued)

6. That donations are usually treated as income in the period in which they are received
7. That entrance fees are usually treated as income in the year in which they are received
8. That the treatment of life membership fees is purely at the discretion of the organisation, but that they are usually amortised over an appropriate period

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ACF 255 PRINCIPLES OF ACCOUNTING 1

INTRODUCTION TO PARTNERSHIP ACCOUNTING

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KNUST SCHOOL OF BUSINESS

THE NEED FOR PARTNERSHIPS

Two or more people may form themselves into a **partnership**. This is a long-term commitment to operate in business together. The people who own a partnership are called **partners**.

They do not have to be based or work in the same place, though most do. However, they maintain one set of accounting records and share the profits and losses.. By forming a partenership, the level of risk is reduced. Firstly, any loss can be shared by all the partners and, secondly, by involving more than one person's expertise, the chances of failure are reduced.

DEFINITION OF PARTNERSHIPS

According to the INCORPORATED PRIVATE PARTNERSHIPS ACT, 1962 (ACT 152) of Ghana,

(1) Partnership means the association of two or more individuals carrying on business jointly for the purpose of making profits except

(a) a company registered under the Companies Ordinance, (Cap. 193), or any statutory re-enactment thereof, unless it is re-registered hereunder in accordance with section 59 of this Act and the Second Schedule hereto;

(b) a company, body corporate, or unincorporated association formed under any other enactment;

(c) a body corporate formed in accordance with the law of any foreign country whether or not carrying on business in Ghana; or

(d) a joint venture without a firm name for one or more specific operations, shall not be a partnership within the meaning of this Act.

DEFINITION OF PARTNERSHIPS

(2) Family ownership or co-ownership of property shall not of itself create a partnership whether or not the family or co-owners share any profits made by the use of that property.

(3) Subject as aforesaid, the sharing of the net profits of a business shall, prima facie, be evidence of a partnership, but,

(a) the remuneration of a servant or agent of a person engaged in business by a share of profits of the business shall not of itself make the servant or agent a partner; and

(b) a person shall not be deemed to be a partner if it is shown that he did not participate in the carrying on of the business and was not authorised so to do.

LIMITED PARTNERSHIPS

Limited partnerships are partnerships containing one or more **limited partners**.

Limited partnerships must be registered with the Registrar of Companies. Limited partners are not liable for the debts as in Section 41.2 (4) above.
Limited partners have the following characteristics and restrictions on their role in the partnership:

1 Their liability for the debts of the partnership is limited to the capital they have put in. They can lose that capital, but they cannot be asked for any more money to pay the debts unless
they contravene the regulations relating to their involvement in the partnership

LIMITED PARTNERSHIPS

2 They are not allowed to take out or receive back any part of their contribution to the partnership during its lifetime.

3 They are not allowed to take part in the management of the partnership or to have the power to make the partnership take a decision. If they do, they become liable for all the debts and obligations of the partnership up to the amount taken out or received back or incurred while taking part in the management of the partnership.

4 All the partners cannot be limited partners, so there must be at least one general partner with unlimited liability.

PARTNERSHIP AGREEMENTS

Agreements in writing are not necessary. However, it is better if a written agreement is drawn up by a lawyer or an accountant. Where there is a proper written agreement there will be fewer problems between partners. A written agreement means less confusion about what has been agreed.

CONTENTS OF PARTNERSHIP AGREEMENTS

The written agreement can contain as much, or as little, as the partners want. The law does not say what it must contain. The usual accounting contents are:

1 The capital to be contributed by each partner.
2 The ratio in which profits (or losses) are to be shared.
3 The rate of interest, if any, to be paid on capital before the profits are shared.
4 The rate of interest, if any, to be charged on partners' drawings.
5 Salaries to be paid to partners.
6 Arrangements for the admission of new partners.
7 Procedures to be carried out when a partner retires or dies.

CAPITAL CONTRIBUTIONS

Partners need not contribute equal amounts of capital. What matters is how much capital each partner *agrees* to contribute. It is not unusual for partners to increase the amount of capital they have invested in the partnership.

PROFIT (OR LOSS) SHARING RATIOS

Partners can agree to share profits/losses in any ratio or any way that they may wish. However, it is often thought that profits should be shared in the same ratio as that in which capital is contributed. For example, suppose the capitals were Allen £40,000 and Beet £20,000.
Some would assume that the partners would share the profits in the ratio of two-thirds to one-third, even though the work to be done by each partner is similar. The division of the first few years' profits on such a basis might be:

Years	1	2	3	4	5	Total
	£	£	£	£	£	£
Net profits	36,000	48,000	60,000	60,000	72,000	276,000
Shared:						
Allen $^2/_3$	24,000	32,000	40,000	40,000	48,000	184,000
Beet $^1/_3$	12,000	16,000	20,000	20,000	24,000	92,000

Overall, Allen would receive £184,000, i.e. £92,000 more than Beet. As the duties of the partners are the same, in order to treat each partner fairly, the difference between the two shares of profit should be adequate to compensate Allen for putting extra capital into the firm. It should not be excessive. It is obvious that £92,000 extra profits is excessive, as Allen only put in an extra £20,000 as capital. Consider too the position of capital ratio sharing of profits if one partner puts in £99,000 and the other puts in £1,000 as capital. To overcome the difficulty of compensating fairly for the investment of extra capital, the concept of **interest on capital** was devised.

INTEREST ON CAPITAL

If the work to be done by each partner is of equal value but the capital contributed is unequal, it is reasonable to pay interest on the partners' capitals out of partnership profits. This interest is treated as a deduction prior to the calculation of profits and their distribution among the partners
according to the profit sharing ratio.
The rate of interest is a matter of agreement between the partners, but it should equal the return which they would have received if they had invested the capital elsewhere.
Taking Allen and Beet's firm again, but sharing the profits equally after charging 5 per cent per annum interest on capital, the division of profits would become:

Years	1	2	3	4	5		Total
	£	£	£	£	£		£
Net profit	36,000	48,000	60,000	60,000	72,000		276,000
Interest on capitals							
Allen	2,000	2,000	2,000	2,000	2,000	=	10,000
Beet	1,000	1,000	1,000	1,000	1,000	=	5,000
Remainder shared:							
Allen ½	16,500	22,500	28,500	28,500	34,500	=	130,500
Beet ½	16,500	22,500	28,500	28,500	34,500	=	130,500

Summary	*Allen*	*Beet*
	£	£
Interest on capital	10,000	5,000
Balance of profits	130,500	130,500
	140,500	135,500

Allen has thus received £5,000 more than Beet, this being adequate return (in the partners' estimation) for having invested an extra £20,000 in the firm for five years.

INTEREST ON DRAWINGS

It is obviously in the best interests of the firm if cash is withdrawn from the firm by the partners in accordance with the two basic principles of:
(*a*) as little as possible, and
(*b*) as late as possible.

The more cash that is left in the firm the more expansion can be financed, the greater the economies of having ample cash to take advantage of bargains and of not missing cash discounts because cash is not available and so on.
To deter the partners from taking out cash unnecessarily the concept can be used of charging the partners interest on each withdrawal, calculated from the date of withdrawal to the end of the financial year. The amount charged to them helps to swell the profits divisible between the partners. The rate of interest should be sufficient to achieve this without being too harsh.

Suppose that Allen and Beet have decided to charge **interest on drawings** at 5 per cent per annum, and that their year end was 31 December. The following drawings are made:

Allen

Drawings	£	*Interest*		£
1 January	2,000	£2,000 × 5% × 12 months	=	100
1 March	4,800	£4,800 × 5% × 10 months	=	200
1 May	2,400	£2,400 × 5% × 8 months	=	80
1 July	4,800	£4,800 × 5% × 6 months	=	120
1 October	1,600	£1,600 × 5% × 3 months	=	20
		Interest charged to Allen	=	520

Beet

Drawings	£	*Interest*		£
1 January	1,200	£1,200 × 5% × 12 months	=	60
1 August	9,600	£9,600 × 5% × 5 months	=	200
1 December	4,800	£4,800 × 5% × 1 month	=	20
		Interest charged to Beet	=	280

Partnership salaries

One partner may have more responsibility or tasks than the others. As a reward for this, rather than change the profit and loss sharing ratio, the partner may have a **partnership salary** which is deducted before sharing the balance of profits.

Performance-related payments to partners

Partners may agree that commission or performance-related bonuses be payable to some or all the partners linked to their individual performance. As with salaries, these would be deducted before sharing the balance of profits.

An example of the distribution of profits

Taylor and Clarke have been in partnership for one year sharing profits and losses in the ratio of Taylor 3/5, Clarke 2/5. They are entitled to 5 per cent per annum interest on capitals, Taylor having £20,000 capital and Clarke £60,000. Clarke is to have a salary of £15,000. They charge interest on drawings, Taylor being charged £500 and Clarke £1,000. The net profit, before any distributions to the partners, amounted to £50,000 for the year ended 31 December 20X7.

	£	£	£
Net profit			50,000
Add Charged for interest on drawings:			
Taylor		500	
Clarke		1,000	
			1,500
			51,500
Less Salary: Clarke		15,000	
Interest on capital:			
Taylor	1,000		
Clarke	3,000		
		4,000	
			(19,000)
Balance of profits			32,500
Shared:			
Taylor 3/5		19,500	
Clarke 2/5		13,000	
			32,500

The £50,000 net profits have therefore been shared:

	Taylor £	Clarke £
Balance of profits	19,500	13,000
Interest on capital	1,000	3,000
Salary	–	15,000
	20,500	31,000
Less Interest on drawings	(500)	(1,000)
	20,000	30,000
	£50,000	

THE FINANCIAL STATEMENTS

If the sales, stock and expenses of a partnership were exactly the same as that of a sole trader, then the trading and profit and loss account would be identical with that as prepared for the sole trader. However, a partnership would have an extra section shown under the profit and loss account. This section is called the profit and loss appropriation account, and it is in this account that the distribution of profits is shown. The heading to the trading and profit and loss account
for a partnership does not normally include the words ‘appropriation account’. It is purely an accounting custom not to include it in the heading.

The profit and loss appropriation account of Taylor and Clarke from the details given would be

Taylor and Clarke
Trading and Profit and Loss Account for the year ending 31 December 20X7

(Trading Account – same as for sole trader)

(Profit and Loss Account – same as for sole trader)

Profit and Loss Appropriation Account

	£	£	£
Net profit (from the Profit and Loss Account)			50,000
Interest on drawings:			
Taylor		500	
Clarke		1,000	
			1,500
			51,500
Less: Salary: Clarke		4,000	
Interest on capitals			
Taylor	1,000		
Clarke	3,000		
		15,000	(19,000)
			32,500
Balance of profits shared:			
Taylor $^3/_5$		19,500	
Clarke $^2/_5$		13,000	
			32,500

FIXED AND FLUCTUATING CAPITAL ACCOUNTS

The capital account for each partner remains year by year at the figure of capital put into the firm by the partners. The profits, interest on capital and the salaries to which the partner may be entitled are then credited to a separate current account for the partner, and the drawings and the interest on drawings are debited to it. The balance of the current account at the end of each financial year will then represent the amount of undrawn (or withdrawn) profits. A credit balance will be undrawn profits, while a debit balance will be drawings in excess of the profits to which the partner was entitled.

For Taylor and Clarke, capital and current accounts, assuming drawings of £15,000 for Taylor and £26, 000 for Clarke will be:

Taylor – Capital

	20X7			£
	Jan	1	Bank	20,000

Clarke – Capital

	20X7			£
	Jan	1	Bank	60,000

CURRENT ACCOUNTS

Taylor – Current Account

20X7			£	20X7			£
Dec	31	Cash: Drawings	15,000	Dec	31	Profit and loss appropriation account:	
"	31	Profit and loss appropriation account:				Interest on capital	1,000
		Interest on drawings	500			Share of profits	19,500
"	31	Balance c/d	5,000				
			20,500				20,500
				20X8			
				Jan	1	Balance b/d	5,000

Clarke – Current Account

20X7			£	20X7			£
Dec	31	Cash: Drawings	26,000	Dec	31	Profit and loss appropriation account:	
"	31	Profit and loss appropriation account:				Salary	15,000
		Interest on drawings	1,000			Interest on capital	3,000
"	31	Balance c/d	4,000			Share of profits	13,000
			31,000				31,000
				20X8			
				Jan	1	Balance b/d	4,000

COLUMNAR ACCOUNTS

Capital Accounts

	Taylor	Clarke		Taylor	Clarke
	£	£	20X7	£	£
			Jan 1 Bank	20,000	60,000

Current Accounts

	Taylor	Clarke		Taylor	Clarke
20X7	£	£	20X7	£	£
Dec 31 Cash: Drawings	15,000	26,000	Dec 31 Salary	19,500	15,000
" 31 Interest on drawings	500	1,000	" 31 Interest on capital	1,000	3,000
" 31 Balances c/d	5,000	4,000	" 31 Share of profits		13,000
	20,500	31,000		20,500	31,000
			20X8		
			Jan 1 Balances b/d	5,000	4,000

FLUCTUATING CAPITAL ACCOUNTS

The distribution of profits would be credited to the capital account, and the drawings and interest on drawings debited. Therefore the balance on the capital account will change each year, i.e. it will fluctuate.

If fluctuating capital accounts had been kept for Taylor and Clarke they would have appeared

Taylor – Capital

20X7			£	20X7			£
Dec	31	Cash: Drawings	15,000	Jan	1	Bank	20,000
"	31	Profit and loss appropriation account:		Dec	31	Profit and loss appropriation account:	
		Interest on drawings	500			Interest on capital	1,000
"	31	Balance c/d	25,000			Share of profits	19,500
			40,500				40,500
				20X8			
				Jan	1	Balance b/d	25,000

Clarke – Capital

20X7			£	20X7			£
Dec	31	Cash: Drawings	26,000	Jan	1	Bank	60,000
"	31	Profit and loss appropriation account:		Dec	31	Profit and loss appropriation account:	
						Salary	15,000
		Interest on drawings	1,000			Interest on capital	3,000
"	31	Balance c/d	64,000			Share of profit	13,000
			91,000				91,000
				20X8			
				Jan	1	Balance b/d	64,000

THE BALANCE SHEET

For the partnership, the capital part of the balance sheet will appear:

Balance Sheet as at 31 December 20X7 (extract)

						£	£
Capital accounts	Taylor					20,000	
	Clarke					60,000	
							80,000
Current accounts		Taylor		Clarke			
		£	£	£	£		
Salary			–		15,000		
Interest on capital			1,000		3,000		
Share of profits			19,500		13,000		
			20,500		31,000		
Less Drawings		15,000		26,000			
Interest on drawings		500		1,000			
			(15,500)		(27,000)		
			5,000		4,000		
							9,000

THE END