

# **BSBFIA401**

# **Prepare financial reports**

Release 1

**Learner guide**

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**Learner guide**

Aspire Version 1.1

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Level 1, 464 St Kilda Road  
MELBOURNE VIC 3004 AUSTRALIA  
Phone: (03) 9820 1300

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## Contact details

| <b>Participant</b>                            |
|---|
| Name:   |
| Start date:                                   |
| Phone number:                                 |
| Email:  |
| <b>Work location</b>                          |
| Name:   |
| Address:                                      |
| Postal address:                               |
| Workplace supervisor name:                    |
| Phone number:                                 |
| Fax:  |
| Email:  |
| <b>Registered Training Organisation (RTO)</b> |
| Name:   |
| Address:                                      |
| Postal address (if different):                |
| Phone number:                                 |
| Fax:  |
| RTO contact name:                             |
| Mobile:                                       |
| Email:  |



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# Before you begin

This learner guide is based on the unit of competency *BSBFIA401 Prepare financial reports*, Release 1. Your trainer or training organisation must give you information about this unit of competency as part of your training program. You can access the unit of competency and assessment requirements at: [www.training.gov.au](http://www.training.gov.au).

## How to work through this learner guide

This learner guide contains a number of features that will assist you in your learning. Your trainer will advise which parts of the learner guide you need to read, and which practice tasks and learning checkpoints you need to complete. The features of this learner guide are detailed in the following table.

| Feature of the learner guide | How you can use each feature   |
|------------------------------|--|
| Learning content             | Read each topic in this learner guide. If you come across content that is confusing, make a note and discuss it with your trainer. Your trainer is in the best position to offer assistance. It is very important that you take on some of the responsibility for the learning you will undertake.             |
| Examples and case studies    | Examples of completed documents that may be used in a workplace are included in this learner guide. You can use these examples as models to help you complete practice tasks and learning checkpoints. Case studies highlight learning points and provide realistic examples of workplace situations.          |
| Practice tasks               | Practice tasks give you the opportunity to put your skills and knowledge into action. Your trainer will tell you which practice tasks to complete.   |
| Video clips                  | Where QR codes appear, learners can use smartphones and other devices to access video clips relating to the content. For information about how to download a QR reader app or accessing video on your device, please visit our website: <a href="http://www.aspirelr.com.au/help">www.aspirelr.com.au/help</a> |
| Summary                      | Key learning points are provided at the end of each topic.   |
| Learning checkpoints         | There is a learning checkpoint at the end of each topic. Your trainer will tell you which learning checkpoints to complete. These checkpoints give you an opportunity to check your progress and apply the skills and knowledge you have learnt.   |



## Foundation skills

As you complete learning using this guide, you will be developing the foundation skills relevant for this unit. Foundation skills are the language, literacy and numeracy (LLN) skills and the employability skills required for participation in modern workplaces and contemporary life.

The following table outlines specific foundation skills noted for your learning in this learner guide.

| Foundation skill area      | Foundation skill description  |
|----------------------------|---|
| Reading                    | <ul style="list-style-type: none"> <li>Identifies and interprets information from organisational policies, procedures and job requirements</li> <li>Checks documents for errors or discrepancies</li> </ul>   |
| Writing                    | <ul style="list-style-type: none"> <li>Records accurate data using relevant format, structure and vocabulary</li> </ul>   |
| Oral communication         | <ul style="list-style-type: none"> <li>Explains issues clearly using appropriate industry terminology</li> <li>Asks questions and listens to responses to clarify understanding</li> </ul>  |
| Numeracy                   | <ul style="list-style-type: none"> <li>Uses a wide range of mathematical calculations to interpret and arrange/compare numerical information</li> </ul>   |
| Navigate the world of work | <ul style="list-style-type: none"> <li>Adheres to industry standards, organisational policies and procedures in the conduct of own work</li> </ul>  |
| Interact with others       | <ul style="list-style-type: none"> <li>Selects the appropriate form, channel and mode of communication for a specific purpose relevant to own role</li> </ul>   |
| Get the work done          | <ul style="list-style-type: none"> <li>Plans and completes tasks according to set guidelines and timelines</li> <li>Recognises and addresses problems in the context of own work and seeks advice from others, as necessary</li> <li>Uses digital technologies to access, record, store, organise and compile data as required</li> </ul> |

## What do you already know?

Use the following table to identify what you may already know. This may assist you to work out what to focus on in your learning.

| Topic  | Key outcome  | Rate your confidence in each section   |
|--|--|--|
| Topic 1 Maintain an asset register                                 | 1A Prepare a register of property, plant and equipment                           | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 1B Calculate depreciation in accordance with organisational requirements         | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 1C Maintain an asset register and associated depreciation schedule               | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
| Topic 2 Record general journal entries for balance-day adjustments | 2A Understand balance-day activities   | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 2B Adjust the accounts for depreciation, prepayments and accruals on balance day | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 2C Record bad and doubtful debts at balance day                                  | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 2D Adjust ledger accounts for inventories and leave at balance day               | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
| Topic 3 Prepare final general ledger accounts                      | 3A Understand the trading account  | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 3B Prepare the profit and loss account   | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 3C Determine owner's equity  | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|  | 3D Understand service organisations  | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |

| <b>Topic</b>  | <b>Key outcome</b>   | <b>Rate your confidence in each section</b>  |
|---|--|--|
| Topic 4 Prepare the end-of-period financial reports | 4A Prepare the income (profit and loss) statement              | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |
|   | 4B Prepare the statement of financial position (balance sheet) | <input type="checkbox"/> Confident<br><input type="checkbox"/> Basic understanding<br><input type="checkbox"/> Not confident |

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# Topic 1

## Maintain an asset register

Assets are generally defined as physical or non-physical items that:

- will provide future economic benefits to the organisation by generating revenue and/or through the disposal of the asset
- are controlled by the organisation; for example, through ownership of the asset
- arise due to a past transaction or event; for example, a purchase.

An asset register, also known as a register of property, plant and equipment, records all the details of the non-current/fixed assets of a business. A separate record is kept by the business for each individual fixed asset. The individual asset registers can be seen as a subsidiary ledger in much the same way as a debtors subsidiary ledger and a creditors subsidiary ledger.

An organisation records the details of all of its assets in an asset register.

In this topic you will learn how to:

- 1A Prepare a register of property, plant and equipment
- 1B Calculate depreciation in accordance with organisational requirements
- 1C Maintain an asset register and associated depreciation schedule

# 1A

## Prepare a register of property, plant and equipment

An organisation's financial activities consist of hundreds and thousands of transactions or economic exchanges between the business and other parties. Every organisation has financial dealings with other parties.

Each of these financial transactions results in some kind of financial information being created. The organisation must record and collect information on every financial transaction it engages in via its accounting systems. This data is then evaluated, coded, aggregated and summarised in the preparation of financial reports for management and others to use in decision-making processes.

For example, an organisation may:

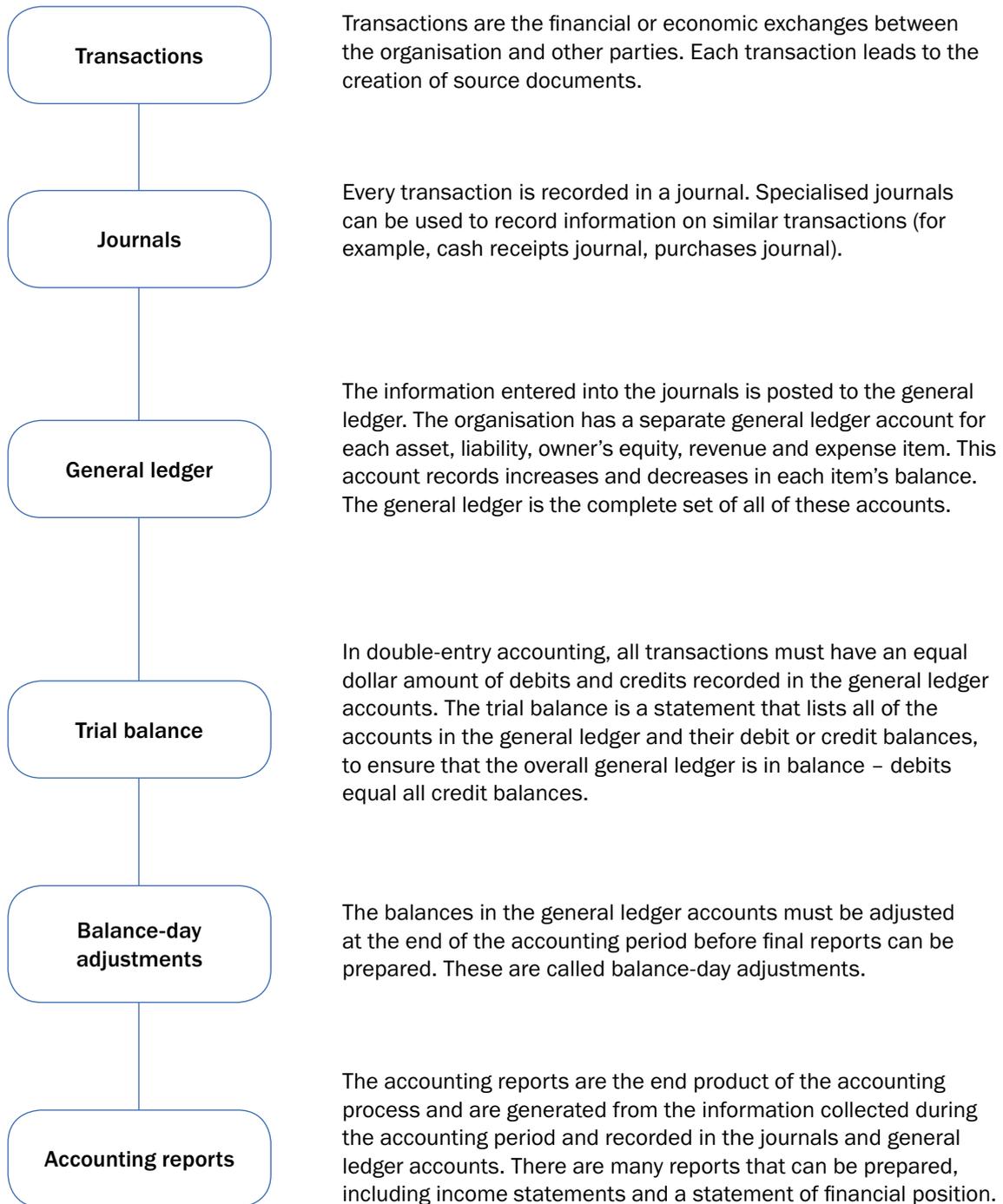
- buy goods from suppliers
- borrow money from lenders
- pay creditors, loans, suppliers and expenses
- make sales to customers
- employ staff
- accept investments from owners
- pay profits to owners and shareholders.

### The accounting process

An organisation's accounting process consists of the steps required to record all of the transactions that take place, and to organise and collate this information before producing financial reports that are analysed and used in decision-making.

The accounting process is made up of this sequence.





## The concept of accrual accounting

The organisation's financial performance (profits) can be measured on either a cash or an accrual basis. Most organisations use the accrual basis of accounting because this most accurately determines the organisation's performance when there are transactions that overlap from one accounting period to the next.

Here is an explanation of the two types of accounting systems.

| Cash basis  | Accrual basis   |
|---|---|
| <p>Under the cash basis of accounting, the organisation's revenues are recorded in the accounting period when cash is received and expenses are recorded when cash is paid. Cash in this sense refers to the act of payment, not the tender, and can include credit card, cheque or barter as well as cash.</p> | <p>Under the accrual basis of accounting, revenues are recorded when they are earned (that is, when the business sells goods or performs services) and expenses are recorded when they are incurred in earning that revenue (that is, when goods and services are consumed). Thus, the concept of receiving or paying cash is not relevant in determining profit.</p> |

### Example: accrual and cash accounting

Here are two examples of the way cash and rentals are managed in organisations.



Cash received from a customer may relate to services performed in the previous accounting period. Under the cash basis, this would be recorded as revenue when the cash is received, even though the services for the customer were performed in the previous period. Recording this as revenue for the current period is misleading because the business expended its energy and resources in earning the revenue during the last period, so it makes sense to record this as revenue for the previous period under the accrual basis.



An organisation may prepay a rental lease for an entire year. If profit is to be calculated halfway through the year, then only half of the rent has been consumed with the other half relating to the next accounting period. Under the accrual basis, only the rent consumed is included as an expense. However, under the cash basis, the entire rental amount paid at the start of the year is treated as an expense for the previous accounting period, even though half of this payment relates to the future. This results in a misleading and mismatched profit calculation.

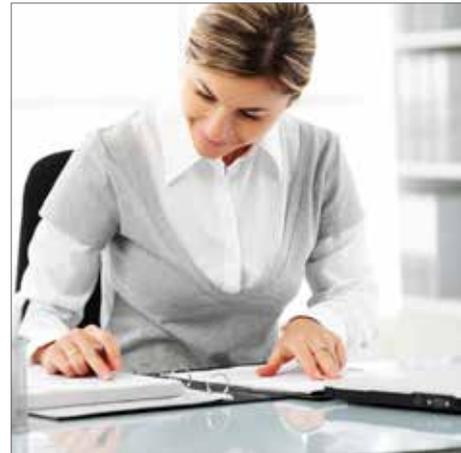
## The matching principle

One of the core principles of accounting is the matching principle, which states that all revenues generated in an accounting period should be matched with the expenses incurred in generating them, in order to determine the organisation's performance (profit).

Therefore, the accrual basis of accounting facilitates the matching principle by recording revenues and expenses when they are earned or incurred, rather than recording them when cash is received or paid.

During an accounting period, there may be many transactions that overlap from one period to the next. For example, some expenses may be paid in advance while others may have been incurred in the previous period but payment is not due until the next period. Similarly, revenue may have been earned in the previous period but payment is not expected until the next period. How should transactions such as these be recorded?

Accrual accounting ensures the matching principle is maintained by only including revenues and expenses that have been earned and incurred in the accounting period in question when determining profit. Using this method requires the organisation to make balance-day adjustments.



## Double-entry accounting

The rules of double-entry accounting require amounts to be recorded in debit and credit columns according to their classifications; that is, assets, liabilities, owner's equity, revenues and expenses. Here is an explanation for each of these terms.

### Assets

An item is considered an asset if it provides the organisation with a long-term benefit or is considered an item of value owned by the organisation. This includes cash at the bank, cash on hand (for example, in the cash registers), stock on hand, buildings, equipment and amounts owing by debtors.

### Liabilities

An item is considered a liability if it relates to amounts the organisation has not yet paid, such as bank loans, mortgages, taxes and amounts owing to creditors.

### Owner's equity

Owner's equity refers to the amount of money personally invested into the business by the owner.

**Revenues**

Revenues arise when an organisation makes a sale or provides a service to a customer.

**Expenses**

An organisation incurs expenses for items such as wages and salaries, advertising, stationery, motor vehicles, equipment, machinery and payments for utilities.

## Debit and credit entries

Customers or debtors who owe the organisation money are classified as assets. As a result, when posting transactions from the journals to each debtor's account:

- an entry recorded in the debit column will increase the amount owing by the debtor
- an entry recorded in the credit column will decrease the amount owing by the debtor.

Here are the account classifications and the double-entry accounting rules to record increases and decreases in these accounts.

**Asset accounts**

To increase an asset account, record the amount in the debit column.  
To decrease an asset account, record the amount in the credit column.

**Liability accounts**

To increase a liability account, record the amount in the credit column.  
To decrease a liability account, record the amount in the debit column.

**Owner's equity accounts**

To increase an owner's equity account, record the amount in the credit column.  
To decrease an owner's equity account, record the amount in the debit column.

### Revenue accounts

- ↳ To increase a revenue account, record the amount in the credit column.
- ↳ To decrease a revenue account, record the amount in the debit column.

### Expense accounts

- ↳ To increase an expense account, record the amount in the debit column.
- ↳ To decrease an expense account, record the amount in the credit column.

## T accounts

Accountants use the T-account format to enter the values for each account so that they are easier to visualise. T accounts have the debit values for an account on the left and credits on the right.

Here are some examples of T accounts.

| Asset account (for example, cash)   |  |
|---|--|
| <b>Debit</b>  | <b>Credit</b>  |
| Increases an asset  | Decreases an asset   |
| (For example, enter the date and amount here if an asset is being added to) | (For example, enter the date and amount here if an asset is decreasing, such as spending cash) |

| Liability account (for example, taking out a loan)                               |  |
|--|--|
| <b>Debit</b>   | <b>Credit</b>  |
| Decreases a liability  | Increases a liability  |
| (For example, enter the date and amount here if a repayment is made on the loan) | (For example, enter the date and amount here if another loan is taken out) |

## Journal entry system and narratives

Another way to visualise transactions is to use a journal entry system. Journal entries have the date, details about the transaction (which accounts will be debited and which will be credited) and the corresponding amounts.

The information that is included with the journal entry is called the narration. It is a short description of what the entry is about. An example of a journal entry is shown below. The narration is the part written in italics: '3 months' depreciation at 40% reducing-balance method'.

| Date    | Particulars  | Folio | Debit<br>\$ | Credit<br>\$ |
|---------|--|-------|-------------|--------------|
| 30/6/15 | Depreciation – computer<br>Accumulated depreciation – computer<br><i>3 months' depreciation at 40% reducing-balance method</i> |       | 515         | 515          |

## Balance-day adjustments

Balance day refers to the end day of the accounting period; for example, 30 June or 31 December. The occurrence of balance day may mean that some transactions overlap from one accounting period to the next. This means that some adjustments to the balances in the general ledger accounts need to be made on balance day to ensure that all revenues and expenses recorded relate to the accounting period in question and not another period in the future.

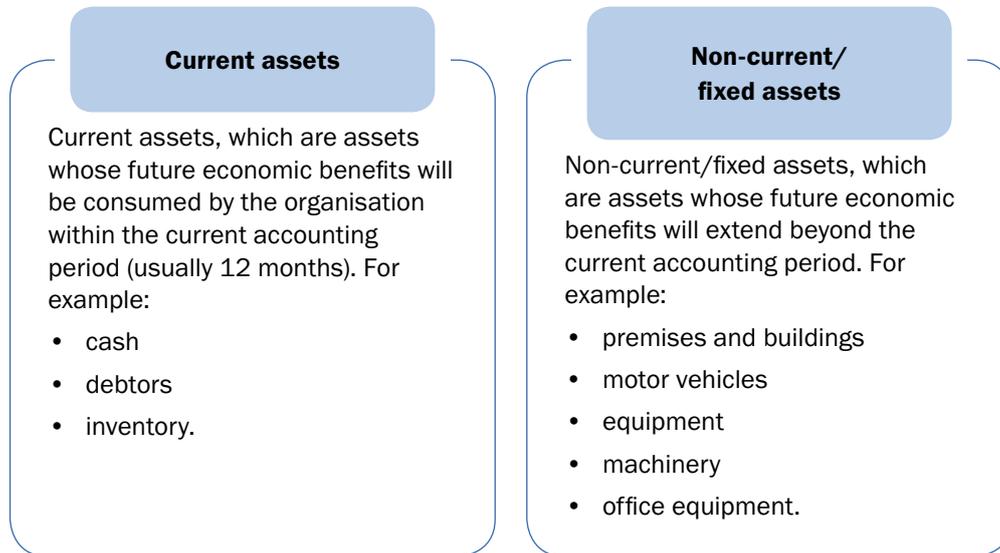
Only once these balance-day adjustments are made can the organisation take the next step in the accounting process and begin to accurately prepare its accounting reports.

The balance-day adjustments relate to:

- depreciation
- sale of non-current assets
- prepaid expenses
- accrued expenses
- prepaid revenue
- accrued revenue
- stocks of supplies and materials.

## Types of assets

Assets are listed in the organisation's statement of financial position in order of liquidity, which is defined as the ability to turn the asset into cash. As such, assets are usually broken up into two categories.



## Non-current assets

Non-current assets are classified into a further three categories.

### Tangible assets

Tangible assets are also known as 'property, plant and equipment' or 'fixed assets'. They are physical assets. Examples of tangible (fixed) assets are land and buildings, plant and machinery, motor vehicles and office equipment.

### Intangible assets

Intangible assets do not have a physical existence. Examples of intangible assets are goodwill, copyrights, trademarks and patents.

### Investments or financial assets

Investments or financial assets are amounts that have been invested by the business into financial instruments or securities such as shares, debentures and bonds. These investments are for periods greater than 12 months.

## Asset registers

All assets are recorded in an asset register. The records contained in an asset register can be in the form of a card system or a computerised system.

The details recorded on the fixed asset register may include:

- a description of the asset
- the location of the asset
- annual depreciation and accumulated depreciation
- estimated residual value
- total capital cost
- repairs and maintenance
- an identification number
- supplier information
- depreciation method and rate of depreciation
- estimated asset life
- disposal of asset details
- other information.

### Example: an asset register card

Here is an example of an asset register card. When information is kept in computer accounting systems instead of cards, the information is the same, but it is added to a database instead of a physical card.

| Asset register card |         |                             |                                |                          |              |                   |                          |
|---------------------|---------|-----------------------------|--------------------------------|--------------------------|--------------|-------------------|--------------------------|
| Description         |         |                             |                                | Estimated residual       |              |                   |                          |
| Asset ID            |         |                             |                                | Depreciation method      |              |                   |                          |
| Location            |         |                             |                                | Depreciation rate        |              |                   |                          |
| Supplier            |         |                             |                                | Estimated useful life    |              |                   |                          |
| Date                | Details | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$ | Depreciation |                   | Written-down value<br>\$ |
|                     |         |                             |                                |                          | Annual<br>\$ | Accumulated<br>\$ |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |

*continued ...*

... continued

| <b>Repairs, maintenance and other information</b> |                         |                                 |                    |
|---|-------------------------|---------------------------------|--------------------|
| <b>Date</b>                                       | <b>Service provider</b> | <b>Details of work provided</b> | <b>Cost<br/>\$</b> |
|   |                         |                                 |                    |
|   |                         |                                 |                    |
|   |                         |                                 |                    |
|   |                         |                                 |                    |
|   |                         |                                 |                    |
|   |                         |                                 |                    |
|   |                         |                                 |                    |
|   |                         |                                 |                    |

| <b>Disposal details</b> |                            |                    |
|-------------------------|----------------------------|--------------------|
| <b>Date</b>             | <b>Details of disposal</b> | <b>Cost<br/>\$</b> |
|                         |                            |                    |
|                         |                            |                    |

## Calculate the capital cost of an asset

The total capital cost of an asset includes its purchase price and any additional costs associated with preparing the asset for use in the business.

The capital cost of an asset does not include any goods and services tax (GST) paid, as this is claimed back by the business from the Australian Taxation Office (ATO) as an input tax credit (if the business is registered for GST).

Additional costs include:

- installation
- delivery
- modifications required by the business
- stamp duty
- customs duty.

## Recurring costs

Recurring costs associated with an asset are also not included in the capital cost. Recurring costs are those costs associated with the ongoing use of an asset.

Examples of recurring costs include:

- annual insurance
- registration
- repairs and maintenance.

### Example: how to calculate capital cost

Barmos Manufacturing purchased a Toyota Camry Hybrid sedan (registration BRMOS5) from Morgan Brothers Motors on 1 January 2015. Barmos Manufacturing obtained a loan from Ezy Finance for \$30,000 and paid the balance by cheque number 260269. Details of the purchase are as follows:

- Purchase price: \$38,500 (including GST)
- Dealer delivery fee: \$770 (including GST)
- Stamp duty : \$1,544
- Registration: \$425
- Insurance: \$660 (including GST)

The supply and installation of a CD stacker by Sound Plus on 1 January 2015 was paid by cheque number 260270. Cost and installation were as follows:

- CD stacker: \$495 (including GST)
- Installation of CD stacker: \$66 (including GST)

Calculation of the capital cost of the vehicle is:

| Item                       | Type of cost | Price paid<br>\$ | GST<br>\$ | Capital cost<br>\$ |
|----------------------------|--------------|------------------|-----------|--------------------|
| Purchase price             | Capital      | 38,500           | 3,500     | 35,000             |
| Dealer delivery fee        | Capital      | 770              | 70        | 700                |
| Stamp duty                 | Capital      | 1,544            | Nil       | 1,544              |
| Registration               | Recurring    | 425              | Nil       | Nil                |
| Insurance                  | Recurring    | 660              | 60        | Nil                |
| CD stacker                 | Capital      | 495              | 45        | 450                |
| Installation of CD stacker | Capital      | 66               | 6         | 60                 |
| Total capital cost         |              |                  |           | 37,754             |

To calculate the GST portion on prices that are quoted as GST inclusive, divide the cost by 11.

Using the information in the table, the asset register card for the vehicle has been completed and is shown here.

*continued ...*

... continued

| Asset register card |                        |                             |                                |                              |              |                   |                          |
|---------------------|------------------------|-----------------------------|--------------------------------|------------------------------|--------------|-------------------|--------------------------|
| <b>Description</b>  | Toyota Camry Hybrid    |                             |                                | <b>Estimated residual</b>    |              |                   |                          |
| <b>Asset ID</b>     | BRMOS5                 |                             |                                | <b>Depreciation method</b>   |              |                   |                          |
| <b>Location</b>     |                        |                             |                                | <b>Depreciation rate</b>     |              |                   |                          |
| <b>Supplier</b>     | Morgan Brothers Motors |                             |                                | <b>Estimated useful life</b> |              |                   |                          |
| Date                | Details                | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$     | Depreciation |                   | Written-down value<br>\$ |
|                     |                        |                             |                                |                              | Annual<br>\$ | Accumulated<br>\$ |                          |
| 1/1/15              | Capital cost           | 37,244                      |                                | 37,244                       |              |                   |                          |
| 1/1/15              | CD stacker             |                             | 510                            | 37,754                       |              |                   |                          |
|                     |                        |                             |                                |                              |              |                   |                          |
|                     |                        |                             |                                |                              |              |                   |                          |
|                     |                        |                             |                                |                              |              |                   |                          |

## Practice task 1

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

Sateen Designs purchased a new computer system, serial number X11XX1XXX11, from Cyber Systems on 1 April 2015. The total cost was paid by cheque number 000935. The price paid (including GST) for each item was:

- iMac – \$2,486
- HP laser printer – \$682
- External hard drive 2TB – \$165
- Microsoft Office Home & Business – \$299
- AZM Accounting software – \$594
- Installation of software – \$528
- Annual AZM Accounting support plan – \$198

Note: Company policy is to capitalise all payments of \$200 or more. Amounts below \$200 are to be expensed.



*continued ...*

... continued

1. Determine the capital cost of each item of the asset using this table.

| Item | Type of cost | Price paid<br>\$ | GST<br>\$ | Capital cost<br>\$ |
|------|--------------|------------------|-----------|--------------------|
|      |              |                  |           |                    |
|      |              |                  |           |                    |
|      |              |                  |           |                    |
|      |              |                  |           |                    |
|      |              |                  |           |                    |
|      |              |                  |           |                    |
|      |              |                  |           |                    |
|      |              |                  |           |                    |

2. Using the template provided, complete the information required on an asset register card based on this information.

| Asset register card |         |                             |                                |                          |              |                   |                          |
|---------------------|---------|-----------------------------|--------------------------------|--------------------------|--------------|-------------------|--------------------------|
| Description         |         |                             |                                | Estimated residual       |              |                   |                          |
| Asset ID            |         |                             |                                | Depreciation method      |              |                   |                          |
| Location            |         |                             |                                | Depreciation rate        |              |                   |                          |
| Supplier            |         |                             |                                | Estimated useful life    |              |                   |                          |
| Date                | Details | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$ | Depreciation |                   | Written-down value<br>\$ |
|                     |         |                             |                                |                          | Annual<br>\$ | Accumulated<br>\$ |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |
|                     |         |                             |                                |                          |              |                   |                          |

continued ...

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| <b>Repairs, maintenance and other information</b> |                  |                          |            |
|---|------------------|--------------------------|------------|
| Date  | Service provider | Details of work provided | Cost<br>\$ |
|   |                  |                          |            |
|   |                  |                          |            |
|   |                  |                          |            |
|   |                  |                          |            |
|   |                  |                          |            |
|   |                  |                          |            |
|   |                  |                          |            |
|   |                  |                          |            |

| <b>Disposal details</b> |                     |            |
|-------------------------|---------------------|------------|
| Date                    | Details of disposal | Cost<br>\$ |
|                         |                     |            |
|                         |                     |            |

## 1B

## Calculate depreciation in accordance with organisational requirements

A fundamental requirement of accounting is to allocate expenses against revenues in the year in which they are incurred so that the reported profit reflects the year's revenues and costs.

Fixed assets are normally purchased with the intent of earning sales revenue over the life of the asset. For example, a taxi may generate revenue for three years or a machine may produce goods for resale over a five-year period.

Fixed assets will deteriorate and suffer wear and tear as they are used and consequently they lose value each year. This is referred to as depreciation expense. This loss in value must be included as an expense in the year in which the depreciation was incurred and matched against the revenue earned by the asset.



## Calculate the amount of depreciation

There are a number of methods a business may use to calculate depreciation of an asset. The two most commonly used methods are:

- straight-line depreciation
- reducing-balance depreciation.

## Straight-line depreciation

Also known as prime-cost depreciation or on-cost depreciation, the straight-line depreciation method allocates the total capital cost of the asset evenly over the asset's estimated useful life, meaning that the annual depreciation amount is the same each year.

The formula used to calculate straight-line depreciation is as follows:

$$\frac{\text{Capital cost of the asset less estimated residual value}}{\text{Estimated useful life}} = \text{Annual depreciation}$$

The estimated residual value is the value that the asset is expected to be worth at the end of its estimated useful life. It takes into account factors such as usage, wear and tear, maintenance and past experience in the use and sale of used assets.

## Useful life of an asset

In some circumstances, it is compulsory to use the effective useful life of an asset as determined by the Australian Taxation Office (ATO); in others you can determine the effective useful life yourself.

The ATO website ([www.ato.gov.au](http://www.ato.gov.au)) provides advice on determining the effective life of an asset and will keep you up to date with any new depreciation arrangements.

Accounting standard AASB 116 Property, Plant and Equipment discusses the factors to be considered when determining the cost of an asset, the estimated useful life of an asset and issues relating to depreciation. Standards have amendments made to them and you should always check that those you are using are current.

Straight-line depreciation is often quoted as a percentage rate rather than a number of years. The percentage can be calculated by dividing 100 per cent by the number of years of an asset's life. This table shows how the number of years of an asset's life can be equated as a percentage.

|                                     |     |     |     |    |    |    |
|-------------------------------------|-----|-----|-----|----|----|----|
| <b>Years of asset's useful life</b> | 2   | 5   | 10  | 20 | 25 | 50 |
| <b>Straight-line depreciation %</b> | 50% | 20% | 10% | 5% | 4% | 2% |

### Example: straight-line depreciation

Office equipment purchased on 1 July 2015 had a capitalised cost of \$3,450. The estimated residual value of the equipment at the end of its five-year estimated useful life is \$450. Calculation of the annual depreciation is as follows:

$$\frac{\text{Capital cost of the asset less estimated residual value}}{\text{Estimated useful life}} = \text{Annual depreciation}$$

$$\frac{\$3,450 - \$450}{5} = \$600 \text{ depreciation expense per annum}$$

This can also be calculated using the annual straight-line depreciation rate:

$$\$3,000 \times 20\% = \$600$$

The following table shows the annual depreciation charge, the accumulation of the annual depreciation charges and the written-down value of the asset, also referred to as the 'carrying cost' or the 'book value', for each year of its useful life.

| <b>Year</b> | <b>Capital cost<br/>\$</b> | <b>Annual<br/>depreciation<br/>\$</b> | <b>Accumulated<br/>depreciation<br/>\$</b> | <b>Written-down value<br/>\$</b> |
|-------------|----------------------------|---------------------------------------|--|----------------------------------|
| 1           | 3,450                      | 600                                   | 600  | 2,850                            |
| 2           |                            | 600                                   | 1,200                                      | 2,250                            |
| 3           |                            | 600                                   | 1,800                                      | 1,650                            |
| 4           |                            | 600                                   | 2,400                                      | 1,050                            |
| 5           |                            | 600                                   | 3,000                                      | 450                              |

Notice that the annual depreciation charge under the straight-line method is the same in each year and in the last year the written-down value of the asset will equal its residual value.

## Reducing-balance depreciation

Reducing-balance depreciation is also known as written-down-value depreciation or diminishing-value depreciation. This method calculates depreciation based on the written-down value of the asset each year.

The written-down value is equal to the cost price of the asset less the accumulated depreciation charged against the asset. The written-down value can also be referred to as the book value or the carrying cost.

The effect of using the reducing-balance depreciation method is higher annual depreciation in the early years of the asset's estimated useful life than in the later years.



Under the reducing-balance method:

- the annual depreciation expense diminishes in each year
- the written-down value at the end of the asset's life will be different to its residual value as applied under the straight-line method of depreciation.

## Calculate reducing-balance depreciation

Information on percentage depreciation rates is available on the ATO website. In each example and task in this unit you will be provided with the annual rate of reducing-balance depreciation. (You will not be required to calculate it yourself.)

However, you need to know how the amount of annual depreciation is calculated, using the asset's written-down value multiplied by the annual depreciation rate (percentage) using the following formula:

$$\text{Written-down value} \quad \times \quad \text{Percentage depreciation rate} \quad = \quad \text{Annual depreciation}$$

The rate of depreciation using this method is approximately calculated by multiplying the straight-line percentage by 1.5, as shown in the following table:

| Years of asset's useful life    | 2   | 5   | 10  | 20   | 25 | 50 |
|---------------------------------|-----|-----|-----|------|----|----|
| Straight-line depreciation %    | 50% | 20% | 10% | 5%   | 4% | 2% |
| Reducing-balance depreciation % | 75% | 30% | 15% | 7.5% | 6% | 3% |

## Example: reducing-balance depreciation

The following formula is used to calculate the depreciation expense in the first year of the asset's life:

$$\text{Capital cost of asset} \times \text{Depreciation rate} = \text{Depreciation expense}$$

Unlike the straight-line method, this method does not acknowledge the residual value of the asset.

Therefore:  $\$3,450 \times 30\% = \$1,035$  depreciation expense.

After the first year, the following values would be recognised:

| Year | Capital cost<br>\$ | Annual<br>depreciation<br>\$ | Accumulated<br>depreciation<br>\$ | Written-down value<br>\$ |
|------|--------------------|------------------------------|-----------------------------------|--------------------------|
| 1    | 3,450.00           | 1,035.00                     | 1,035.00                          | 2,415.00                 |

The depreciation expense calculation in subsequent years requires the depreciation rate to be applied to the written-down value of the asset, not the cost price. Therefore, at the end of year two, the depreciation calculation is as follows:

$\$2,415 \times 30\% = \$724.50$  depreciation expense.

The depreciation calculations and carrying cost of the asset are as follows:

| Year | Capital cost<br>\$ | Annual<br>depreciation<br>\$ | Accumulated<br>depreciation<br>\$ | Written-down value<br>\$ |
|------|--------------------|------------------------------|-----------------------------------|--------------------------|
| 1    | 3,450.00           | 1,035.00                     | 1,035.00                          | 2,415.00                 |
| 2    |                    | 724.50                       | 1,759.50                          | 1,690.50                 |

At the end of the third year, depreciation expense is calculated as follows:

$\$1,690.50 \times 30\% = \$507.15$  depreciation expense.

| Year | Capital cost<br>\$ | Annual<br>depreciation<br>\$ | Accumulated<br>depreciation<br>\$ | Written-down value<br>\$ |
|------|--------------------|------------------------------|-----------------------------------|--------------------------|
| 1    | 3,450              | 1,035.00                     | 1,035.00                          | 2,415.00                 |
| 2    |                    | 724.50                       | 1,759.50                          | 1,690.50                 |
| 3    |                    | 507.15                       | 2,266.65                          | 1,183.35                 |

At the end of year four:

$\$1,183.35 \times 30\% = \$355$  depreciation expense.

| Year | Capital cost<br>\$ | Annual<br>depreciation<br>\$ | Accumulated<br>depreciation<br>\$ | Written-down value<br>\$ |
|------|--------------------|------------------------------|-----------------------------------|--------------------------|
| 1    | 3,450              | 1,035.00                     | 1,035.00                          | 2,415.00                 |
| 2    |                    | 724.50                       | 1,759.50                          | 1,690.50                 |
| 3    |                    | 507.15                       | 2,266.65                          | 1,183.35                 |
| 4    |                    | 355.00                       | 2,621.65                          | 828.35                   |

*continued ...*

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At the end of the final year:

$\$828.35 \times 30\% = \$248.50$  depreciation expense.

| Year | Capital cost<br>\$ | Annual depreciation<br>\$ | Accumulated depreciation<br>\$ | Written-down value<br>\$ |
|------|--------------------|---------------------------|--------------------------------|--------------------------|
| 1    | 3,450              | 1,035.00                  | 1,035.00                       | 2,415.00                 |
| 2    |                    | 724.50                    | 1,759.50                       | 1,690.50                 |
| 3    |                    | 507.15                    | 2,266.65                       | 1,183.35                 |
| 4    |                    | 355.00                    | 2,621.65                       | 828.35                   |
| 5    |                    | 248.50                    | 2,870.15                       | 579.85                   |

## Pro-rata depreciation

Annual depreciation of an asset is calculated at the end of the business's financial year. If an asset is acquired or disposed of during the financial year, a pro-rata depreciation calculation is required to determine the part-year's depreciation.

### Example: pro-rata depreciation

Neutron Ltd purchased machinery on 1 October 2015 for a capital cost of \$80,000 (excluding GST). The machinery is to be depreciated at 20 per cent per annum on cost. The calculation of the pro-rata depreciation for the nine months to 30 June 2016 is as follows:

|                     |   |  |   |                       |
|---------------------|---|--|---|-----------------------|
| Capital cost        | x | Percentage depreciation rate                     | = | Annual depreciation   |
| \$80,000            | x | 20%  | = | \$16,000              |
| Annual depreciation | x | $\frac{\text{No. of months}}{12 \text{ months}}$ | = | Pro-rata depreciation |
| \$16,000            | x | $\frac{9}{12}$                                   | = | \$12,000              |

## Account for depreciation

Recording the depreciation of an asset in the accounting records is usually done at the end of the accounting period (balance day), which in Australia is generally 30 June.

A general journal entry is necessary at balance day (30 June) to:

- recognise the depreciation expense incurred in the current accounting period (this entry creates the depreciation expense for the year)
- recognise the accumulated depreciation of the asset since its purchase up to the end of the current accounting period.

## Journal entry to record depreciation expenses

The general journal entry to record depreciation expenses and the accumulation of depreciation is as follows:

- Debit – Depreciation Expense – Expense Account
- Credit – Accumulated Depreciation – Reducing Asset Account

The accumulated depreciation account is classified as a reducing asset account and is to be shown in the statement of financial position matched against the asset that is being depreciated. As the accumulated depreciation account has a credit balance, it will effectively reduce the value of the asset on the statement of financial position to show its carrying cost or written-down value.



### Example: depreciation

The accounting entries required to record the pro-rata depreciation calculated in the previous example are shown below.

| General journal – Neutron Ltd |   |       |          |           |
|-------------------------------|---|-------|----------|-----------|
| Date                          | Particulars   | Folio | Debit \$ | Credit \$ |
| 30/06/16                      | Depreciation expense – machinery<br>Accumulated depreciation – machinery<br><i>Nine months' depreciation calculated at 20% on cost (straight-line method)</i> |       | 12,000   | 12,000    |

The general ledger accounts after the above entry has been posted are shown below.

| General ledger                              |                                      |          |          |           |            |
|---|--------------------------------------|----------|----------|-----------|------------|
| Date  | Particulars                          | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Depreciation expense – machinery</b>     |                                      |          |          |           |            |
| 30/06/16                                    | Accumulated depreciation – machinery | GJ       | 12,000   |           | 12,000 Dr  |
| <b>Accumulated depreciation – machinery</b> |                                      |          |          |           |            |
| 30/06/16                                    | Depreciation – machinery             | GJ       |          | 12,000    | 12,000 Cr  |

## Example: calculate and record depreciation

At balance day, 30 June 2015 and again on 30 June 2016, Barmos Manufacturing is required to update its asset register for depreciation and record the depreciation in the accounting records. The depreciation for the Toyota Camry Hybrid (registration BRMOS5) is to be calculated at 22.5 per cent per annum using the reducing-balance method.

### Calculation of depreciation for first year (30 June 2015):

|                     |   |  |   |                       |
|---------------------|---|--|---|-----------------------|
| Capital cost        | x | Percentage depreciation rate                     | = | Annual depreciation   |
| \$37,754            | x | 22.5%  | = | \$8,495               |
| Annual depreciation | x | $\frac{\text{No. of months}}{12 \text{ months}}$ | = | Pro-rata depreciation |
| \$8,495             | x | $\frac{6}{12}$                                   | = | \$4,248               |

### Calculation of depreciation for second year (30 June 2016):

|                    |   |                              |   |                     |
|--------------------|---|------------------------------|---|---------------------|
| Capital cost       | - | Accumulated depreciation     | = | Written-down value  |
| \$37,754           | - | \$4,248                      | = | \$33,506            |
| Written-down value | x | Percentage depreciation rate | = | Annual depreciation |
| \$33,506           | x | 22.5%                        | = | \$7,539             |

*continued ...*

... continued

The asset register card has been updated with the above information for the vehicle.

| Asset register card |                          |                             |                                |                          |                  |                   |                          |
|---------------------|--------------------------|-----------------------------|--------------------------------|--------------------------|------------------|-------------------|--------------------------|
| Description         | Toyota Camry Hybrid      |                             |                                | Estimated residual       |                  |                   |                          |
| Asset ID            | BRMOS5                   |                             |                                | Depreciation method      | Reducing-balance |                   |                          |
| Location            |                          |                             |                                | Depreciation rate        | 22.5%            |                   |                          |
| Supplier            | Morgan Brothers Motors   |                             |                                | Estimated useful life    |                  |                   |                          |
| Date                | Details                  | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$ | Depreciation     |                   | Written-down value<br>\$ |
|                     |                          |                             |                                |                          | Annual<br>\$     | Accumulated<br>\$ |                          |
| 1/1/15              | Capital cost             | 37,244                      |                                | 37,244                   |                  |                   |                          |
| 1/1/15              | CD stacker               |                             | 510                            | 37,754                   |                  |                   |                          |
| 30/6/15             | Depreciation (6 months)  |                             |                                |                          | 4,248            | 4,248             | 33,506                   |
| 30/6/16             | Depreciation (12 months) |                             |                                |                          | 7,539            | 11,787            | 25,967                   |

The annual depreciation charges would be recorded in the general journal, as follows.

| General journal – Barmos Manufacturing |  |             |              |
|--|--|-------------|--------------|
| Date                                   | Particulars  | Debit<br>\$ | Credit<br>\$ |
| 30/6/15                                | Depreciation expense – motor vehicles<br>Accumulated depreciation – motor vehicles<br><i>Six months' depreciation calculated at 22.5% reducing-balance method</i>    | 4,248       | 4,248        |
| 30/6/16                                | Depreciation expense – motor vehicles<br>Accumulated depreciation – motor vehicles<br><i>Twelve months' depreciation calculated at 22.5% reducing-balance method</i> | 7,539       | 7,539        |

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The general ledger entries to record the depreciation are as follows.

| General ledger                                   |   |          |          |           |            |
|--|---|----------|----------|-----------|------------|
| Date   | Particulars                               | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Depreciation expense – motor vehicles</b>     |   |          |          |           |            |
| 30/6/15  | Accumulated depreciation – motor vehicles | GJ       | 4,248    |           | 4,248 Dr   |
|  | Profit and loss account**                 | GJ       |          | 4,248     | Nil        |
| 30/6/16  | Accumulated depreciation – motor vehicles | GJ       | 7,539    |           | 7,539 Dr   |
|  | Profit and loss account**                 |          |          | 7,539     | Nil        |
| <b>Accumulated depreciation – motor vehicles</b> |   |          |          |           |            |
| 30/6/15  | Depreciation – motor vehicles             | GJ       |          | 4,248     | 4,248 Cr   |
| 30/6/16  | Depreciation – motor vehicles             | GJ       |          | 7,539     | 11,787 Cr  |

\*\*All expense accounts are closed at the end of each accounting period.

The motor vehicle and the related accumulated depreciation accounts would be shown in the statement of financial position, as follows.

| Barmos Manufacturing                       |               |               |
|--|---------------|---------------|
| Extract of statement of financial position |               |               |
| As at                                      | 30 June 2015  | 30 June 2016  |
|  | \$            | \$            |
| <b>Non-current assets</b>                  |               |               |
| Motor vehicle                              | 37,754        | 37,754        |
| less accumulated depreciation              | 4,248         | 11,787        |
| <b>Written-down value</b>                  | <b>33,506</b> | <b>25,967</b> |

## Practice task 2

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.



1. Complete these tables to calculate the annual depreciation and written-down values for the assets for their useful lives, rounding to the nearest dollar. Use the blank space to write down any key information or calculations.
  - a) Machinery with a capital cost of \$55,000 (including GST) was purchased on 1 July 2015. The estimated useful life is expected to be four years and the expected residual value is \$10,000. Depreciation is to be determined using the straight-line method.

| Year | Capital cost<br>\$ | Annual<br>depreciation<br>\$ | Accumulated<br>depreciation<br>\$ | Written-<br>down value<br>\$ |
|------|--------------------|------------------------------|-----------------------------------|------------------------------|
| 1    |                    |                              |                                   |                              |
| 2    |                    |                              |                                   |                              |
| 3    |                    |                              |                                   |                              |
| 4    |                    |                              |                                   |                              |

*continued ...*

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- b) Computers with a capitalised cost of \$8,800 (including GST) were purchased on 1 July 2015. The asset has a life expectancy of four years and is to be depreciated using the reducing-balance method at 40 per cent.

|  |
|--|
|  |
|--|

| Year | Capital cost<br>\$ | Annual depreciation<br>\$ | Accumulated depreciation<br>\$ | Written-down value<br>\$ |
|------|--------------------|---------------------------|--------------------------------|--------------------------|
| 1    |                    |                           |                                |                          |
| 2    |                    |                           |                                |                          |
| 3    |                    |                           |                                |                          |
| 4    |                    |                           |                                |                          |

| Year | Written-down value<br>\$ | Annual depreciation<br>\$ |
|------|--------------------------|---------------------------|
| 1    |                          |                           |
| 2    |                          |                           |
| 3    |                          |                           |
| 4    |                          |                           |

2. Calculate the annual depreciation for the following assets as at 30 June 2016.
- a) Plant and equipment with a capital cost of \$70,000 (excluding GST) were purchased on 1 December 2015. The depreciation rate is 20 per cent per annum on cost and the asset has a \$5,000 residual value.

|  |
|--|
|  |
|--|

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- b) A motor vehicle with a capitalised cost of \$19,000 (excluding GST) was purchased on 31 March 2016. The depreciation rate is 22.5 per cent using the reducing-balance method.

3. In Practice task 1, Sateen Designs purchased a new computer system on 1 April 2015, for which you were required to calculate the capital cost and record the details on an asset register card. You will need to refer to your response for this practice task.

You are now required to do the following:

- a) Update the asset register card by calculating and recording the depreciation charges for the years ended 30 June 2015 and 30 June 2016. Sateen uses the reducing-balance method of depreciation at a rate of 40 per cent per annum (round your depreciation calculations to the nearest dollar).
- b) Using the template provided, record the depreciation expenses for each year in a general journal.
- c) Using the template provided, post the journal entries to the general ledger for:
  - depreciation expense – computers
  - accumulated depreciation – computers
- d) In the following table, show the statement of financial position extract for the asset at the end of each year.

| <b>Sateen Designs</b>                             |                     |                     |
|---|---------------------|---------------------|
| <b>Extract of statement of financial position</b> |                     |                     |
| <b>As at</b>                                      | <b>30 June 2015</b> | <b>30 June 2016</b> |
|   | \$                  | \$                  |
| <b>Non-current assets</b>                         |                     |                     |
|   |                     |                     |
|   |                     |                     |
| <b>Written-down value</b>                         |                     |                     |

## 1C

## Maintain an asset register and associated depreciation schedule

All repairs and maintenance of assets are recorded in the relevant section of the asset register card to provide a full history of the asset. The date, service provider's name, service details and cost (excluding GST) are entered so the information is up to date and easily accessible to authorised personnel.

## Example: repairs and maintenance

These repairs and maintenance were performed on the Toyota Camry Hybrid owned by Barmos Manufacturing, registration number BRMOS5.

| Date     | Particulars                          | Service provider        | Price inc. GST \$ |
|----------|--------------------------------------|-------------------------|-------------------|
| 14/2/15  | 1,500 km warranty service            | Morgan Brothers Motors  | No charge         |
| 31/3/15  | 5,000 km service                     | Morgan Brothers Motors  | 495               |
| 7/7/15   | 10,000 km service                    | Morgan Brothers Motors  | 770               |
| 18/10/15 | 15,000 km service                    | Morgan Brothers Motors  | 550               |
| 14/1/16  | 20,000 km service                    | Morgan Brothers Motors  | 847               |
| 1/3/16   | Windscreen replacement               | Clearview Windscreens   | 363               |
| 20/4/16  | 25,000 km service                    | Morgan Brothers Motors  | 539               |
| 27/6/16  | Repair electrical fault in dashboard | Lighting Auto Electrics | 418               |

The asset register card has been updated with the above information for the vehicle.

| Asset register card |                          |                          |                             |                       |                  |                |                       |
|---------------------|--------------------------|--------------------------|-----------------------------|-----------------------|------------------|----------------|-----------------------|
| Description         | Toyota Camry Hybrid      |                          |                             | Estimated residual    |                  |                |                       |
| Asset ID            | BRMOS5                   |                          |                             | Depreciation method   | Reducing-balance |                |                       |
| Location            |                          |                          |                             | Depreciation rate     | 22.5%            |                |                       |
| Supplier            | Morgan Brothers Motors   |                          |                             | Estimated useful life |                  |                |                       |
| Date                | Details                  | Original capital cost \$ | Additional capital costs \$ | Total capital cost \$ | Depreciation     |                | Written-down value \$ |
|                     |                          |                          |                             |                       | Annual \$        | Accumulated \$ |                       |
| 1/1/15              | Capital cost             | 37,244                   |                             | 37,244                | 4,248            | 4,248          |                       |
| 1/1/15              | CD stacker               |                          | 510                         | 37,754                | 7,539            | 11,787         |                       |
| 30/6/15             | Depreciation (6 months)  |                          |                             |                       |                  |                | 33,506                |
| 30/6/16             | Depreciation (12 months) |                          |                             |                       |                  |                | 25,967                |

continued ...

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| <b>Repairs, maintenance and other information</b> |                         |                                      |                            |
|---|-------------------------|--------------------------------------|----------------------------|
| <b>Date</b>                                       | <b>Service provider</b> | <b>Details of work provided</b>      | <b>Cost ex. GST<br/>\$</b> |
| 14/2/15   | Morgan Brothers Motors  | 1,500 km warranty service            | No charge                  |
| 31/3/15   | Morgan Brothers Motors  | 5,000 km service                     | 450                        |
| 7/7/15  | Morgan Brothers Motors  | 10,000 km service                    | 700                        |
| 18/10/15  | Morgan Brothers Motors  | 15,000 km service                    | 500                        |
| 14/1/16   | Morgan Brothers Motors  | 20,000 km service                    | 770                        |
| 1/3/16  | Clearview Windscreens   | Windscreen replacement               | 330                        |
| 20/4/16   | Morgan Brothers Motors  | 25,000km service                     | 490                        |
| 27/6/16   | Lighting Auto Electrics | Repair electrical fault in dashboard | 380                        |

## Dispose of an asset

When an asset is sold, the asset register card must be updated to show the details of the disposal (date, purchaser and price) and the profit or loss that resulted from the disposal of the asset.

Here are the steps to follow when an asset is sold.

### Record the details

Record the details of the disposal in the disposal section of the asset register card.

### Calculate the amount of depreciation

Calculate the amount of depreciation on the asset to the disposal date and record it on the asset register card.

### Determine whether a profit or loss has resulted

Determine whether a profit or loss has resulted from the disposal of the asset. The disposal value, excluding GST, is recorded on the main section of the asset register card. If the disposal value is greater than the asset's written-down value, a profit on disposal will be recorded. If the disposal value is less than the asset's written-down value, a loss on disposal will be recorded.

## Example: dispose of an asset

Eden Developments held a Toyota that was purchased on 1 January 2014 at a cost of \$25,000. On 1 August 2015 the vehicle was sold to Evelyn Adams for \$18,150 including GST.

The asset register card at the date of disposal was as follows:

| Asset register card |                          |                             |                                |                          |                  |                   |                          |
|---------------------|--------------------------|-----------------------------|--------------------------------|--------------------------|------------------|-------------------|--------------------------|
| Description         | Toyota                   |                             |                                | Estimated residual       |                  |                   |                          |
| Asset ID            | EDEN14                   |                             |                                | Depreciation method      | Reducing-balance |                   |                          |
| Location            |                          |                             |                                | Depreciation rate        | 25%              |                   |                          |
| Supplier            | Aspley Toyota            |                             |                                | Estimated useful life    |                  |                   |                          |
| Date                | Details                  | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$ | Depreciation     |                   | Written-down value<br>\$ |
|                     |                          |                             |                                |                          | Annual<br>\$     | Accumulated<br>\$ |                          |
| 1/1/14              | Capital cost             | 25,000                      |                                | 25,000                   |                  |                   |                          |
| 30/6/14             | Depreciation (6 months)  |                             |                                |                          | 3,125            | 3,125             | 21,875                   |
| 30/6/15             | Depreciation (12 months) |                             |                                |                          | 5,469            | 8,594             | 16,406                   |

As the asset was sold on 1 August 2015, pro-rata depreciation for one month must be calculated. The depreciation calculation is as follows:

$$\$16,406 \times 25\% \times 1/12 = \$342$$

As the vehicle was sold for \$18,150 including GST, the disposal amount excluding GST must be calculated as follows:

$$\$18,150 - (\$18,150/11) = \$16,500$$

The pro-rata depreciation amount, the disposal amount and the profit or loss on disposal must be recorded on the asset register card. As the asset had a written-down value of \$16,064 at the disposal date and was sold for \$16,500, a profit of \$436 must be recorded.

*continued ...*

... continued

| Asset register card |                          |                             |                                |                          |                  |                   |                          |
|---------------------|--------------------------|-----------------------------|--------------------------------|--------------------------|------------------|-------------------|--------------------------|
| Description         | Toyota                   |                             | Estimated residual             |                          |                  |                   |                          |
| Asset ID            | EDEN14                   |                             | Depreciation method            |                          | Reducing-balance |                   |                          |
| Location            |                          |                             | Depreciation rate              |                          | 25%              |                   |                          |
| Supplier            | Aspley Toyota            |                             | Estimated useful life          |                          |                  |                   |                          |
| Date                | Details                  | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$ | Depreciation     |                   | Written-down value<br>\$ |
|                     |                          |                             |                                |                          | Annual<br>\$     | Accumulated<br>\$ |                          |
| 1/1/14              | Capital cost             | 25,000                      |                                | 25,000                   |                  |                   |                          |
| 30/6/14             | Depreciation (6 months)  |                             |                                |                          | 3,125            | 3,125             | 21,875                   |
| 30/6/15             | Depreciation (12 months) |                             |                                |                          | 5,469            | 8,594             | 16,406                   |
| 1/8/15              | Depreciation (1 month)   |                             |                                |                          | 342              | 8,936             | 16,064                   |
| 1/8/15              | Disposal                 |                             |                                |                          |                  |                   | (16,500)                 |
| 1/8/15              | Profit on disposal       |                             |                                |                          |                  |                   | 436                      |

The reverse side of the asset register card must also report the disposal amount.

| Disposal details |                     |            |
|------------------|---------------------|------------|
| Date             | Details of disposal | Cost<br>\$ |
| 1/8/15           | Evelyn Adams        | 16,500     |

## Account for the disposal of an asset

When an asset is sold, a new account called disposal of asset is opened in the general ledger. This account is known as a clearing account and is used to accumulate amounts relating to the asset being sold so the profit (or loss) on disposal can be accounted for.

The disposal of asset account accumulates the:

- capital cost
- accumulated depreciation of the asset
- disposal value received from the sale of the asset.

The balance remaining in the asset account after these amounts have been entered represents a profit (if a credit balance) or a loss (if a debit balance) on the disposal.

The balance of the disposal of asset account is then transferred to another newly created account called profit or loss on disposal of asset before being transferred to the profit and loss account at the end of the year.

The general journal entries required to record disposal of assets are as follows.

1. Record pro-rata depreciation to the date of disposal:

Debit – depreciation expense

Credit – accumulated depreciation

2. Transfer the capital cost of the asset from the asset account to the disposal of asset account:

Debit – disposal of asset

Credit – asset account

3. Transfer the balance of the accumulated depreciation of asset account to the disposal of asset account:

Debit – accumulated depreciation

Credit – disposal of asset

4. Record the value received on disposal in the relevant disposal of asset account:

- a) If cash was received:

Debit – bank account

Credit – GST payable

Credit – disposal of asset

This entry would be recorded in the cash receipts journal and not the general journal.

- b) If the asset was sold on credit:
    - Debit – sundry debtor account
    - Credit – GST payable
    - Credit – disposal of asset
  - c) If the trade-in amount was taken off the purchase price of a new asset:
    - Debit – new asset account
    - Credit – GST payable
    - Credit – disposal of asset
5. Transfer the balance remaining in the disposal of asset account to the profit or loss on disposal of asset account.
- a) If there is a credit balance in the disposal of asset account:
    - Debit – disposal of asset
    - Credit – profit (loss) on disposal of asset
  - b) If there is a debit balance in the disposal of asset account:
    - Debit – profit (loss) on disposal of asset
    - Credit – disposal of asset

### Example: record the disposal of an asset

In an earlier example, Barmos Manufacturing prepared an asset register card for its Toyota Camry Hybrid to 30 June 2016.

On 1 September 2016, the car was sold to Outdoor Escapades on tax invoice number 30951 for \$27,500 (including GST). Outdoor Escapades agreed to pay the amount outstanding in full on 30 September 2016.

**Step 1: Perform final calculations.**

- a) Calculate the pro-rata depreciation from 30 June 2016 to 1 September 2016 (2 months):  
 $\$25,967 \times 22.5\% \times 2/12 = \$974$
- b) Calculate the sale value excluding GST:  
 $\$27,500 - (\$27,500/11) = \$25,000$

*continued ...*

... continued

**Step 2: Record the depreciation and disposal value on the asset register card:**

| Asset register card |                          |                             |                                |                          |                  |                   |                          |
|---------------------|--------------------------|-----------------------------|--------------------------------|--------------------------|------------------|-------------------|--------------------------|
| Description         | Toyota Camry Hybrid      |                             |                                | Estimated residual       |                  |                   |                          |
| Asset ID            | BRMOS5                   |                             |                                | Depreciation method      | Reducing-balance |                   |                          |
| Location            |                          |                             |                                | Depreciation rate        | 22.5%            |                   |                          |
| Supplier            | Morgan Brothers Motors   |                             |                                | Estimated useful life    |                  |                   |                          |
| Date                | Details                  | Original capital cost<br>\$ | Additional capital costs<br>\$ | Total capital cost<br>\$ | Depreciation     |                   | Written-down value<br>\$ |
|                     |                          |                             |                                |                          | Annual<br>\$     | Accumulated<br>\$ |                          |
| 1/1/15              | Capital cost             | 37,244                      |                                | 37,244                   |                  |                   |                          |
| 1/1/15              | CD stacker               |                             | 510                            | 37,754                   |                  |                   |                          |
| 30/6/15             | Depreciation (6 months)  |                             |                                |                          | 4,248            | 4,248             | 33,506                   |
| 30/6/16             | Depreciation (12 months) |                             |                                |                          | 7,539            | 11,787            | 25,967                   |
| 1/9/16              | Depreciation (2 months)  |                             |                                |                          | 974              | 12,761            | 24,993                   |
| 1/9/16              | Disposal                 |                             |                                |                          |                  |                   | (25,000)                 |
| 1/9/16              | Profit on disposal       |                             |                                |                          |                  |                   | 7                        |

**Step 3: Record the transactions on the disposal date in the general journal:**

a) Record the pro-rata depreciation as follows:

| General journal - Barmos Manufacturing |   |       |             |              |
|--|---|-------|-------------|--------------|
| Date                                   | Particulars   | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/9/16                                 | Depreciation – motor vehicles<br>Accumulated depreciation – motor vehicles<br><i>Two months' depreciation calculated at 22.5% (reducing-balance method)</i> |       | 974         | 974          |

continued ...

... continued

- b) Transfer the cost price of the disposed asset account to the asset disposal account as follows:

| <b>General journal – Barmos Manufacturing</b> |  |       |             |              |
|---|--|-------|-------------|--------------|
| Date  | Particulars  | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/9/16  | Disposal of motor vehicle<br>Motor vehicle<br><i>Transfer capital cost of disposed vehicle to disposal account</i> |       | 37,754      | 37,754       |

- c) Transfer the accumulated depreciation on the disposed asset to the disposal account as follows:

| <b>General journal – Barmos Manufacturing</b> |  |       |             |              |
|---|--|-------|-------------|--------------|
| Date  | Particulars  | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/9/16  | Accumulated depreciation – motor vehicles<br>Disposal of motor vehicle<br><i>Transfer accumulated depreciation of disposed vehicle to disposal account</i> |       | 12,761      | 12,761       |

- d) Record the sale details of the disposed asset as follows:

| <b>General journal – Barmos Manufacturing</b> |   |       |             |                 |
|---|---|-------|-------------|-----------------|
| Date  | Particulars   | Folio | Debit<br>\$ | Credit<br>\$    |
| 1/9/16  | Sundry debtor – Outdoor Escapades<br>Disposal of motor vehicle<br>GST payable<br><i>Disposal of Toyota Camry Hybrid BRMOS5 to Outdoor Escapades (tax invoice 30951)</i> |       | 27,500      | 25,000<br>2,500 |

- e) Transfer the profit on disposal to a profit on disposal account as follows:

| <b>General journal – Barmos Manufacturing</b> |  |       |             |              |
|---|--|-------|-------------|--------------|
| Date  | Particulars  | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/9/15  | Disposal of motor vehicle<br>Profit on disposal of motor vehicle<br><i>Transfer to profit on disposal of motor vehicle</i> |       | 7           | 7            |

continued ...

... continued

**Step 4: Post the journal entries to the general ledger as follows:**

| <b>General Ledger – Barmos Manufacturing</b>     |   |                 |                 |                  |                   |
|--|---|-----------------|-----------------|------------------|-------------------|
| <b>Date</b>                                      | <b>Particulars</b>                        | <b>Jnl ref.</b> | <b>Debit \$</b> | <b>Credit \$</b> | <b>Balance \$</b> |
| <b>Motor vehicles</b>                            |   |                 |                 |                  |                   |
| 1/9/16   | Balance                                   |                 |                 |                  | 37,754 Dr         |
|  | Disposal of motor vehicle                 | GJ              |                 | 37,754           | Nil               |
| <b>Accumulated depreciation – motor vehicles</b> |   |                 |                 |                  |                   |
| 30/6/15  | Balance                                   |                 |                 |                  | 11,787 Cr         |
| 1/9/16   | Depreciation – motor vehicles             | GJ              |                 | 974              | 12,761 Cr         |
|  | Disposal of motor vehicle                 | GJ              | 12,761          |                  | Nil               |
| <b>Depreciation expense – motor vehicles</b>     |   |                 |                 |                  |                   |
| 1/9/16   | Accumulated depreciation – motor vehicles | GJ              | 974             |                  | 974 Dr            |
| <b>Disposal of motor vehicle</b>                 |   |                 |                 |                  |                   |
| 1/9/16   | Motor vehicles                            |                 | 37,754          |                  | 37,754 Dr         |
|  | Accumulated depreciation – motor vehicles | GJ              |                 | 12,761           | 24,993 Dr         |
|  | Sundry debtor – Outdoor Escapades         | GJ              |                 | 25,000           | 7 Cr              |
|  | Profit on disposal of motor vehicles      | GJ              | 7               |                  | Nil               |
|  | GST payable – motor vehicle               |                 |                 | 2,500            | 2,500 CR          |
| <b>Profit on disposal of motor vehicle</b>       |   |                 |                 |                  |                   |
| 1/9/16   | Disposal of motor vehicle                 | GJ              |                 | 7                | 7 Cr              |
| <b>Sundry debtor – Outdoor Escapades</b>         |   |                 |                 |                  |                   |
| 1/9/16   | Disposal of motor vehicle and GST payable | GJ              | 27,500          |                  | 27,500 Dr         |

## Trade-in an asset

Disposing of an asset by trading it in on the purchase of a replacement asset is recorded in a similar way to disposal by sale, except for the entries regarding GST.

Normally, the value of the input tax credits is based on the GST included in the purchase price of the new asset. For example, if a new vehicle is purchased for \$33,000 (including GST), then \$3,000 (the GST) is claimed as an input tax credit.

If an old vehicle is traded for \$12,100 (including GST), only \$11,000 would be treated as a deposit paid on the new vehicle. There is no adjustment for the GST component (\$1,100) as all the GST was claimed as an input tax credit when the traded vehicle was purchased.



### Example: trade-in an asset

This example demonstrates the accounting entries recorded when an asset is traded-in on the purchase of a replacement asset.

G-Force Security traded-in its Ford Falcon on the purchase of a new Holden Cruze from Riverside Holden on 1 February 2016.

- The Falcon's capital cost was \$24,000. The accumulated depreciation including pro-rata depreciation up to the date of disposal is \$11,500.
- Riverside Holden has given a trade-in allowance of \$9,900 including GST on the Falcon.
- The purchase price of the new Cruze is \$27,500 including GST.
- The balance owing on the new Cruze after deduction of the trade-in allowance is paid by cheque number 250. The amount is \$17,600.

**Step 1: Transfer the cost price of the asset to the disposal account as follows:**

| General journal – G-Force Security |  |       |          |           |
|------------------------------------|--|-------|----------|-----------|
| Date                               | Particulars  | Folio | Debit \$ | Credit \$ |
| 1/2/16                             | Disposal of Ford Falcon<br>Ford Falcon<br><i>Transfer capital cost to disposal account</i> |       | 24,000   | 24,000    |

*continued ...*

... continued

**Step 2: Transfer the accumulated depreciation to the disposal account as follows:**

| General journal – G-Force Security |   |       |             |              |
|------------------------------------|---|-------|-------------|--------------|
| Date                               | Particulars   | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/2/16                             | Accumulated depreciation – Ford Falcon<br>Disposal of Ford Falcon<br><i>Transfer accumulated depreciation to disposal account</i> |       | 11,500      | 11,500       |

**Step 3: Record the trade-in details as follows:**

| General journal – G-Force Security |   |       |             |              |
|------------------------------------|---|-------|-------------|--------------|
| Date                               | Particulars   | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/2/16                             | Holden Cruze<br>Disposal of Ford Falcon<br><i>Disposal of Ford Falcon as trade-in on Holden Cruze</i> |       | 9,000       | 9,000        |

**Step 4: Transfer the loss on disposal from the disposal account as follows:**

| General journal – G-Force Security |   |       |             |              |
|------------------------------------|---|-------|-------------|--------------|
| Date                               | Particulars   | Folio | Debit<br>\$ | Credit<br>\$ |
| 1/2/16                             | Loss on disposal of Ford Falcon<br>Disposal of Ford Falcon<br><i>Transfer to loss on disposal account</i> |       | 3,500       | 3,500        |

**Step 5: Record the final payment on the purchased asset in the cash payments journal as follows:**

| Cash payments journal – G-Force Security |                                     |            |                 |                 |                |                           |            |
|--|-------------------------------------|------------|-----------------|-----------------|----------------|---------------------------|------------|
| Date                                     | Particulars                         | Chq<br>no. | Creditors<br>\$ | Purchases<br>\$ | Sundries<br>\$ | Input Tax<br>Credit<br>\$ | Bank<br>\$ |
| 1/2/16                                   | Motor vehicle<br>(Riverside Holden) | 250        |                 |                 | 16,000         | 1,600                     | 17,600     |

continued ...

... continued

**Step 6: Post the journal entries to the general ledger as follows:**

| General Ledger                                |  |          |             |              |               |
|---|--|----------|-------------|--------------|---------------|
| Date  | Particulars                            | Jnl ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
| <b>Ford Falcon</b>                            |  |          |             |              |               |
| 1/2/16  | Balance                                |          |             |              | 24,000 Dr     |
|   | Disposal of Ford Falcon                | GJ       |             | 24,000       | Nil           |
| <b>Accumulated depreciation – Ford Falcon</b> |  |          |             |              |               |
| 1/2/16  | Balance                                |          |             |              | 11,500 Cr     |
|   | Disposal of Ford Falcon                | GJ       | 11,500      |              | Nil           |
| <b>Disposal of Ford Falcon</b>                |  |          |             |              |               |
| 1/2/16  | Ford Falcon                            | GJ       | 24,000      |              | 24,000 Dr     |
|   | Accumulated depreciation – Ford Falcon | GJ       |             | 11,500       | 12,500 Dr     |
|   | Holden Cruze                           | GJ       |             | 9,000        | 3,500 Dr      |
|   | Loss on disposal                       | GJ       |             | 3,500        | Nil           |
| <b>Loss on disposal of Ford Falcon</b>        |  |          |             |              |               |
| 1/2/16  | Disposal Ford Falcon                   | GJ       | 3,500       |              | 3,500 Dr      |
| <b>Holden Cruze</b>                           |  |          |             |              |               |
| 1/2/16  | Disposal of Ford Falcon                | GJ       | 9,000       |              | 9,000 Dr      |
|   | Cash at bank                           | CPJ      | 16,000      |              | 25,000 Dr     |

## Accounting and organisational requirements

There are specific rules that address the accounting treatment and disclosure requirements of various topics/issues within organisations. These rules are known as accounting standards.

In Australia, these accounting standards are developed by the Australian Accounting Standards Board (AASB). The AASB was formed under the *Australian Securities and Investments Commission Act 2001* (Cth).

The accounting standard relating to the acquisition, depreciation and disposal of fixed assets is AASB 116 Property, Plant and Equipment. For businesses and companies that are legally required to produce financial reports, the AASB has a number of standards according to the nature of the business. The current accounting standards can be accessed from the AASB's website at: [www.aasb.gov.au](http://www.aasb.gov.au).

The accounting standards are legally binding and apply to organisations that are registered as companies under corporations law and are classified as reporting entities.

The purpose of the accounting standards is to:

- detail procedures on the accounting for transactions
- detail disclosure requirements for financial reports
- ensure uniformity and consistency in accounting.

## Financial reporting requirements

There are a number of statutory requirements that must be met when preparing financial reports and financial statements. The *Corporations Act 2001* (Cth) sets these out. All businesses need to keep financial and accounting records, but not all are required by law to produce a financial report. Financial reports include financial records, half-yearly and annual financial reports, director's reports and auditing documentation.

Financial statements relate to accounting processes and include profit and loss statements (financial performance), balance sheets (statement of financial position) and cashflow statements.

### Financial performance

#### Financial performance statements

Financial performance statements show income and expenses for a particular financial year. Opening and closing balances are shown, as are transfers in and out. The document closes with the amount of profit retained by the business at the end of that financial year.

### Financial position

#### Financial position statements

Financial position statements show the assets, liabilities and equity in the business. Assets and liabilities may be listed separately as current or non-current.

### Cashflow

#### Cashflow statements

Cashflow statements detail the cash coming in and out of the business over the financial year. They detail how much cash is held by the organisation at any point in time.

## Taxation and depreciation

Depreciation is a tax-deductible business expense under the *Income Tax Assessment Act 1997* (Cth). The ATO requires that proper documentation of depreciation calculations be kept to support deductions claimed in tax returns.

As mentioned in the section on depreciation earlier in this topic, the ATO website includes information to assist taxpayers in determining an asset's estimated useful life. Taxpayers choosing to determine the estimated useful life of an asset themselves are required to retain documentation showing how the estimate was derived. Depreciation tables that list the straight-line and reducing-balance rates applicable for various effective lives (years) are also available.



### Practice task 3

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

1. These repairs and maintenance were performed on the computer system owned by Sateen Designs. Record these events in the asset register card created previously.

| Date     | Particulars                    | Service provider | Price inc. GST<br>\$ |
|----------|--------------------------------|------------------|----------------------|
| 20/4/15  | Replacement of faulty keyboard | Cyber Systems    | No charge            |
| 11/7/15  | Clean and service              | Cyber Systems    | 198                  |
| 31/10/15 | Replace system battery         | IT Computing     | 165                  |
| 9/3/16   | Clean and service              | IT Computing     | 176                  |
| 15/6/16  | Internet connection faulty     | IT Computing     | 99                   |

2. On 1 April 2017, Sateen Designs sold the computer system to Lynette Kirby for \$1,100 (including GST). Payment was received in cash in full on 1 April 2017 (receipt number 2908).
  - a) Update the asset register card to record the depreciation to 1 April 2017 and the disposal of the computer system.
  - b) Using the template provided, prepare the general journal entries required for the disposal of the asset.



*continued ...*

... continued

c) Record the payment received into the cash receipts journal using this table.

| <b>Cash receipts journal</b> |                    |              |                 |                   |                      |                    |                       |                |
|------------------------------|--------------------|--------------|-----------------|-------------------|----------------------|--------------------|-----------------------|----------------|
| <b>Date</b>                  | <b>Particulars</b> | <b>Folio</b> | <b>Rec. no.</b> | <b>Debtors \$</b> | <b>Cash sales \$</b> | <b>Sundries \$</b> | <b>GST payable \$</b> | <b>Bank \$</b> |
|                              |                    |              |                 |                   |                      |                    |                       |                |
|                              |                    |              |                 |                   |                      |                    |                       |                |
|                              |                    |              |                 |                   |                      |                    |                       |                |

d) Post the general journal and cash receipts journal entries required for the disposal of the asset to the appropriate general ledger accounts using the template provided.

## Summary

1. Assets are items that provide future economic benefits to the organisation by generating revenue and/or through their disposal.
2. Assets can be current or non-current/fixed depending on whether their expected economic benefits will extend beyond 12 months. Examples of current assets are cash, debtors and inventory. Examples of non-current/fixed assets are buildings, motor vehicles, equipment, machinery and office equipment.
3. An asset register records all the details of the organisation's fixed assets, such as supplier information, depreciation method, rate of depreciation, estimated residual value, estimated asset life and total capital cost. A separate record is kept by the business for each individual fixed asset.
4. The asset register records fixed assets at their capital cost, which includes the purchase price plus any additional costs associated with preparing the asset for use in the business; for example, installation, delivery, stamp duty.
5. The capital cost of a fixed asset does not include goods and services tax (GST) paid or any recurring costs associated with the asset such as annual insurance, registration, repairs and maintenance.
6. Fixed assets deteriorate, suffer wear and tear and lose value over time as they are used. This represents the depreciation of the asset and must be calculated and included as an expense in the year in which the depreciation was incurred and matched against the revenue earned by the asset.
7. The two most common methods of calculating depreciation are the straight-line and reducing-balance methods. Straight-line depreciation allocates the total capital cost of the asset evenly over the asset's estimated useful life, meaning the annual depreciation is the same amount each year. Reducing-balance depreciation calculates depreciation based on the written-down value of the asset each year, resulting in higher annual depreciation in the early years of the asset's estimated useful life than in the later years.
8. If an asset is acquired or disposed of during the financial year, a pro-rata depreciation calculation is required to determine the part-year's depreciation.
9. A general journal entry is required on balance day to recognise the depreciation expense incurred in the current accounting period, as well as the accumulated depreciation of the asset since its purchase up to the end of the current accounting period.
10. The asset register card must be updated when the asset is repaired/maintained and disposed of (sold). These details must also be recorded in the general journal at the time of the repair/maintenance or disposal.

## Learning checkpoint 1

### Maintain an asset register

This learning checkpoint allows you to review your skills and knowledge in maintaining an asset register. Templates for the accountancy tables are available at <http://chilp.it/ee80e58> or by scanning the QR code.



#### Part A

Explain the difference between current and non-current assets, giving four examples of each.

#### Part B

Read the case study, then complete the tasks that follow. All calculations should be rounded to the nearest dollar.

##### Case study

A motor vehicle was purchased on 30 April 2013 for \$30,600 (excluding GST). Twelve months' registration, costing \$500, was included in the purchase price.

Prior to delivery, the vehicle was converted to dual-fuel with the supply and installation of an LPG tank. The cost of the conversion was \$2,090 (including GST).

The motor vehicle is to be depreciated at a rate of 25 per cent per annum reducing-balance method.

1. Calculate the capital cost of the vehicle.

2. Calculate the vehicle's pro-rata depreciation charge and the closing written-down value at 30 June 2013.

3. Calculate the depreciation for the years ended 30 June 2014, 30 June 2015 and 30 June 2016.

## Part C

Read the case study, then complete the tasks that follow. All calculations should be rounded to the nearest dollar.

### Case study

On 1 October 2012, Springfield Nursery Supplies purchased a new desktop computer, serial number P2602MAS69, for use in the office. The computer was installed and put into operation immediately. Computers are depreciated at 30 per cent per annum using the straight-line method.

On 1 December 2012, Springfield Nursery Supplies purchased a 2012 model Isuzu truck, registration number SNS17, from Maroondah Trucks. The truck was delivered that day and put into operation immediately. The business depreciates motor vehicles at 22.5 per cent per annum using the reducing-balance method.

#### Additional information

##### 2012

- |            |  |
|------------|--|
| 1 October  | <ul style="list-style-type: none"> <li>• Invoice cost of the desktop computer System from WWW Computer Systems – \$3,410 (GST inclusive).</li> <li>• Installation and configuration of the computer system on the new machine by WWW Computer Systems – \$198 (GST inclusive).</li> <li>• Installation of additional memory and software to enhance the new computer's abilities – \$814 (GST inclusive), payable to IT Computing.</li> <li>• Annual insurance premium of \$264 (GST inclusive) paid to Colonial Insurance.</li> </ul> |
| 1 December | <ul style="list-style-type: none"> <li>• Invoice cost of the Isuzu truck from Maroondah Trucks – \$34,100 (GST inclusive).</li> <li>• Dealer delivery fee – \$726 (GST inclusive).</li> <li>• Annual registration paid to VicRoads – \$550 (no GST).</li> <li>• Annual insurance paid to GIO Insurance – \$1,100 (GST inclusive).</li> </ul>   |

##### 2013

- |             |  |
|-------------|--|
| 21 January  | 1,500 km service on truck by Maroondah Trucks under warranty (no cost).                                    |
| 15 April    | Replacement of computer video card (in the new computer) under warranty by WWW Computer Systems (no cost). |
| 20 April    | 5,000 km service on truck by Maroondah Trucks – \$440 (GST inclusive).                                     |
| 30 June     | Balance day.   |
| 27 July     | 10,000 km service on truck by Maroondah Trucks – \$715 (GST inclusive).                                    |
| 1 September | Repairs to CD-ROM drive on the new computer by MG Electronics – \$132 (GST inclusive).                     |
| 1 October   | Annual insurance premium for computer system paid to Colonial Insurance – \$286 (GST inclusive).           |
| 4 November  | 15,000 km service on truck by Maroondah Trucks – \$484 (GST inclusive).                                    |
| 26 November | Annual registration on truck paid to VicRoads – \$561 (no GST).  |
| 29 November | Annual insurance on truck paid to GIO Insurance – \$1,111 (GST inclusive).                                 |

*continued ...*

... continued

**2014**

|             |   |
|-------------|---|
| 26 February | 20,000 km service on truck by Maroondah Trucks – \$660 (GST inclusive). |
| 9 March     | Service on new computer by IT Computing – \$99 (GST inclusive).         |
| 30 June     | Balance day.  |
| 4 July      | 25,000 km service on truck by Maroondah Trucks – \$451 (GST inclusive). |

**2015**

|         |  |
|---------|--|
| 1 March | Isuzu truck sold to Simpson Trucking on 30 days credit for \$18,150 (GST inclusive). |
| 30 June | Balance day.   |

1. Complete the asset register cards for both the computer system and the truck.
2. Record the capital costs of the new desktop computer and Isuzu truck into the general ledger asset accounts as balances at 30 June 2013.
3. Show the general journal entries to record depreciation of the assets for the years ended 30 June 2013 and 2014.
4. Show the general journal entries to record the disposal of the Isuzu truck.
5. Post the general journal entries applicable for the following general ledger accounts:
  - Desktop computer
  - Depreciation – desktop computer
  - Accumulated depreciation – desktop computer
  - Isuzu truck
  - Depreciation – Isuzu truck
  - Accumulated depreciation – Isuzu truck
  - Disposal of Isuzu truck
  - Loss on disposal of Isuzu truck



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## Topic 2

# Record general journal entries for balance-day adjustments

The end of an accounting period is called balance day. Generally, an accounting period lasts for one year and ends on 31 December (calendar year) or 30 June (financial year).

On balance day, it is necessary to calculate the profit or loss made for the year and prepare two major financial reports:

- Income (profit and loss) statement
- Statement of financial position

In this topic you will learn how to:

- 2A Understand balance-day activities
- 2B Adjust the accounts for depreciation, prepayments and accruals on balance day
- 2C Record bad and doubtful debts at balance day
- 2D Adjust ledger accounts for inventories and leave at balance day

## 2A

### Understand balance-day activities

To calculate profit or loss, the revenue earned by the business is matched against the expenses incurred. If the revenue exceeds the expenses, the business has made a profit; if the expenses are greater, a loss has been incurred.

The activities that must be performed at balance day are illustrated in this flow chart.



### Role of the accountant

It is the accountant's objective to measure, as accurately as possible, the profit or loss earned by the business during an accounting period. In order to do this you have to match, as closely as possible, the revenue earned during the period with the associated expenses of that period.

Accrual accounting is the accounting practice used by most businesses. Accrual accounting is based on the matching principle; that is, it relies on the accurate matching of the revenue earned in a period with the expenses incurred to generate that revenue.

Revenue is earned when the transaction takes place, rather than when the cash is collected. Expenses are recognised in the period in which they are incurred, not when they are actually paid. Therefore, profit is calculated as the revenue recognised in the period less the expenses incurred in earning that revenue. Matching revenue and expenses in this way provides a more accurate account of the operating performance of a business than the alternative – the cash basis of accounting.



## Allocate expenses to the correct period

Up to the trial balance stage, it is assumed that the expenses paid during an accounting period correspond exactly to the amounts due to be paid during that period. For example, if the profit is being calculated for the year ended 30 June 2016, it is assumed that the rent paid and recorded in the rent account is exactly the amount that was due for that period. However, in reality it is likely that some of the rent will have been paid in advance for the next period. Other expenses, such as wages and electricity, may have been incurred but may not be paid until after the end of the current accounting period.



Accountants assume that a business is a profitable concern. In the absence of clear evidence to the contrary, the business will continue operating beyond the end of the accounting period. Because of this, certain transactions may overlap accounting periods.

Therefore, revenue and expenses received or paid within a period may not necessarily relate to that particular accounting period. All or part may apply to the accounting period before, or after, the period in which it was actually received or paid.

### Practice task 4

Explain the accounting activities that must be performed at the end of each accounting period – on balance day.

## 2B

### Adjust the accounts for depreciation, prepayments and accruals on balance day

While accrual accounting provides an accurate picture of profitability, its accuracy depends on certain adjustments being made prior to the preparation of the financial statements. Therefore, it is very important that adjustments be made to certain revenue and expenses in order to show a true net profit for the accounting period.

These adjustments are referred to as balance-day adjustments and there are a number to be considered.

#### Balance-day adjustments to be considered

- Accrued expenses
- Prepaid expenses
- Accrued revenue
- Prepaid revenue
- Depreciation
- Bad and doubtful debts
- Stock on hand at the end of the accounting period
- Annual leave
- Long service leave

### Accrued expenses

Accrued expenses are those that have been incurred in the current accounting period but not paid by the end of the period. For example, salaries and wages are an expense that is often incurred but not paid as of balance day, because the end of the accounting period may fall midway through a pay period.

#### Example: accrued expenses

At MLMA Corporation, wages paid to 27 June 2016 totalled \$35,000 (as disclosed by the salaries and wages expense account), and a further \$1,000 was incurred but not paid for the period 28 to 30 June. The balance day is 30 June 2016.

As the benefit of the labour was received in the current period, it must be recognised as an expense of that period.

An adjustment is necessary at balance day to:

- recognise the expense incurred of \$1,000 for the period 28 to 30 June 2016
- create a liability account (accrued expenses) to recognise the \$1,000 owing at 30 June 2016.

*continued ...*

... continued

| General journal |  |       |          |           |  |
|-----------------|--|-------|----------|-----------|--|
| Date            | Particulars                                    | Folio | Debit \$ | Credit \$ |  |
| 30/6/16         | Salaries and wages expense                     |       | 1,000    |           |  |
|                 | Accrued expenses                               |       |          | 1,000     |  |
|                 | <i>Wages owing but not paid at balance day</i> |       |          |           |  |

The balance for the salaries and wages expense account would now be \$36,000 (\$35,000 + \$1,000), being the correct salaries and wages expense for the current accounting period. This adjusted amount will then be transferred to a profit and loss account.

The accrued expenses account will appear as a current liability in the current period's statement of financial position, as it represents a short-term liability that will be paid early in the next accounting period.

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger                    |                                 |          |          |           |            |
|-----------------------------------|---------------------------------|----------|----------|-----------|------------|
| Date                              | Particulars                     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Salaries and wages expense</b> |                                 |          |          |           |            |
| 30/6/16                           | Balance (wages paid to 27/6/15) |          |          |           | 35,000 Dr  |
|                                   | Accrued expenses                | GJ       | 1,000    |           | 36,000 Dr  |
| <b>Accrued expenses</b>           |                                 |          |          |           |            |
| 30/6/16                           | Salaries and wages expense      | GJ       |          | 1,000     | 1,000 Cr   |

## Prepaid expenses

Prepaid expenses are expenses that have been paid in the current accounting period but relate to the next financial year. This results in an overstatement of expenses for the current period as the payment of the expenses will be recorded in the current period. For example, insurance is an expense that is often paid in advance.

## Example: prepaid expenses

MLMA Corporation paid a \$1,320 (GST inclusive) insurance premium for 12 months on 1 April 2016. The balance day is 30 June 2016.

The adjustment necessary is the proportion applicable to the next accounting period; that is, nine months (1 July to 31 March), as only three months of the premium (1 April to 30 June) are applicable to the current year. (Note: GST is not an expense, is claimed in the current accounting period and does not require adjustment.)

The calculation required to determine the amount to be adjusted is as follows:

Insurance premium (\$1,320) – GST (\$120) = Annual insurance expense (\$1,200)

Monthly expense: \$1,200/12 = \$100

An adjustment is necessary at balance day to:

- reduce the expense in this accounting period for the nine months that have been prepaid (9 x \$100 = \$900)
- create an asset account (prepaid expenses) to recognise the \$900 that has been prepaid for the next accounting period.

| General journal |                                  |       |             |              |
|-----------------|----------------------------------|-------|-------------|--------------|
| Date            | Particulars                      | Folio | Debit<br>\$ | Credit<br>\$ |
| 30/6/16         | Prepaid expenses                 |       | 900         |              |
|                 | Insurance expense                |       |             | 900          |
|                 | <i>Insurance paid in advance</i> |       |             |              |

The balance for the insurance expense account would now be \$300 (\$1,200 – \$900), being the correct insurance expense for the current accounting period. This adjusted amount will then be transferred to a profit and loss account.

The prepaid expenses account will appear as a current asset in the current period's statement of financial position, as it represents a short-term asset that will be used in the next accounting period.

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger           |                   |             |             |              |               |
|--------------------------|-------------------|-------------|-------------|--------------|---------------|
| Date                     | Particulars       | Jnl<br>ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
| <b>Insurance expense</b> |                   |             |             |              |               |
| 1/4/16                   | Bank              |             | 1,200       |              | 1,200 Dr      |
| 30/6/16                  | Prepaid expenses  | GJ          |             | 900          | 300 Dr        |
| <b>Prepaid expenses</b>  |                   |             |             |              |               |
| 30/6/16                  | Insurance expense | GJ          | 900         |              | 900 Dr        |

## Accrued revenue

Accrued revenue is revenue that has been earned in the current accounting period but not received as at the end of the accounting period. Examples of accrued revenue include commission revenue, dividends revenue and interest revenue on investments earned and not received or recorded as owing to the business.

### Example: accrued revenue

At MLMA Corporation, the commission earned to 25 June 2016 was \$3,500, as disclosed by the commission revenue account. A further \$1,000 was earned but had not been received as at 30 June.

As the commission was earned in the current period, it must be recognised as a revenue item for that period. The balance day is 30 June 2016.

An adjustment is necessary at balance day to:

- record the revenue earned in this accounting period (\$1,000)
- create an asset account (accrued revenue) to recognise the \$1,000 that is owed to the organisation; accrued revenue can be likened to a debtor account.

| General journal |   |       |          |           |
|-----------------|---|-------|----------|-----------|
| Date            | Particulars                                   | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Accrued revenue                               |       | 1,000    |           |
|                 | Commission revenue                            |       |          | 1,000     |
|                 | <i>Commission earned but not yet received</i> |       |          |           |

The balance for the commission revenue account would now be \$4,500 (\$3,500 + \$1,000), being the correct commission revenue for the current accounting period. This adjusted amount will then be transferred to a profit and loss account.

The accrued revenue account will appear as a current asset in the current period's statement of financial position, as it represents a short-term asset that will be converted to cash in the next accounting period.

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger            |                    |          |          |           |            |
|---------------------------|--------------------|----------|----------|-----------|------------|
| Date                      | Particulars        | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Commission revenue</b> |                    |          |          |           |            |
| 25/6/16                   | Balance            |          |          |           | 3,500 Cr   |
| 30/6/16                   | Accrued revenue    | GJ       |          | 1,000     | 4,500 Cr   |
| <b>Accrued revenue</b>    |                    |          |          |           |            |
| 30/6/16                   | Commission revenue | GJ       | 1,000    |           | 1,000 Dr   |

## Prepaid revenue

Prepaid revenue is revenue that has been received in the current accounting period but not yet been earned as at the end of the accounting period. For example, rent earned on a rental property may have been received in advance for the following period.

Where revenue has been received in advance, the revenue account must be reduced to ensure the account only includes income for the current period and the amount received in advance is recorded as a liability; that is, owing to the person or organisation that paid in advance.



### Example: prepaid revenue

Rent received to 15 June 2016 was \$12,500, as disclosed by the rent revenue account. The last receipt of \$1,000 on 15 June was for rent in advance to 15 July.

The adjustment on balance day (30 June 2016) would be \$500 for the period 1 July–15 July, representing the period that has been received in advance; that is, two weeks in advance.

An adjustment is necessary at balance day to:

- reduce the revenue recorded in this accounting period (\$500)
- create a liability account (prepaid revenue) to recognise the \$500 rental value that has been received in advance. (This account is a liability account because income has been received without being earned. If the tenant vacated on 30 June, they would be owed the unused rent.)

| General journal |   |       |          |           |
|-----------------|---|-------|----------|-----------|
| Date            | Particulars                             | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Rent revenue                            |       | 500      |           |
|                 | Prepaid revenue                         |       |          | 500       |
|                 | <i>Rent revenue received in advance</i> |       |          |           |

The balance for the rent revenue account would now be \$12,000 (\$12,500 – \$500), being the correct rent revenue for the current accounting period. This adjusted amount will then be transferred to a profit and loss account.

The prepaid revenue account will appear as a current liability in the current period's statement of financial position, as it represents a short-term liability that will be eliminated in the next accounting period.

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

*continued ...*

... continued

| General ledger         |                 |          |          |           |            |
|------------------------|-----------------|----------|----------|-----------|------------|
| Date                   | Particulars     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Rent revenue</b>    |                 |          |          |           |            |
| 15/6/15                | Balance         |          |          |           | 11,500 Cr  |
|                        | Bank            |          |          | 1,000     | 12,500 Cr  |
| 30/6/15                | Prepaid revenue | GJ       | 500      |           | 12,000 Cr  |
| <b>Prepaid revenue</b> |                 |          |          |           |            |
| 30/6/15                | Rent revenue    | GJ       |          | 500       | 500 Cr     |

## Depreciation

As depreciation is normally recorded at balance day, it is regarded as a balance-day adjustment, part of the process of ensuring that all expenses incurred for the current accounting period are recorded and that the assets are reported at their written-down value.

Depreciation is the allocation of the capital cost of an asset over its estimated useful life. The two most commonly used ways of calculating depreciation are the straight-line and reducing-balance methods.



### Example: depreciation

Wizard Printing purchased a new printing press on 1 July 2014 at a capital cost of \$80,000. It is anticipated that the printing press will have an estimated useful life of 10 years, with no residual value. Depreciation is to be calculated at 10 per cent per annum on cost (straight-line method).

Wizard Printing also purchased a new motor vehicle on 1 July 2014 at a capital cost of \$40,000. Depreciation is to be calculated at 25 per cent per annum by the reducing-balance method. The accumulated depreciation as at 30 June 2015 was \$10,000.

The general journal entries need to be prepared and posted to the general ledger for the accounting period ending 30 June 2016.

**Depreciation: printing press**

Calculation of depreciation at 30 June 2016: \$80,000 (capital cost) x 10% = \$8,000

**Depreciation: motor vehicle**

Written-down value at 30 June 2015: \$40,000 (capital cost) – \$10,000 (accumulated depreciation) = \$30,000

Calculation of depreciation at 30 June 2016: \$30,000 x 25% = \$7,500

continued ...

... continued

| General journal |  |       |          |           |
|-----------------|--|-------|----------|-----------|
| Date            | Particulars  | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Depreciation expense – printing press                                |       | 8,000    |           |
|                 | Accumulated depreciation – printing press                            |       |          | 8,000     |
|                 | <i>Annual depreciation calculated at 10% straight-line method</i>    |       |          |           |
| 30/6/16         | Depreciation expense – motor vehicle                                 |       | 7,500    |           |
|                 | Accumulated depreciation – motor vehicle                             |       |          | 7,500     |
|                 | <i>Annual depreciation calculated at 25% reducing-balance method</i> |       |          |           |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger                                   |   |          |          |           |            |
|--|---|----------|----------|-----------|------------|
| Date   | Particulars                               | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Depreciation expense – printing press</b>     |   |          |          |           |            |
| 30/6/16  | Accumulated depreciation – printing press | GJ       | 8,000    |           | 8,000 Dr   |
| <b>Accumulated depreciation – printing press</b> |   |          |          |           |            |
| 30/6/15  | Balance                                   |          |          |           | 8,000 Cr   |
| 30/6/16  | Depreciation – printing press             | GJ       |          | 8,000     | 16,000 Cr  |
| <b>Depreciation expense – motor vehicle</b>      |   |          |          |           |            |
| 30/6/15  | Accumulated depreciation – motor vehicle  | GJ       | 7,500    |           | 7,500 Dr   |
| <b>Accumulated depreciation – motor vehicle</b>  |   |          |          |           |            |
| 30/6/16  | Balance                                   |          |          |           | 10,000 Cr  |
| 30/6/16  | Depreciation – motor vehicle              | GJ       |          | 7,500     | 17,500 Cr  |

## Practice task 5

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.



1. Precision Engineering received a rates notice for \$600 (nil GST) for the 12 months ending 31 March 2016. As at balance day, 30 June 2015, Precision Engineering had not yet paid this account. Prepare and post the general journal entry to record the accrued expense for rates as at 30 June 2015. Post this general journal entry to the relevant general ledger accounts.
2. On 1 October 2014, Precision Engineering paid 12 months' internet access of \$1,650 (including GST) for the year ending 30 September 2015. Prepare and post the general journal entry to record the prepaid expense for internet access as at 30 June 2015. Post this general journal entry to the relevant general ledger accounts.
3. Precision Engineering has been notified that a dividend payment on its share investment has been declared. As at balance day, 30 June 2015, the dividend of \$1,000 had not yet been received. Prepare and post the general journal entry to record the accrued revenue as at 30 June 2015. Post this general journal entry to the relevant general ledger accounts.
4. On 28 June 2015, Precision Engineering entered into a contract with a client for work to commence on 1 July 2015. The client has paid Precision Engineering an advance/deposit of \$2,000. Prepare and post the general journal entry to record the prepaid revenue as at 30 June 2015. Post this general journal entry to the relevant general ledger accounts.
5. Suzi's Pottery purchased a new pottery wheel on 1 July 2014 at a capital cost of \$2,000. It is anticipated that the pottery wheel will have an estimated useful life of five years with no residual value. Depreciation is to be calculated at 20 per cent per annum on cost (straight-line method).  
Suzi's Pottery also purchased a new motor vehicle on 1 July 2012 at a capital cost of \$25,000. Depreciation is calculated at 20 per cent per annum reducing-balance method. The accumulated depreciation as at 30 June 2014 was \$9,000.  
Prepare and post the general journal entries to record the depreciations as at 30 June 2015. Post these general journal entries to the relevant general ledger accounts.

# 2C

## Record bad and doubtful debts at balance day

An organisation may decide to write off an amount that is owed by a debtor if it is deemed to be irrecoverable due to bankruptcy or other reasons. The writing off of a bad debt is an expense to the business and is only done when all other avenues of debt collection have been exhausted, with no chance of recovering the money from the debtor.



### Bad debts

Bad debts are written off during the year as they occur. However, an organisation may analyse its debtors' balances at the end of the year to decide whether any further debtors need to be written off. The writing off of debtors at balance day is referred to as 'additional bad debts'. The accounting entries for additional bad debts are the same as for bad debts during the year, as shown in this example.

### Example: record a bad debt

A business receives a letter on 15 September 2015 from Browne, Black & Co. Solicitors informing it that debtor P McKenna has been declared bankrupt, with no possibility of recovering the money owed. P McKenna's account has an outstanding balance of \$550 (including GST). The total value of debtors at this time is \$8,000. The GST payable account has a balance of \$1,200 credit.

The debt is written off, as follows.

| General journal |   |       |             |              |
|-----------------|---|-------|-------------|--------------|
| Date            | Particulars   | Folio | Debit<br>\$ | Credit<br>\$ |
| 15/9/15         | Bad debts   |       | 500         |              |
|                 | GST payable   |       | 50          |              |
|                 | Trade debtors control   |       |             | 550          |
|                 | <i>Bad debt write-off. P McKenna declared bankrupt as per letter received from solicitors 15/9/15</i> |       |             |              |

The bad debts expense account will now have a balance of \$500. The GST payable account has now been reduced by \$50, effectively reversing the GST charged on the original sale/s. The balance for the trade debtors control account will now be \$7,450 (\$8,000 - \$550).

The general ledger accounts, after the entry above has been posted, will be as follows.

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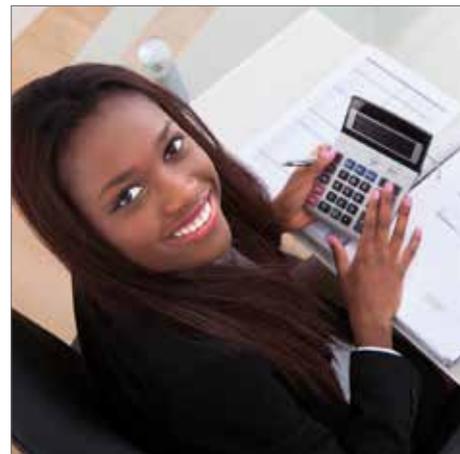
| General ledger               |                           |          |          |           |            |
|------------------------------|---------------------------|----------|----------|-----------|------------|
| Date                         | Particulars               | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Bad debts</b>             |                           |          |          |           |            |
| 15/9/15                      | Trade debtors control     | GJ       | 500      |           | 500 Dr     |
| <b>GST payable</b>           |                           |          |          |           |            |
| 15/9/15                      | Balance                   |          |          |           | 1,200 Cr   |
|                              | Trade debtors control     | GJ       | 50       |           | 1,150 Cr   |
| <b>Trade debtors control</b> |                           |          |          |           |            |
| 15/9/15                      | Balance                   |          |          |           | 8,000 Dr   |
|                              | Bad debts and GST payable | GJ       |          | 550       | 7,450 Dr   |

## Doubtful debts

Remember that your aim is to measure, as accurately as possible, the profit or loss earned by your organisation during an accounting period. In order to do this you must match, as closely as possible, the revenue earned during the period with the associated expenses of that period.

When goods are sold on credit, there is always the risk of the debtor not paying the amount due. This may not become evident until a later accounting period. Therefore, the bad debt expense would not be matched with the revenue earned in the accounting period in which the original sale occurred.

It is standard practice to estimate the value of debts that are unlikely to be collected in the future from credit sales made in the current accounting period. This estimate is referred to as 'doubtful debts' and is recorded as an expense in the current accounting period to be matched against the revenue earned from the sale in that period.



## Example: handle a doubtful debt

An organisation has trade debtors totalling \$30,000 at 30 June 2015. Based on past experience, the organisation estimates that two per cent of the outstanding debts will prove uncollectable.

This means that the expected benefit from the current accounting period's outstanding sales will not be the full \$30,000, but is estimated to be only \$29,400 (\$30,000 less two per cent). The organisation needs to make a provision for these doubtful debts of \$600 in the current accounting period.

An adjustment is necessary at balance day (30 June) to:

- record the doubtful debts expense of \$600
- create a provision for doubtful debts account for \$600 (this account is a negative asset that is deducted from the statement of financial position value of trade debtors in order to show a more realistic amount owed to the organisation).

| General journal |   |       |             |              |
|-----------------|---|-------|-------------|--------------|
| Date            | Particulars   | Folio | Debit<br>\$ | Credit<br>\$ |
| 30/6/15         | Doubtful debts<br><br>Provision for doubtful debts<br><br><i>Provide for 2% of closing debtors estimated to be doubtful</i> |       | 600         | 600          |

The doubtful debts expense account will now have a debit balance of \$600. This expense account will then be transferred to a profit and loss account. The provision for doubtful debts account will now have a credit balance of \$600.

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger                      |                              |             |             |              |               |
|-------------------------------------|------------------------------|-------------|-------------|--------------|---------------|
| Date                                | Particulars                  | Jnl<br>ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
| <b>Doubtful debts</b>               |                              |             |             |              |               |
| 30/6/15                             | Provision for doubtful debts | GJ          | 600         |              | 600 Dr        |
| <b>Provision for doubtful debts</b> |                              |             |             |              |               |
| 30/6/15                             | Doubtful debts               | GJ          |             | 600          | 600 Cr        |

## Age analysis

In the previous example, the estimate of the doubtful debts was based on a percentage of the closing debtors balance as at balance day. An alternative way to estimate the doubtful debts is to prepare an age analysis of the debtors.

An age analysis classifies debtors according to how long their accounts have been outstanding. The classifications are usually broken down into 0 to 30 days, 31 to 60 days, 61 to 90 days and 91 days and over.

A percentage of debtors unlikely to pay is estimated for each classification and totalled to determine the overall doubtful debts. A higher percentage is attributed to the older outstanding debts, as they have a greater likelihood of being uncollectable.



## Record bad and doubtful debts

By recording doubtful debts as an expense of this accounting period, expenses have been matched to revenue earned in this accounting period.

If your estimate of doubtful debts actually becomes bad debts in the future, you must ensure that you do not record this expense a second time, but rather offset the bad debts against the amount of doubtful debts provided for from the previous accounting period. This is in effect using the amount set aside or provided for doubtful debts that go bad.

### Example: record bad and doubtful debts

The following information is provided for the business of Toowey Pty Ltd on 30 June 2016:

- Debtors balance prior to any additional bad debts is \$36,880.
- Bad debts written off during the year total \$500.
- Toowey, after reviewing debtors, decided to write off an additional amount of \$880. Note that GST was included in the original sale.
- The provision for doubtful debts that had been provided for at the last balance day (30 June 2015) was \$1,500.
- After reviewing the history of previous debt collections, it was estimated that five per cent of debts might prove to be uncollectable.

*continued ...*

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**Step 1: To record the additional bad debts at balance day, an adjustment is necessary to:**

- recognise the additional bad debts expense of \$800
- reverse or reduce the GST payable by \$80
- reduce the value of the trade debtors control account by \$880.

| General journal – Toowey Pty Ltd |  |       |             |              |
|----------------------------------|--|-------|-------------|--------------|
| Date                             | Particulars  | Folio | Debit<br>\$ | Credit<br>\$ |
| 30/6/16                          | Bad debts  |       | 800         |              |
|                                  | GST payable  |       | 80          |              |
|                                  | Trade debtors control                                  |       |             | 880          |
|                                  | <i>Additional bad debts written off at balance day</i> |       |             |              |

- The bad debts expense account will now have a balance of \$1,300 (\$500 written off during the year + \$800 additional bad debts at balance day).
- The GST payable account has now been reduced by \$80, effectively reversing the GST charged on the original sale/s.
- The balance for the trade debtors control account would now be \$36,000 (\$36,880 – \$880).

The general ledger accounts, after the entry above has been posted, will be as follows.

| General ledger – Toowey Pty Ltd |                                   |             |             |              |               |
|---------------------------------|-----------------------------------|-------------|-------------|--------------|---------------|
| Date                            | Particulars                       | Jnl<br>ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
| <b>Trade debtors control</b>    |                                   |             |             |              |               |
| 30/6/16                         | Balance                           |             |             |              | 36,880 Dr     |
|                                 | Bad debts and GST payable         | GJ          |             | 880          | 36,000 Dr     |
| <b>Bad debts</b>                |                                   |             |             |              |               |
| 30/6/16                         | Balance (written off during year) |             |             |              | 500 Dr        |
|                                 | Trade debtors control             | GJ          | 800         |              | 1,300 Dr      |
| <b>GST payable</b>              |                                   |             |             |              |               |
| 30/6/16                         | Balance (assumed)                 |             |             |              | 2,000 Cr      |
|                                 | Trade debtors control             | GJ          | 80          |              | 1,920 Cr      |

continued ...

... continued

**Step 2: Transfer the balance of the bad debts expense account to the provision for doubtful debts account, as this represents the amount of the provision actually used.**

| General journal – Toowey Pty Ltd |  |       |             |              |
|----------------------------------|--|-------|-------------|--------------|
| Date                             | Particulars  | Folio | Debit<br>\$ | Credit<br>\$ |
| 30/6/16                          | Provision for doubtful debts                                     |       | 1,300       |              |
|                                  | Bad debts  |       |             | 1,300        |
|                                  | <i>Transfer of bad debts to the provision for doubtful debts</i> |       |             |              |

- The bad debts expense account will now have a nil balance and the provision for doubtful debts will be reduced by \$1,300. As the existing balance in the provision for doubtful debts account from the previous year was \$1,500, the balance will now be \$200 (\$1,500 – \$1,300). This \$200 balance represents the amount by which the company had 'over-provided' or overestimated the value of debts that were likely to prove uncollectable.

The general ledger accounts, after the entry above has been posted, will be as follows.

| General ledger – Toowey Pty Ltd     |  |             |             |              |               |
|-------------------------------------|--|-------------|-------------|--------------|---------------|
| Date                                | Particulars                            | Jnl<br>ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
| <b>Trade debtors control</b>        |  |             |             |              |               |
| 30/6/16                             | Balance                                |             |             |              | 36,880 Dr     |
|                                     | Bad debts and GST payable              | GJ          |             | 880          | 36,000 Dr     |
| <b>Bad debts</b>                    |  |             |             |              |               |
| 30/6/16                             | Balance (written off during year)      |             |             |              | 500 Dr        |
|                                     | Trade debtors control                  | GJ          | 800         |              | 1,300 Dr      |
|                                     | Provision for doubtful debts           | GJ          |             | 1,300        | Nil           |
| <b>GST payable</b>                  |  |             |             |              |               |
| 30/6/16                             | Balance (assumed)                      |             |             |              | 2,000 Cr      |
|                                     | Trade debtors control                  | GJ          | 80          |              | 1,920 Cr      |
| <b>Provision for doubtful debts</b> |  |             |             |              |               |
| 30/6/15                             | Doubtful debts (last year's provision) |             |             | 1,500        | 1,500 Cr      |
| 30/6/16                             | Bad debts                              | GJ          | 1,300       |              | 200 Cr        |

- When the value of bad debts for this current period has been transferred to the provision for doubtful debts account, \$200 remains in the provision for doubtful debts account. This represents an over-provision or the amount by which the organisation's future bad debts last year were overestimated. The \$200 will be carried over to become part of the calculation for this year's provision for doubtful debts, as shown in Step 3.

continued ...

... continued

**Step 3: Estimate and record the provision for doubtful debts for this accounting period.**

Toowey has estimated that five per cent of its current debtors may not pay their accounts in the future. The estimate is calculated on the trade debtors control account balance as at balance day after adjustments have been made for the additional bad debts.

Provision for doubtful debts:  $\$36,000 \times 5\% = \$1,800$

The general journal entry to record the provision is as follows:

- The doubtful debts expense is only recorded at \$1,600 (\$1,800 – \$200), as the expense last year was overstated by \$200 and therefore cannot be included again as an expense this year. The doubtful debts expense amount of \$1,600 will be transferred to a profit and loss account.
- The provision for doubtful debts is calculated above to be \$1,800, but because there is already a balance of \$200 unused from last year in the provision for doubtful debts account, the company only needs to increase (credit) the account with the difference (\$1,600).

| General journal – Toowey Pty Ltd |   |       |          |           |
|----------------------------------|---|-------|----------|-----------|
| Date                             | Particulars   | Folio | Debit \$ | Credit \$ |
| 30/6/16                          | Doubtful debts  |       | 1,600    |           |
|                                  | Provision for doubtful debts                                      |       |          | 1,600     |
|                                  | <i>Provide for 5% of closing debtors estimated to be doubtful</i> |       |          |           |

The general ledger accounts, after the entry above has been posted, will be as follows.

| General ledger – Toowey Pty Ltd     |  |          |          |           |            |
|-------------------------------------|--|----------|----------|-----------|------------|
| Date                                | Particulars                            | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Trade debtors control</b>        |  |          |          |           |            |
| 30/6/16                             | Balance                                |          |          |           | 36,880 Dr  |
|                                     | Bad debts and GST payable              | GJ       |          | 880       | 36,000 Dr  |
| <b>Bad debts</b>                    |  |          |          |           |            |
| 30/6/16                             | Balance (written off during year)      |          |          |           | 500 Dr     |
|                                     | Trade debtors control                  | GJ       | 800      |           | 1,300 Dr   |
|                                     | Provision for doubtful debts           | GJ       |          | 1,300     | Nil        |
| <b>GST payable</b>                  |  |          |          |           |            |
| 30/6/16                             | Balance (assumed)                      |          |          |           | 2,000 Cr   |
|                                     | Trade debtors control                  | GJ       | 80       |           | 1,920 Cr   |
| <b>Provision for doubtful debts</b> |  |          |          |           |            |
| 30/6/15                             | Doubtful debts (last year's provision) |          |          | 1,500     | 1,500 Cr   |
| 30/6/16                             | Bad debts                              | GJ       | 1,300    |           | 200 Cr     |
|                                     | Doubtful debts                         | GJ       |          | 1,600     | 1,800 Cr   |
| <b>Doubtful debts</b>               |  |          |          |           |            |
| 30/6/16                             | Provision for doubtful debts           | GJ       | 1,600    |           | 1,600 Dr   |

## Adjustments for overestimating or underestimating doubtful debts

In the previous example, the provision for doubtful debts account at balance day 30 June 2015 was \$1,500 Cr. During the year ended 30 June 2016, \$1,300 of this amount was written off as bad debts. This resulted in the provision account showing a \$200 Cr balance. This indicates that the amount of doubtful debts had been overestimated at 30 June 2015.

At 30 June 2016, the total of the provision for doubtful debts account had to be \$1,800 Cr. As the account already contained the \$200 amount that was over-provided from the previous year, an adjustment of \$1,600 was required to bring the balance of the account to \$1,800 Cr.



In other words, although the doubtful debts expense for 2016 was calculated to be \$1,800, the company had to reduce it by the amount overestimated from 2015 (\$200). Therefore, the doubtful debts expense for 2016 will only be \$1,600.

It is unlikely that a business would accurately estimate its doubtful debts and, as such, an over- or under-provision is likely to occur. As you have seen in the previous example, any discrepancy will be adjusted in the following year at balance day once the actual bad debts are known.

## Summary of accounting entries for bad and doubtful debts

Here is a summary of accounting entries for bad and doubtful debts.

### Step 1

#### Step 1: Write off additional bad debts at balance day

Dr: Bad debts  
Dr: GST payable  
Cr: Trade debtors control

### Step 2

#### Step 2: Transfer the balance in the bad debts account to the provision for doubtful debts account

Dr: Provision for doubtful debts  
Cr: Bad debts

**Step 3****Step 3: Estimate and record the provision for doubtful debts for the current accounting period**

If an over-provision last year:

Dr: Doubtful debts

Cr: Provision for doubtful debts

Note that the amount estimated will be reduced by last year's over-provision.

If an under-provision last year:

Dr: Doubtful debts

Cr: Provision for doubtful debts

Note that the amount estimated will be increased by last year's under-provision.

**Practice task 6**

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

From the following information provided by H Simpson, prepare and post the general journal entries for additional bad debts and doubtful debts at 30 June 2016. Post these entries to the relevant accounts in the general ledger.

- Trade debtors balance prior to any additional bad debts written off is \$53,520.
- Bad debts written off during the year totalled \$800.
- Additional bad debts of \$1,320 are to be written off at balance day. Note that GST was included in the original sales (GST payable balance at 30 June 2016 is \$620 credit).
- The provision for doubtful debts at the end of the previous year (30 June 2015) was \$1,755.
- H Simpson requires the provision for doubtful debts to be 2.5 per cent of trade debtors.



## 2D Adjust ledger accounts for inventories and leave at balance day

Trading stock, sometimes referred to as inventory, consists of the goods an organisation buys from suppliers and sells to its customers. On balance day, the organisation performs a manual stocktake to ascertain the value of the trading stock that is on hand and available for sale in the next accounting period.

Purchases of trading goods are recorded in the purchases expense account. In accordance with the accrual accounting concept, purchases are recognised in the period in which they are incurred. At the end of the accounting period, the organisation may still have some of these trading goods in stock. In other words, the organisation now has an unused purchases expense for this accounting period.

Those goods still in stock will be sold in the next accounting period so the expense should be identified and recorded in the next accounting period.

For the current accounting period, you may expect that the purchases expense will be reduced by the value of the items still in stock to accurately reflect the actual expense incurred. Although this is in principle correct, it is common accounting practice to record this unused expense in an account called the trading account. By using this account you will, in effect, be indirectly reducing the purchases expense.

### Example: trading stock

At balance day, as a result of a stocktake, it was established that there was \$3,000 worth of trading stock on hand (unsold).

An adjustment is necessary at balance day (30 June 2016) to:

- record the unsold stock in an asset account called stock or inventory
- record the reduction in purchases expense through the trading account.

| General journal |   |       |          |           |
|-----------------|---|-------|----------|-----------|
| Date            | Particulars   | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Stock<br>Trading<br><i>Record closing stock as at balance day</i> |       | 3,000    | 3,000     |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger |             |          |          |           |            |
|----------------|-------------|----------|----------|-----------|------------|
| Date           | Particulars | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Stock</b>   |             |          |          |           |            |
| 30/6/16        | Trading     | GJ       | 3,000    |           | 3,000 Dr   |
| <b>Trading</b> |             |          |          |           |            |
| 30/6/16        | Stock       | GJ       |          | 3,000     | 3,000 Cr   |

## Stocks of sundry items

An organisation may need to purchase items, such as cleaning supplies or stationery, to be used during the accounting period. When these are purchased, they are recorded in the applicable expense account; for example, the stationery expense account.

At the end of the accounting period, the organisation may still have some of these items in stock. In other words, the organisation has not used up all the expense in this accounting period. Those items still in stock will be used in the next accounting period so the expense should be identified and recorded in the next accounting period.

For the current accounting period, the recorded expense will need to be reduced by the value of the items still in stock to accurately reflect the actual expense incurred.

### Example: record stocks of sundry items

A company purchased \$1,500 of stationery items during the current accounting period ending 30 June 2016. At balance day, as a result of a stocktake of stationery, it was established that there was \$300 worth of stationery still unused.

An adjustment is necessary at balance day to:

- reduce the stationery expense in this accounting period by \$300
- create an asset account (stock of stationery) to recognise the \$300 value of stationery on hand at balance day.

| General journal |  |       |          |           |
|-----------------|--|-------|----------|-----------|
| Date            | Particulars                              | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Stock of stationery                      |       | 300      |           |
|                 | Stationery expense                       |       |          | 300       |
|                 | <i>Stationery on hand at balance day</i> |       |          |           |

The balance for the stationery expense account would now be \$1,200 (\$1,500 – \$300), being the correct stationery expense for the current accounting period. This adjusted amount will then be transferred to a profit and loss account.

The stock of stationery account will appear as a current asset in the current period's statement of financial position, as it represents a short-term asset that will be used in the next accounting period.

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger             |                     |          |          |           |            |
|----------------------------|---------------------|----------|----------|-----------|------------|
| Date                       | Particulars         | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Stationery expense</b>  |                     |          |          |           |            |
| 30/6/16                    | Balance             |          | 1,500    |           | 1,500 Dr   |
|                            | Stock of stationery | GJ       |          | 300       | 1,200 Dr   |
| <b>Stock of stationery</b> |                     |          |          |           |            |
| 30/6/16                    | Stationery expense  | GJ       | 300      |           | 300 Dr     |

## Provision for annual leave

Annual leave for most employees in Australia is four weeks per annum. For staff employed on a weekly award rate or on an annual salary, the entitlement to annual leave usually accrues after each week of employment and the full entitlement of four weeks of annual leave is available after 12 months of continuous service.

This means that employees will work for 48 weeks of the year and be entitled to four weeks of annual leave, giving a total of 52 weeks of service.

At the end of the accounting period (balance day), you must calculate the annual leave entitlements accrued by employees so you can record the annual leave expense that has been incurred to date. This must be done to ensure the expense is recorded in the period in which it is incurred in accordance with the accrual accounting principle.

An adjustment is necessary to record the expense in the annual leave expense account and to recognise that the organisation has a liability for the unpaid annual leave earned as of balance day.



## Calculate annual leave entitlements

To calculate the annual leave entitlement owing in weeks, use the following formula:

$$\text{Accrued annual leave entitlement} = \frac{\text{No. of weeks worked}}{\text{Working weeks per year}} \times \text{Employee's annual entitlement}$$

To calculate the annual leave entitlement owing in dollars, use the following formula:

$$\text{Annual leave entitlement (\$)} = \text{Accrued leave (weeks)} \times \text{weekly gross pay (\$)}$$

For most employees who have been employed for a full continuous year, the annual leave calculation is simply:

$$\text{Annual leave entitlement (\$)} = 4 \text{ weeks} \times \text{weekly gross pay (\$)}$$

For employees who have not worked the full year, you need to work out their accrued annual leave entitlement in weeks and then multiply it by their weekly gross pay.

## Example: record annual leave

An employee commenced full-time employment with an organisation on 1 December 2015. The gross wage for this employee is \$700 per week. Their annual leave entitlement based on 30 weeks of employment as of balance day (30 June 2016) is as follows:

$$\begin{aligned}
 \text{Accrued annual leave entitlement} &= \frac{\text{No. of weeks worked}}{\text{Working weeks per year}} \times \text{Employee's annual entitlement} \\
 &= \frac{30}{48} \times 4 \text{ weeks} \\
 &= 2.5 \text{ weeks}
 \end{aligned}$$

$$\begin{aligned}
 \text{Annual leave entitlement (\$)} &= \text{Accrued leave (weeks)} \times \text{Gross weekly wage (\$)} \\
 &= 2.5 \text{ weeks} \times \$700 \\
 &= \$1,750
 \end{aligned}$$

An adjustment is necessary at balance day to:

- record the annual leave expense; this is the amount incurred for the current accounting period and will be transferred to a profit and loss account
- record the liability for the unpaid annual leave at balance day in a provision for annual leave account.

| General journal |   |       |          |           |
|-----------------|---|-------|----------|-----------|
| Date            | Particulars                                   | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Annual leave expense                          |       | 1,750    |           |
|                 | Provision for annual leave                    |       |          | 1,750     |
|                 | <i>Annual leave accrued as at balance day</i> |       |          |           |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger                    |                            |          |          |           |            |
|-----------------------------------|----------------------------|----------|----------|-----------|------------|
| Date                              | Particulars                | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Annual leave expense</b>       |                            |          |          |           |            |
| 30/6/16                           | Provision for annual leave | GJ       | 1,750    |           | 1,750 Dr   |
| <b>Provision for annual leave</b> |                            |          |          |           |            |
| 30/6/16                           | Annual leave expense       | GJ       |          | 1,750     | 1,750 Cr   |

## Provision for long service leave

Long service leave is an entitlement awarded to employees in return for continuous active service of 10 years. Long service leave entitlements vary, depending on the relevant award or agreement and state or territory legislation.

It is normal for an organisation to commence making adjustments for the long service leave accrued by employees after five years' service.

An adjustment is necessary to record the expense in the long service leave expense account. This recognises a liability for the accrued long service leave earned as of balance day, and ensures that the expense is recorded in the period in which it is incurred, in accordance with the accrual accounting principle.



At the end of the accounting period (balance day), you need to calculate the long service leave entitlements accrued by employees in order to record the long service leave expense that has been incurred to date.

To calculate the long service leave entitlement owing in weeks, use the following formula:

$$\text{Accrued long service leave entitlement} = \frac{\text{No. of years worked}}{\text{Total years required}} \times \text{Long service leave entitlement}$$

### Example: calculate long service leave entitlements

An employee has been with an organisation for a continuous period of five years. The gross wage for this employee is currently \$700 per week. The total long service leave entitlement is 8.67 weeks after 10 years of employment. The calculation of the adjustment necessary for this employee as of balance day 2015 is as follows:

$$\begin{aligned} \text{Accrued long service leave entitlement} &= \frac{\text{No. of years worked}}{\text{Total years required}} \times \text{Long service leave entitlement} \\ &= \frac{5 \text{ years}}{10 \text{ years}} \times 8.667 \text{ weeks} \\ &= 4.333 \text{ weeks} \\ \text{Long service leave entitlement (\$)} &= \text{Accrued leave (weeks)} \times \text{Gross weekly wage (\$)} \\ &= 4.333 \text{ weeks} \times \$700 \\ &= \$3,033 \end{aligned}$$

An adjustment is necessary at balance day to:

- record the long service leave expense; this records the amount incurred for the current accounting period and will be transferred to a profit and loss account
- record the liability for the accrued long service leave at balance day in a provision for long service leave account.

*continued ...*

... continued

| General journal |   |       |          |           |
|-----------------|---|-------|----------|-----------|
| Date            | Particulars   | Folio | Debit \$ | Credit \$ |
| 30/6/15         | Long service leave expense                          |       | 3,033    |           |
|                 | Provision for long service leave                    |       |          | 3,033     |
|                 | <i>Long service leave accrued as at balance day</i> |       |          |           |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger                          |                                  |          |          |           |            |
|---|----------------------------------|----------|----------|-----------|------------|
| Date                                    | Particulars                      | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Long service leave expense</b>       |                                  |          |          |           |            |
| 30/6/15                                 | Provision for long service leave | GJ       | 3,033    |           | 3,033 Dr   |
| <b>Provision for long service leave</b> |                                  |          |          |           |            |
| 30/6/15                                 | Long service leave expense       | GJ       |          | 3,033     | 3,033 Cr   |

Once an organisation begins to account for an employee's long service leave accrual, it will need to update the provision for long service leave account annually at balance day. The adjustment necessary to update the account will provide for the employee's total accrued long service leave as of balance day, at the current rate of pay.

At balance day 2016, the employee has now been with the organisation for six years and their gross wage has increased to \$800 per week. The calculation of the employee's accrued long service leave entitlement as of balance day 2016 is as follows:

$$\begin{aligned}
 \text{Accrued long service leave entitlement} &= \frac{\text{No. of years worked}}{\text{Total years required}} \times \text{Long service leave entitlement} \\
 &= \frac{6}{10} \times 8.667 \text{ weeks} \\
 &= 5.2 \text{ weeks} \\
 \text{Long service leave entitlement (\$)} &= \text{Accrued leave (weeks)} \times \text{Gross weekly wage (\$)} \\
 &= 5.2 \text{ weeks} \times \$800 \\
 &= \$4,160
 \end{aligned}$$

Calculate the adjustment necessary to record the accounting entry for long service leave at the end of year six as follows:

- Long service leave entitlement at end of year 6 (\$) = \$4,160
- Less provision for long service leave from year 5 = \$3,033
- Adjustment necessary for year 6 = \$1,127

continued ...

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The adjustment necessary at balance day is to:

- record the long service leave expense; this records the amount incurred for the current accounting period and will be transferred to a profit and loss account
- update the provision for long service leave liability for the accrued long service leave entitlement as at balance day 2016.

| General journal |   |       |          |           |
|-----------------|---|-------|----------|-----------|
| Date            | Particulars   | Folio | Debit \$ | Credit \$ |
| 30/6/16         | Long service leave expense                          |       | 1,127    |           |
|                 | Provision for long service leave                    |       |          | 1,127     |
|                 | <i>Long service leave accrued as at balance day</i> |       |          |           |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger                          |                                  |          |          |           |            |
|---|----------------------------------|----------|----------|-----------|------------|
| Date                                    | Particulars                      | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Long service leave expense</b>       |                                  |          |          |           |            |
| 30/6/16                                 | Provision for long service leave | GJ       | 1,127    |           | 1,127 Dr   |
| <b>Provision for long service leave</b> |                                  |          |          |           |            |
| 30/6/15                                 | Long service leave expense       |          |          | 3,033     | 3,033 Cr   |
| 30/6/16                                 | Long service leave expense       | GJ       |          | 1,127     | 4,160 Cr   |

Note that the provision for long service leave account has been increased by \$1,127, which is the value of the expense incurred for this accounting period.

This was the amount necessary to update the long service leave entitlement from the value accrued at the end of year five to the value accrued at the end of year six. Because long service leave is paid to the employee at their current wage rate at the time they take their leave, the annual adjustment incorporates the additional year's entitlement plus an adjustment to the previous year's long service leave expenses, which were calculated on the wage rates paid at the time.

## Practice task 7

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

1. At balance day for H Simpson, as a result of the annual stocktake, it was determined that there was \$4,500 worth of trading stock on hand and \$600 worth of stationery still unused. (The stationery expense account balance is \$2,200 debit before the adjustment.)
  - Prepare the relevant general journal entries to record the stock on hand as of balance day (30 June 2016). Post the journal entries to the general ledger.
2. Max Stead commenced full-time employment with an organisation on 15 November 2015 on a gross weekly wage of \$750 and an annual leave entitlement of four weeks per annum.



- Calculate and record Max's annual leave entitlement in the general journal at 30 June 2016. Post the general journal entry to the general ledger.

The annual leave entitlement is based on 32 weeks' employment as of balance day (30 June 2016).

3. Joe Walsh has been employed with an organisation for six years. The gross wage paid to Joe is currently \$820 per week and according to the employment agreement, the long service leave entitlement is 13 weeks after 15 years' employment.
  - Calculate the long service leave to be accrued for Joe at balance day 30 June 2016. Record the amount in the general journal and post to the general ledger.

The balance in the provision for long service leave account before this year's adjustment is \$3,250.

## Summary

1. The end of an accounting period is called balance day. On balance day, it is necessary to calculate the profit or loss made for the year and prepare the two major financial reports:
  - Income (profit and loss) statement
  - Statement of financial position
2. To calculate the profit or loss made by a business, the revenue earned by the business is matched against the expenses incurred.
3. Under accrual accounting, revenues and expenses are recognised when they are earned and incurred, rather than when they are received or paid. Therefore, profit is calculated as the revenue recognised in the period less the expenses incurred in earning that revenue.

4. Not all expenses paid during an accounting period correspond exactly to the amounts due to be paid during that period. Similarly, not all revenue received in a period may correspond to amounts actually earned for that period. Therefore, in order to accurately calculate profitability, certain adjustments must be made prior to the preparation of the financial statements. These adjustments are referred to as balance-day adjustments.
5. There are a number of balance-day adjustments that you must be able to calculate and record in the organisation's accounting system, including:
  - accrued expenses
  - prepaid expenses
  - accrued revenue
  - prepaid revenue
  - depreciation
  - bad and doubtful debts
  - stock on hand at the end of the accounting period
  - annual leave
  - long service leave.

## Learning checkpoint 2 Record general journal entries for balance-day adjustments

This learning checkpoint allows you to review your skills and knowledge in recording general journal entries for balance-day adjustments. Templates for the accountancy tables are available at <http://chilp.it/ee80e58> or by scanning the QR code.



### Part A

Briefly explain the following terms:

a) Accrual accounting

b) Accrued expenses

c) Accrued revenue

d) Prepaid expenses

e) Prepaid revenue

f) Depreciation

g) Balance day

h) Doubtful debts

i) Bad debts

j) Provision for annual leave

## Part B

An annual stocktake at 30 June 2016 revealed the following:

- Stock of trading goods on hand – \$21,560
- Stock of stationery on hand – \$950
- Balance of stock – \$23,000 Dr
- Balance of stationery expense – \$4,550 Dr

Prepare the general journal entries to record stocks on hand and post the journals to the general ledger accounts.

## Part C

Read the scenario, then complete the tasks that follow.

### Scenario

Morgan Enterprises provides you with the following trial balance and list of balance-day adjustments as at 30 June 2016.

| <b>Morgan Enterprises</b>                      |                     |                      |
|--|---------------------|----------------------|
| <b>Trial balance as at 30 June 2016</b>        |                     |                      |
| <b>Account name</b>                            | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Bank   | 6,440               |                      |
| Trade debtors control                          | 8,200               |                      |
| Allowance for doubtful debts                   |                     | 140                  |
| Bad debts                                      | 780                 |                      |
| Input tax credits                              | 455                 |                      |
| GST payable                                    |                     | 440                  |
| Trade creditors control                        |                     | 9,840                |
| Plant and equipment                            | 12,000              |                      |
| Accumulated depreciation – plant and equipment |                     | 3,300                |
| Showroom fittings                              | 6,500               |                      |
| Accumulated depreciation – showroom fittings   |                     | 975                  |
| Motor vehicle                                  | 14,000              |                      |
| Accumulated depreciation – motor vehicle       |                     | 200                  |
| Land and buildings                             | 172,000             |                      |
| Mortgage on land and buildings                 |                     | 55,000               |
| Salesperson's salary                           | 8,700               |                      |
| Office salaries                                | 8,300               |                      |
| Provision for annual leave                     |                     | 200                  |
| Provision for long service leave               |                     | 2,500                |
| Stock (as at 1/7/15)                           | 2,420               |                      |
| Sales  |                     | 54,000               |
| Sales returns and allowances                   | 1,005               |                      |
| Commission revenue                             |                     | 810                  |
| Discount expense                               | 1,400               |                      |

*continued ...*

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| Account name       | Debit<br>\$    | Credit<br>\$   |
|--------------------|----------------|----------------|
| Purchases          | 54,200         |                |
| Cartage outward    | 800            |                |
| Interest on loans  | 5,400          |                |
| Advertising        | 1,820          |                |
| Office expenses    | 1,300          |                |
| Stationery         | 520            |                |
| Insurance          | 3,020          |                |
| Rent received      |                | 1,600          |
| Loan from APT Bank |                | 28,000         |
| Capital            |                | 153,455        |
| Drawings           | 1,200          |                |
|                    | <b>310,460</b> | <b>310,460</b> |

The balance-day adjustments as at 30 June 2016 are:

- depreciate plant and equipment at 15 per cent per annum using the reducing-balance method
- depreciate motor vehicles at 10 per cent per annum using the straight-line method
- depreciate showroom fittings at 10 per cent per annum using the straight-line method
- two months' insurance paid in advance – annual premium \$3,600
- commission revenue earned but not received – \$715
- rent received in advance – \$400
- amount owing for interest on loans – \$225
- increase provision for long service leave to \$3,000
- increase provision for annual leave to 3.5 per cent of salaries
- additional bad debt to be written off – \$781 (the original sales included GST)
- the allowance for doubtful debts is to be \$260.

You are required to:

- prepare general journal entries to record the balance-day adjustments
- post the balance-day adjustments to the relevant general ledger accounts
- prepare an adjusted trial balance as at 30 June 2016.



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## Topic 3

# Prepare final general ledger accounts

At the end of the accounting period, once all the balance-day adjustments have been posted, it is necessary to finalise the accounts in the general ledger and produce financial reports.

In order to produce these reports, the balances in the revenue and expense accounts in the general ledger need to be transferred or closed to profit determination accounts in the general ledger, thereby closing off the revenue and expenses to a nil balance.

These profit determination accounts, known as the trading account and the profit and loss account, are temporary clearing accounts that are set up and used for the purpose of determining profits/losses.

Finally, the owner's equity account – the capital account – is finalised by transferring the net profit or loss from the profit and loss account together with the amount taken by the owner as drawings.

In this topic you will learn how to:

- 3A Understand the trading account
- 3B Prepare the profit and loss account
- 3C Determine owner's equity
- 3D Understand service organisations

## 3A Understand the trading account

There is a difference between businesses that trade in stock and those that sell services. Here is an explanation of how these businesses run and how they are different.

### Business that buys, marks up and on-sells stock

- Enters general journal entries for closing revenue, expense and stock account balances
- Posts revenue, expense and stock account balances to the trading account and profit and loss accounts
- Determines gross and net profits
- Closes accounts to the capital account

### Business that provides a service

- Enters general journal entries for closing revenue, expense and supplies account balances
- Posts revenue, expense and supplies account balances to the cost of supplies account and profit and loss accounts
- Determines cost of supplies and net profits
- Closes accounts to the capital account

## The trading account

The trading account is used by organisations that buy and sell goods or trading organisations. The purpose of the trading account is to determine the organisation's gross profit or gross loss. The trading result is calculated by deducting the cost of purchasing the goods and getting them ready for sale, from the revenue earned from selling the goods; that is:

$$\text{Trading revenue} - \text{Cost of goods sold} = \text{Gross profit/loss}$$

The gross profit must be sufficient to cover the other operating costs of the organisation to return a net profit.

The information in the trading account is used for the preparation of the income (profit and loss) statement.



## Example: trading section of the income statement

This example illustrates the trading section of the income (profit and loss) statement that will be prepared from balances transferred to the trading account.

| <b>Magic Possum</b><br><b>Income statement</b><br><b>For year ended 30 June 2016</b> |              |              |               |
|--|--------------|--------------|---------------|
|  | \$           | \$           | \$            |
| Sales  |              | 64,000       |               |
| Less sales returns and allowances  |              | <u>2,000</u> |               |
| <b>Net sales</b>   |              |              | 62,000        |
| Less cost of goods sold  |              |              |               |
| Stock (opening stock 1/7/15)   |              | 3,500        |               |
| <i>Add purchases</i>   | 21,000       |              |               |
| <i>Less purchases returns and allowances</i>   | <u>1,000</u> | 20,000       |               |
| <i>Add direct purchasing costs</i>   |              |              |               |
| Freight inwards  | 1,500        |              |               |
| Insurance on stock   | 1,200        |              |               |
| Customs duty   | 1,300        |              |               |
| Wharfage fees  | <u>900</u>   | <u>4,900</u> |               |
| Cost of goods available for sale   |              | 28,400       |               |
| <i>Less stock (closing stock 30/6/16)</i>  |              | <u>2,800</u> |               |
| Total cost of goods sold   |              |              | <u>25,600</u> |
|  |              |              |               |
| <b>Gross profit</b>  |              |              | <b>36,400</b> |

## Opening stock adjustment

Before the revenue and expense accounts can be transferred into the trading account, the opening balance of the stock account needs to be transferred.

The opening balance of the stock account represents the stock that was not sold in the last accounting period and was available to be sold in this accounting period. By transferring the opening stock balance into the trading account, you are following the accrual accounting concept and recognising that the cost of this stock is an expense for this accounting period.

### Example: opening stock adjustment

Magic Possum, a giftware store, has completed all the necessary balance-day adjustments for the financial year ending 30 June 2016. At the end of the last accounting period, 30 June 2015, a stocktake determined that there was \$3,500 of stock on hand. This amount was recorded in the stock account showing the available stock to be sold in this accounting period – this accounting period's opening stock.

The adjustment necessary at balance day (30 June 2016) is to:

- transfer the opening stock balance to the trading account; this recognises the expense incurred for the current accounting period
- reduce the stock asset account by the value of the stock available at the beginning of the accounting period as this has been presumed to have been sold during this accounting period.

| General journal – Magic Possum |  |       |          |           |
|--------------------------------|--|-------|----------|-----------|
| Date                           | Particulars  | Folio | Debit \$ | Credit \$ |
| 30/6/16                        | Trading<br><br>Stock<br><br><i>Transfer opening stock to trading account</i> |       | 3,500    | 3,500     |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger – Magic Possum |             |          |          |           |            |
|-------------------------------|-------------|----------|----------|-----------|------------|
| Date                          | Particulars | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Trading</b>                |             |          |          |           |            |
| 30/6/16                       | Stock       | GJ       | 3,500    |           | 3,500 Dr   |
| <b>Stock</b>                  |             |          |          |           |            |
| 1/7/15                        | Balance     |          |          |           | 3,500 Dr   |
| 30/6/16                       | Trading     | GJ       |          | 3,500     | Nil        |

Note that the stock account now has a nil balance. This is because the closing stock adjustment has not yet been entered.

## Closing stock adjustment

The recording of closing stock recognises the unused purchases expense from this accounting period. Although the closing stock adjustment is a balance-day adjustment, it is more practical to enter the adjustment as part of the closing procedure.

### Example: closing stock adjustment

From a manual stocktake on 30 June 2016, it was determined that Magic Possum had stock on hand valued at \$2,800. This represents the stock that will be available for sale in the next accounting period and therefore it is an unused expense in this accounting period.

The adjustment necessary at balance day is to:

- record the unsold stock in the asset account called stock
- record the reduction in purchases expense through the trading account.

| General journal – Magic Possum |  |       |          |           |
|--------------------------------|--|-------|----------|-----------|
| Date                           | Particulars  | Folio | Debit \$ | Credit \$ |
| 30/6/16                        | Stock  |       | 2,800    |           |
|                                | Trading  |       |          | 2,800     |
|                                | <i>Balance-day adjustments to record closing stock</i> |       |          |           |

The general ledger accounts, after the adjusting entry above has been posted, will be as follows.

| General ledger – Magic Possum |                               |          |          |           |            |
|-------------------------------|-------------------------------|----------|----------|-----------|------------|
| Date                          | Particulars                   | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Trading</b>                |                               |          |          |           |            |
| 30/6/16                       | Stock (opening stock 1/7/15)  | GJ       | 3,500    |           | 3,500 Dr   |
|                               | Stock (closing stock 30/6/16) | GJ       |          | 2,800     | 700 Dr     |
| <b>Stock</b>                  |                               |          |          |           |            |
| 1/7/15                        | Balance                       |          |          |           | 3,500 Dr   |
| 30/6/16                       | Trading                       | GJ       |          | 3,500     | Nil        |
|                               | Trading                       | GJ       | 2,800    |           | 2,800 Dr   |

As the transfers of the revenue and expense accounts have not yet been completed, the balance of the trading account is not yet relevant.

The stock account now has a balance of \$2,800 debit, representing the value of the organisation's asset of unsold stock as at balance day. This amount will be shown on the statement of financial position.

## Trading revenue and expenses

The trading account is used to determine the organisation's gross profit/loss, which is calculated by deducting the cost of goods sold from the trading revenue. The other ledger accounts that need to be transferred into the trading account are shown below.

### Trading revenue

#### Trading revenue accounts

- Sales
- Sales returns and allowances

### Cost of goods sold

#### Cost of goods sold expense accounts

- Purchases
- Purchases returns and allowances
- Other expense accounts that are directly associated with the cost of buying the goods and getting them ready for sale are:
  - cartage/freight inwards
  - insurance on stock
  - customs duty
  - wharfage fees
  - buying expenses
  - assembly costs.

## Ledger accounts

These ledger accounts must have a nil balance after the transfer entries have been recorded. To determine whether a debit or credit entry is required, the balance of each ledger account needs to be identified.

Rather than prepare a separate general journal entry for each ledger account transfer, it is acceptable to prepare a bulk entry that incorporates all accounts with similar balances; that is, debit balances or credit balances.

The following table shows whether the balances for each of the ledger accounts closed to the trading account have a debit or credit balance.

| Ledger account                   | Account type     | Debit or credit balance |
|----------------------------------|------------------|-------------------------|
| Sales                            | Revenue          | Credit                  |
| Sales returns and allowances     | Reducing revenue | Debit                   |
| Purchases                        | Expense          | Debit                   |
| Purchases returns and allowances | Reducing expense | Credit                  |
| Cartage/freight inwards          | Expense          | Debit                   |
| Insurance on stock               | Expense          | Debit                   |
| Customs duty                     | Expense          | Debit                   |
| Wharfage fees                    | Expense          | Debit                   |
| Buying expenses                  | Expense          | Debit                   |
| Assembly costs                   | Expense          | Debit                   |

## Example: record trading revenue and expenses

The trading revenue and cost of goods sold expense accounts for Magic Possum have the following balances after all balance-day adjustments have been recorded for 30 June 2016.

| <b>Magic Possum</b>                             |                     |                      |
|---|---------------------|----------------------|
| <b>Trial balance extract as at 30 June 2016</b> |                     |                      |
| <b>Account name</b>                             | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Sales   |                     | 64,000               |
| Sales returns and allowances                    | 2,000               |                      |
| Purchases                                       | 21,000              |                      |
| Purchases returns and allowances                |                     | 1,000                |
| Freight inwards                                 | 1,500               |                      |
| Insurance on stock                              | 1,200               |                      |
| Customs duty                                    | 1,300               |                      |
| Wharfage fees                                   | 900                 |                      |

The closing entries are necessary at balance day to:

- close the balances of the trading revenue and cost of goods sold expense accounts to the trading account
- reduce the trading revenue and cost of goods sold expense accounts to a nil balance.

| <b>General journal – Magic Possum</b> |                                  |              |                     |                      |
|---------------------------------------|----------------------------------|--------------|---------------------|----------------------|
| <b>Date</b>                           | <b>Particulars</b>               | <b>Folio</b> | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| 30/6/16                               | Trading                          |              | 27,900              |                      |
|                                       | Sales returns and allowances     |              |                     | 2,000                |
|                                       | Purchases                        |              |                     | 21,000               |
|                                       | Freight inwards                  |              |                     | 1,500                |
|                                       | Insurance on stock               |              |                     | 1,200                |
|                                       | Customs duty                     |              |                     | 1,300                |
|                                       | Wharfage fees                    |              |                     | 900                  |
|                                       | <i>Closing entry</i>             |              |                     |                      |
| 30/6/16                               | Sales                            |              | 64,000              |                      |
|                                       | Purchases returns and allowances |              | 1,000               |                      |
|                                       | Trading                          |              |                     | 65,000               |
|                                       | <i>Closing entry</i>             |              |                     |                      |

*continued ...*

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The general ledger accounts, after the closing entries above have been posted, will be as follows.

| <b>General ledger</b>                   |             |          |          |           |            |
|---|-------------|----------|----------|-----------|------------|
| Date                                    | Particulars | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Stock</b>                            |             |          |          |           |            |
| 1/7/15                                  | Balance     |          |          |           | 3,500 Dr   |
| 30/6/16                                 | Trading     | GJ       |          | 3,500     | Nil        |
|   | Trading     | GJ       | 2,800    |           | 2,800 Dr   |
| <b>Sales</b>                            |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 64,000 Cr  |
|   | Trading     | GJ       | 64,000   |           | Nil        |
| <b>Sales returns and allowances</b>     |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 2,000 Dr   |
|   | Trading     | GJ       |          | 2,000     | Nil        |
| <b>Purchases</b>                        |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 21,000 Dr  |
|   | Trading     | GJ       |          | 21,000    | Nil        |
| <b>Purchases returns and allowances</b> |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 1,000 Cr   |
|   | Trading     | GJ       | 1,000    |           | Nil        |
| <b>Freight inwards</b>                  |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 1,500 Dr   |
|   | Trading     | GJ       |          | 1,500     | Nil        |
| <b>Insurance on stock</b>               |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 1,200 Dr   |
|   | Trading     | GJ       |          | 1,200     | Nil        |
| <b>Customs duty</b>                     |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 1,300 Dr   |
|   | Trading     | GJ       |          | 1,300     | Nil        |
| <b>Wharfage fees</b>                    |             |          |          |           |            |
| 30/6/16                                 | Balance     |          |          |           | 900 Dr     |
|   | Trading     | GJ       |          | 900       | Nil        |

continued ...

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| Date           | Particulars                      | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
|----------------|----------------------------------|----------|----------|-----------|------------|
| <b>Trading</b> |                                  |          |          |           |            |
| 30/6/16        | Stock (opening stock 1/7/15)     |          | 3,500    |           | 3,500 Dr   |
|                | Stock (closing stock 30/6/16)    |          |          | 2,800     | 700 Dr     |
|                | Sales returns and allowances     | GJ       | 2,000    |           | 2,700 Dr   |
|                | Purchases                        | GJ       | 21,000   |           | 23,700 Dr  |
|                | Freight inwards                  | GJ       | 1,500    |           | 25,200 Dr  |
|                | Insurance on stock               | GJ       | 1,200    |           | 26,400 Dr  |
|                | Customs duty                     | GJ       | 1,300    |           | 27,700 Dr  |
|                | Wharfage fees                    | GJ       | 900      |           | 28,600 Dr  |
|                | Sales                            | GJ       |          | 64,000    | 35,400 Cr  |
|                | Purchases returns and allowances | GJ       |          | 1,000     | 36,400 Cr  |

All of the trading revenue and cost of goods sold expense accounts now have a nil balance.

- The stock account has a debit balance of \$2,800 representing the value of the unsold stock (unused purchases expense) to be sold in the next accounting period and is shown as an asset on the statement of financial position.
- The trading account has a credit balance of \$36,400. This represents the difference between the trading revenue and the cost of goods sold (gross profit).

## Gross profit or loss

After all the trading revenue and cost of goods sold expense account balances have been transferred to the trading account, the remaining balance represents either:

- a gross profit (if a credit balance)
- a gross loss (if a debit balance).

A gross profit results when the trading revenue earned is greater than the total of all the cost of goods sold expenses – total credits exceed total debits.

A gross loss results when the total of the cost of goods sold expenses is greater than the trading revenue earned – total debits exceed total credits.

Because the trading account is a temporary or clearing account, the balance remaining in the account (gross profit/loss) must be closed to a nil balance. To do this, the gross profit/loss is transferred to another temporary or clearing account called the profit and loss account to determine the overall net profit or loss for the accounting period.



### Example: transfer gross profit/loss

Magic Possum has determined that a gross profit of \$36,400 has been made for the year ended 30 June 2016. This has been determined by transferring all the trading revenue and cost of goods sold expense accounts to the trading account, resulting in a credit balance of \$36,400.

The closing entry necessary at balance day is to:

- reduce the trading account to a nil balance
- transfer the gross profit or loss to the profit and loss account.

| General journal – Magic Possum |                              |       |          |           |
|--------------------------------|------------------------------|-------|----------|-----------|
| Date                           | Particulars                  | Folio | Debit \$ | Credit \$ |
| 30/6/16                        | Trading account              |       | 36,400   |           |
|                                | Profit and loss              |       |          | 36,400    |
|                                | <i>Transfer gross profit</i> |       |          |           |

The general ledger accounts, after the closing entry above has been posted, will be as follows.

| General ledger – Magic Possum |                                  |          |          |           |            |
|-------------------------------|----------------------------------|----------|----------|-----------|------------|
| Date                          | Particulars                      | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Trading</b>                |                                  |          |          |           |            |
| 30/6/16                       | Stock (opening stock 1/7/15)     |          | 3,500    |           | 3,500 Dr   |
|                               | Stock (closing stock 30/6/16)    |          |          | 2,800     | 700 Dr     |
|                               | Sales returns and allowances     | GJ       | 2,000    |           | 2,700 Dr   |
|                               | Purchases                        | GJ       | 21,000   |           | 23,700 Dr  |
|                               | Freight inwards                  | GJ       | 1,500    |           | 25,200 Dr  |
|                               | Insurance on stock               | GJ       | 1,200    |           | 26,400 Dr  |
|                               | Customs duty                     | GJ       | 1,300    |           | 27,700 Dr  |
|                               | Wharfage fees                    | GJ       | 900      |           | 28,600 Dr  |
|                               | Sales                            | GJ       |          | 64,000    | 35,400 Cr  |
|                               | Purchases returns and allowances | GJ       |          | 1,000     | 36,400 Cr  |
|                               | Profit and loss                  | GJ       | 36,400   |           | Nil        |
| <b>Profit and loss</b>        |                                  |          |          |           |            |
| 30/6/16                       | Trading                          | GJ       |          | 36,400    | 36,400 Cr  |

The trading account now has a nil balance and is considered closed. The profit and loss account is now showing a gross profit of \$36,400.

## Practice task 8

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58>

or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

The trading revenue and cost of goods sold expense accounts for BB's Disposals have the following balances after all balance-day adjustments. The stock on hand at 30 June 2015 was \$11,800.

| <b>BB's Disposals</b>                           |                     |                      |
|---|---------------------|----------------------|
| <b>Trial balance extract as at 30 June 2015</b> |                     |                      |
| <b>Account name</b>                             | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Sales   |                     | 125,000              |
| Sales returns and allowances                    | 3,500               |                      |
| Purchases                                       | 74,000              |                      |
| Purchases returns and allowances                |                     | 800                  |
| Freight inwards                                 | 3,600               |                      |
| Buying expenses                                 | 2,200               |                      |
| Insurance on stock                              | 1,500               |                      |
| Stock (1/7/14)                                  | 13,500              |                      |

- Prepare and post the general journal entry to adjust stock.
- Prepare and post the closing general journal entries for transfer to the trading account.
- Prepare and post the general journal entry to transfer gross profit/loss.
- Post these general journal entries to the relevant general ledger accounts.



# 3B

## Prepare the profit and loss account

The profit and loss account is a temporary or clearing account that is used to determine the organisation's net profit/loss. The net profit/loss is calculated by adding any non-trading revenue earned in this accounting period to the gross profit, then deducting all other operating expenses incurred during this accounting period; that is:

$$\text{Gross profit} + \text{Non-trading revenue} - \text{Other operating expenses} = \text{Net profit/loss}$$

If an organisation has recorded a gross loss, the equation would be:

$$\text{Gross loss} + \text{Other operating expenses} - \text{Non-trading revenue} = \text{Net profit/loss}$$

### Example: determine net profit or loss

Following on from the previous example, where only the trading section of the profit and loss statement is explained, continue with the balances transferred from the profit and loss account to determine net profit or loss. This is what the report will look like when it is completed.

| <b>Magic Possum</b><br><b>Income statement</b><br><b>For year ended 30 June 2016</b> |              |              |               |
|--|--------------|--------------|---------------|
|  | \$           | \$           | \$            |
| Sales  |              | 64,000       |               |
| Less sales returns and allowances  |              | <u>2,000</u> |               |
| <b>Net sales</b>   |              |              | 62,000        |
| Less cost of goods sold  |              |              |               |
| Stock (opening stock 1/7/15)   |              | 3,500        |               |
| Add purchases  | 21,000       |              |               |
| Less purchases returns and allowances  | <u>1,000</u> | 20,000       |               |
| Add direct purchasing costs  |              |              |               |
| Freight inwards  | 1,500        |              |               |
| Insurance on stock   | 1,200        |              |               |
| Customs duty   | 1,300        |              |               |
| Wharfage fees  | <u>900</u>   | <u>4,900</u> |               |
| Cost of goods available for sale   |              | 28,400       |               |
| Less stock (closing stock 30/6/16)   |              | <u>2,800</u> |               |
| Total cost of goods sold   |              |              | <u>25,600</u> |
| <b>Gross profit</b>  |              |              | <b>36,400</b> |
| Add other revenue  |              |              |               |

Trading section

*continued ...*

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|                                 |  |            |                     |                         |
|---------------------------------|--|------------|---------------------|-------------------------|
| Discount received               |  | 180        |                     | Profit and loss section |
| Interest revenue                |  | <u>198</u> | <u>378</u>          |                         |
|                                 |  |            | 36,778              |                         |
| Less other operating expenses   |  |            |                     |                         |
| Rent                            |  | 5,200      |                     |                         |
| Freight outwards                |  | 308        |                     |                         |
| Discount allowed                |  | 260        |                     |                         |
| Stationery                      |  | 315        |                     |                         |
| Depreciation – motor vehicles   |  | 1,350      |                     |                         |
| Depreciation – shop fittings    |  | 250        |                     |                         |
| Depreciation – office equipment |  | 800        |                     |                         |
| Advertising                     |  | 2,407      |                     |                         |
| Motor vehicle expenses          |  | 3,604      |                     |                         |
| Wages                           |  | 8,400      |                     |                         |
| Telephone                       |  | 1,869      |                     |                         |
| Electricity                     |  | 912        |                     |                         |
| Gas                             |  | 352        |                     |                         |
| Insurance                       |  | 1,124      |                     |                         |
| Postage                         |  | 95         |                     |                         |
| Bank fees                       |  | 305        |                     |                         |
| Doubtful debts                  |  | 175        |                     |                         |
| Staff amenities                 |  | 360        |                     |                         |
| Interest on loan                |  | 1,500      |                     |                         |
| Rates                           |  | 842        |                     |                         |
| Accounting expenses             |  | <u>600</u> | <u>31,028</u>       |                         |
| <b>Net profit</b>               |  |            | <b><u>5,750</u></b> |                         |

## Complete the closing procedure

To complete the closing procedure, it is necessary to transfer all remaining revenue (non-trading) and expense (operating) accounts that do not have a nil balance to the profit and loss account. By doing this, all revenue and expense accounts will be effectively closed; that is, they will have a nil balance and be ready to record transactions for the next year.

Non-trading revenues may include interest revenue, discount received, rent received and dividends received.

Other operating expenses may include wages, rates, telephone, rent, insurance, electricity, discount expense, depreciation expense, interest on loans, cartage/freight outwards, doubtful debts, motor vehicle expenses, annual leave expense and long service leave expense.

To determine whether a debit or credit entry is required, the balance of each revenue and expense ledger account needs to be identified.

Rather than prepare a separate general journal entry for each ledger account transfer, it is acceptable to prepare a bulk entry that incorporates all accounts with similar balances; that is, debit balances or credit balances.



## Example: transfer revenue and expense accounts

Magic Possum has transferred a gross profit of \$36,400 from the trading account to the profit and loss account (see previous examples).

Magic Possum's trial balance also included the following non-trading revenue and other operating expense account balances that must be transferred to the profit and loss account for the year ended 30 June 2016.

| <b>Magic Possum</b>                             |                     |                      |
|---|---------------------|----------------------|
| <b>Trial balance extract as at 30 June 2016</b> |                     |                      |
| <b>Account name</b>                             | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Rent  | 5,200               |                      |
| Freight outwards                                | 308                 |                      |
| Discount allowed                                | 260                 |                      |
| Stationery                                      | 315                 |                      |
| Depreciation – motor vehicles                   | 1,350               |                      |
| Depreciation – shop fittings                    | 250                 |                      |
| Depreciation – office equipment                 | 800                 |                      |
| Discount received                               |                     | 180                  |
| Advertising                                     | 2,407               |                      |
| Motor vehicle expenses                          | 3,604               |                      |
| Wages   | 8,400               |                      |
| Telephone                                       | 1,869               |                      |
| Electricity                                     | 912                 |                      |
| Gas   | 352                 |                      |
| Insurance                                       | 1,124               |                      |
| Postage   | 95                  |                      |
| Interest revenue                                |                     | 198                  |
| Bank fees                                       | 305                 |                      |
| Doubtful debts                                  | 175                 |                      |
| Staff amenities                                 | 360                 |                      |
| Interest on loan                                | 1,500               |                      |
| Rates   | 842                 |                      |
| Accounting expenses                             | 600                 |                      |

The closing entries at balance day are necessary to:

- record the balances of the non-trading revenue and operating expense accounts in the profit and loss account
- reduce the non-trading revenue and operating expense accounts to a nil balance.

The general journal entry to close the revenue and expense accounts to the profit and loss account can be prepared as follows.

*continued ...*

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| <b>General journal – Magic Possum</b> |                                 |              |                     |                      |
|---------------------------------------|---------------------------------|--------------|---------------------|----------------------|
| <b>Date</b>                           | <b>Particulars</b>              | <b>Folio</b> | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| 30/6/16                               | Profit and loss                 |              | 31,028              |                      |
|                                       | Rent                            |              |                     | 5,200                |
|                                       | Freight outwards                |              |                     | 308                  |
|                                       | Discount allowed                |              |                     | 260                  |
|                                       | Stationery                      |              |                     | 315                  |
|                                       | Depreciation – motor vehicles   |              |                     | 1,350                |
|                                       | Depreciation – shop fittings    |              |                     | 250                  |
|                                       | Depreciation – office equipment |              |                     | 800                  |
|                                       | Advertising                     |              |                     | 2,407                |
|                                       | Motor vehicle expenses          |              |                     | 3,604                |
|                                       | Wages                           |              |                     | 8,400                |
|                                       | Telephone                       |              |                     | 1,869                |
|                                       | Electricity                     |              |                     | 912                  |
|                                       | Gas                             |              |                     | 352                  |
|                                       | Insurance                       |              |                     | 1,124                |
|                                       | Postage                         |              |                     | 95                   |
|                                       | Bank fees                       |              |                     | 305                  |
|                                       | Doubtful debts                  |              |                     | 175                  |
|                                       | Staff amenities                 |              |                     | 360                  |
|                                       | Interest on loan                |              |                     | 1,500                |
|                                       | Rates                           |              |                     | 842                  |
|                                       | Accounting expenses             |              |                     | 600                  |
|                                       | <i>Closing entry</i>            |              |                     |                      |
| 30/6/16                               | Discount received               |              | 180                 |                      |
|                                       | Interest revenue                |              | 198                 |                      |
|                                       | Profit and loss                 |              |                     | 378                  |
|                                       | <i>Closing entry</i>            |              |                     |                      |

These journal entries would result in the following accounts in the general ledger:

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| General ledger                         |                 |          |          |           |            |
|--|-----------------|----------|----------|-----------|------------|
| Date                                   | Particulars     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Rent</b>                            |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 5,200 Dr   |
|  | Profit and loss | GJ       |          | 5,200     | Nil        |
| <b>Freight outwards</b>                |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 308 Dr     |
|  | Profit and loss | GJ       |          | 308       | Nil        |
| <b>Discount allowed</b>                |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 260 Dr     |
|  | Profit and loss | GJ       |          | 260       | Nil        |
| <b>Stationery</b>                      |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 315 Dr     |
|  | Profit and loss | GJ       |          | 315       | Nil        |
| <b>Depreciation – motor vehicle</b>    |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 1,350 Dr   |
|  | Profit and loss | GJ       |          | 1,350     | Nil        |
| <b>Depreciation – shop fittings</b>    |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 250 Dr     |
|  | Profit and loss | GJ       |          | 250       | Nil        |
| <b>Depreciation – office equipment</b> |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 800 Dr     |
|  | Profit and loss | GJ       |          | 800       | Nil        |
| <b>Advertising</b>                     |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 2,407 Dr   |
|  | Profit and loss | GJ       |          | 2,407     | Nil        |
| <b>Motor vehicle expenses</b>          |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 3,604 Dr   |
|  | Profit and loss | GJ       |          | 3,604     | Nil        |
| <b>Wages</b>                           |                 |          |          |           |            |
| 30/6/16                                | Balance         |          |          |           | 8,400 Dr   |
|  | Profit and loss | GJ       |          | 8,400     | Nil        |

continued ...

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| Date                    | Particulars     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
|-------------------------|-----------------|----------|----------|-----------|------------|
| <b>Telephone</b>        |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 1,869 Dr   |
|                         | Profit and loss | GJ       |          | 1,869     | Nil        |
| <b>Electricity</b>      |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 912 Dr     |
|                         | Profit and loss | GJ       |          | 912       | Nil        |
| <b>Gas</b>              |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 352 Dr     |
|                         | Profit and loss | GJ       |          | 352       | Nil        |
| <b>Insurance</b>        |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 1,124 Dr   |
|                         | Profit and loss | GJ       |          | 1,124     | Nil        |
| <b>Postage</b>          |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 95 Dr      |
|                         | Profit and loss | GJ       |          | 95        | Nil        |
| <b>Bank fees</b>        |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 305 Dr     |
|                         | Profit and loss | GJ       |          | 305       | Nil        |
| <b>Doubtful debts</b>   |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 175 Dr     |
|                         | Profit and loss | GJ       |          | 175       | Nil        |
| <b>Staff amenities</b>  |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 360 Dr     |
|                         | Profit and loss | GJ       |          | 360       | Nil        |
| <b>Interest on loan</b> |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 1,500 Dr   |
|                         | Profit and loss | GJ       |          | 1,500     | Nil        |
| <b>Rates</b>            |                 |          |          |           |            |
| 30/6/16                 | Balance         |          |          |           | 842 Dr     |
|                         | Profit and loss | GJ       |          | 842       | Nil        |

continued ...

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| Date                       | Particulars                     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
|----------------------------|---------------------------------|----------|----------|-----------|------------|
| <b>Accounting expenses</b> |                                 |          |          |           |            |
| 30/6/16                    | Balance                         |          |          |           | 600 Dr     |
|                            | Profit and loss                 | GJ       |          | 600       | Nil        |
| <b>Discount received</b>   |                                 |          |          |           |            |
| 30/6/16                    | Balance                         |          |          |           | 180 Cr     |
|                            | Profit and loss                 | GJ       | 180      |           | Nil        |
| <b>Interest revenue</b>    |                                 |          |          |           |            |
| 30/6/16                    | Balance                         |          |          |           | 198 Cr     |
|                            | Profit and loss                 | GJ       | 198      |           | Nil        |
| <b>Profit and loss</b>     |                                 |          |          |           |            |
| 30/6/16                    | Trading                         | GJ       |          | 36,400    | 36,400 Cr  |
|                            | Rent                            | GJ       | 5,200    |           | 31,200 Cr  |
|                            | Freight outwards                | GJ       | 308      |           | 30,892 Cr  |
|                            | Discount allowed                | GJ       | 260      |           | 30,632 Cr  |
|                            | Stationery                      | GJ       | 315      |           | 30,317 Cr  |
|                            | Depreciation – motor vehicles   | GJ       | 1,350    |           | 28,967 Cr  |
|                            | Depreciation – shop fittings    | GJ       | 250      |           | 28,717 Cr  |
|                            | Depreciation – office equipment | GJ       | 800      |           | 27,917 Cr  |
|                            | Advertising                     | GJ       | 2,407    |           | 25,510 Cr  |
|                            | Motor vehicle expenses          | GJ       | 3,604    |           | 21,906 Cr  |
|                            | Wages                           | GJ       | 8,400    |           | 13,506 Cr  |
|                            | Telephone                       | GJ       | 1,869    |           | 11,637 Cr  |
|                            | Electricity                     | GJ       | 912      |           | 10,725 Cr  |
|                            | Gas                             | GJ       | 352      |           | 10,373 Cr  |
|                            | Insurance                       | GJ       | 1,124    |           | 9,249 Cr   |
|                            | Postage                         | GJ       | 95       |           | 9,154 Cr   |
|                            | Bank fees                       | GJ       | 305      |           | 8,849 Cr   |
|                            | Doubtful debts                  | GJ       | 175      |           | 8,674 Cr   |
|                            | Staff amenities                 | GJ       | 360      |           | 8,314 Cr   |
|                            | Interest on loan                | GJ       | 1,500    |           | 6,814 Cr   |

continued ...

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| Date | Particulars         | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
|------|---------------------|----------|----------|-----------|------------|
|      | Rates               | GJ       | 842      |           | 5,972 Cr   |
|      | Accounting expenses | GJ       | 600      |           | 5,372 Cr   |
|      | Discount received   | GJ       |          | 180       | 5,552 Cr   |
|      | Interest revenue    | GJ       |          | 198       | 5,750 Cr   |

- All of the non-trading revenue and operating expense accounts now have a nil balance.
- The profit and loss account has a credit balance of \$5,750. This represents the effect of any non-trading revenue and other operating expenses on the gross profit/loss, in this case resulting in a net profit.

## Transfer net profit or loss

After all the non-trading revenue and operating expense account balances have been transferred to the profit and loss account, the remaining balance represents either:

- a net profit (if a credit balance)
- a net loss (if a debit balance).

A net profit results where the total revenue earned is greater than the total of all the expenses incurred – that is, the total credits exceed total debits.

A net loss results where the total of all expenses incurred is greater than the total revenue earned – that is, the total debits exceed total credits.

As the profit and loss account is a temporary or clearing account, the balance remaining in the account (net profit/loss) must be closed to a nil balance.



## Profit/loss transferred to owner

As an organisation's net profits or losses belong to the owner/s of the organisation, the balance of the profit and loss account is transferred to the appropriate owner's equity account. Here is an explanation of how this is done.

### Sole trader

In the case of a sole trader, the net profit/loss is transferred to the owner's capital account, as this represents an increase in the owner's wealth.

### Partnership

For a partnership, the net profit/loss is transferred to a further temporary account called the profit and loss appropriation account. This account is then used to distribute the appropriate share of the profit or loss to each partner's capital account.

### Company

For a company, the net profit/loss is transferred to a retained profits account where it can be distributed as dividends to the shareholders.

## Example: net profit/loss transferred to the capital account

Possum Magic made a net profit of \$5,750 for the year ended 30 June 2016. This has been determined by transferring the gross profit, non-trading revenue and operating expense accounts to the profit and loss account, resulting in a credit balance of \$5,750. The opening balance in the capital account is \$33,522 credit.

The closing entry necessary at balance day (30 June 2016) is to:

- reduce the profit and loss account to a nil balance
- transfer the net profit or loss to the owner's capital account.

This is shown in the following general journal entry.



| General journal – Possum Magic |  |       |          |           |
|--------------------------------|--|-------|----------|-----------|
| Date                           | Particulars  | Folio | Debit \$ | Credit \$ |
| 30/6/16                        | Profit and loss<br>Capital<br><i>Transfer net profit</i> |       | 5,750    | 5,750     |

*continued ...*

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The general ledger accounts, after the closing entry above has been posted, will be as follows.

| <b>General ledger</b>  |                                 |          |          |           |            |
|------------------------|---------------------------------|----------|----------|-----------|------------|
| Date                   | Particulars                     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Profit and loss</b> |                                 |          |          |           |            |
| 30/6/16                | Trading                         | GJ       |          | 36,400    | 36,400 Cr  |
|                        | Rent                            | GJ       | 5,200    |           | 31,200 Cr  |
|                        | Freight outwards                | GJ       | 308      |           | 30,892 Cr  |
|                        | Discount allowed                | GJ       | 260      |           | 30,632 Cr  |
|                        | Stationery                      | GJ       | 315      |           | 30,317 Cr  |
|                        | Depreciation – motor vehicles   | GJ       | 1,350    |           | 28,967 Cr  |
|                        | Depreciation – shop fittings    | GJ       | 250      |           | 28,717 Cr  |
|                        | Depreciation – office equipment | GJ       | 800      |           | 27,917 Cr  |
|                        | Advertising                     | GJ       | 2,407    |           | 25,510 Cr  |
|                        | Motor vehicle expenses          | GJ       | 3,604    |           | 21,906 Cr  |
|                        | Wages                           | GJ       | 8,400    |           | 13,506 Cr  |
|                        | Telephone                       | GJ       | 1,869    |           | 11,637 Cr  |
|                        | Electricity                     | GJ       | 912      |           | 10,725 Cr  |
|                        | Gas                             | GJ       | 352      |           | 10,373 Cr  |
|                        | Insurance                       | GJ       | 1,124    |           | 9,249 Cr   |
|                        | Postage                         | GJ       | 95       |           | 9,154 Cr   |
|                        | Bank fees                       | GJ       | 305      |           | 8,849 Cr   |
|                        | Doubtful debts                  | GJ       | 175      |           | 8,674 Cr   |
|                        | Staff amenities                 | GJ       | 360      |           | 8,314 Cr   |
|                        | Interest on loan                | GJ       | 1,500    |           | 6,814 Cr   |
|                        | Rates                           | GJ       | 842      |           | 5,972 Cr   |
|                        | Accounting expenses             | GJ       | 600      |           | 5,372 Cr   |
|                        | Discount received               | GJ       |          | 180       | 5,552 Cr   |
|                        | Interest revenue                | GJ       |          | 198       | 5,750 Cr   |
|                        | Capital                         | GJ       | 5,750    |           | Nil        |
| <b>Capital</b>         |                                 |          |          |           |            |
| 1/7/15                 | Balance                         |          |          |           | 33,522 Cr  |
| 30/6/16                | Profit and loss (net profit)    | GJ       |          | 5,750     | 39,272 Cr  |

The profit and loss account now has a nil balance and is considered closed. The capital account has now been increased by the \$5,750 net profit to recognise that this profit belongs to the owner/s.

## Practice task 9

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

Here is an extract of the adjusted trial balance for BB's Disposals as at 30 June 2015.

| <b>BB's Disposals</b>                           |                     |                      |
|---|---------------------|----------------------|
| <b>Trial balance extract as at 30 June 2015</b> |                     |                      |
| <b>Account name</b>                             | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Wages   | 15,500              |                      |
| Rates   | 500                 |                      |
| Insurance                                       | 1,200               |                      |
| Electricity                                     | 750                 |                      |
| Telephone                                       | 980                 |                      |
| Depreciation – motor vehicles                   | 1,600               |                      |
| Depreciation – fixtures and fittings            | 250                 |                      |
| Discount received                               |                     | 200                  |
| Discount expense                                | 550                 |                      |
| Staff amenities                                 | 275                 |                      |
| Dividend revenue                                |                     | 315                  |
| Rent  | 6,000               |                      |
| Postage   | 105                 |                      |
| Bank fees                                       | 120                 |                      |
| Capital   |                     | 19,679               |

- Prepare and post the closing general journal entries to the profit and loss account.
- Prepare and post the general journal entry to transfer net profit/loss.
- Post these general journal entries to the relevant general ledger accounts.
- You may need to use information from your answer to Practice task 8.



# 3C

## Determine owner's equity

The final stage of the closing procedure is to identify the closing balance for the capital account/s at the end of this accounting period. The final account that must be closed and transferred is the drawings account.

Drawings represents the value of the total withdrawals made by the owner during this accounting period and must be deducted from the overall capital balance.

### Example: owner's equity

Liz Francis, owner of Possum Magic, has withdrawn a total of \$3,300 in cash and assets from the business during this accounting period. This amount is shown in the drawings account, which has a balance of \$3,300 debit.

The closing entry necessary at balance day is to:

- adjust the capital account balance to show the net proprietorship of the business as at 30 June 2016
- reduce the drawings account to a nil balance.

The general journal entry to transfer the drawings account balance to the owner's capital account is as follows.

| General journal – Possum Magic |                      |       |          |           |
|--------------------------------|----------------------|-------|----------|-----------|
| Date                           | Particulars          | Folio | Debit \$ | Credit \$ |
| 30/6/16                        | Capital              |       | 3,300    |           |
|                                | Drawings             |       |          | 3,300     |
|                                | <i>Closing entry</i> |       |          |           |

The general ledger accounts, after the closing entry above has been posted, will be as follows.

| General ledger – Possum Magic |                 |          |          |           |            |
|-------------------------------|-----------------|----------|----------|-----------|------------|
| Date                          | Particulars     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Drawings</b>               |                 |          |          |           |            |
| 30/6/16                       | Balance         |          |          |           | 3,300 Dr   |
|                               | Capital         | GJ       |          | 3,300     | Nil        |
| <b>Capital</b>                |                 |          |          |           |            |
| 1/7/15                        | Balance         |          |          |           | 33,522 Cr  |
| 30/6/16                       | Profit and loss | GJ       |          | 5,750     | 39,272 Cr  |
|                               | Drawings        | GJ       | 3,300    |           | 35,972 Cr  |

Note that the balance of \$35,972 in the capital account represents the increase in wealth of the owner due to the earning of a net profit of \$5,750 and the withdrawal from the business of \$3,300.

## Practice task 10

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

During the year ended 30 June 2015, Billy Bob, owner of BB's Disposals, withdrew \$6,000 from the business. Prepare and post the general journal entry to close the drawings account. Post these general journal entries to the relevant general ledger accounts.

You may need to use information from your answers to practice tasks 8 and 9.



# 3D

## Understand service organisations

A service organisation provides a service to customers in return for a fee. Service organisations do not buy goods for the purpose of selling them but may buy supplies or materials to be consumed in providing the service to customers. For example, a hairdressing salon purchases shampoos, treatments and dyes that are not sold to customers but are used in providing the hairdressing service.



As a service organisation does not buy or sell trading goods, the closing procedure differs slightly to that of a trading organisation. Because there is no requirement to determine the cost of goods sold and, therefore, gross profit, there is no need for a trading account in the closing process. Therefore, all revenue and expense accounts are closed directly to the profit and loss account.

However, because a service organisation may purchase supplies or materials to be used in providing the service, they need to determine the cost of the supplies used during the accounting period before closing the revenue and expense accounts to the profit and loss account.

### Calculate the cost of supplies

The calculation of the cost of supplies used is similar to the calculation used by trading organisations when determining cost of goods sold.

The method used to calculate the cost of supplies used is as follows:

$$\begin{array}{r} \text{Stock of supplies on} \\ \text{hand at beginning of} \\ \text{period} \end{array} + \begin{array}{r} \text{Purchases of} \\ \text{supplies} \end{array} - \begin{array}{r} \text{Stock of supplies} \\ \text{on hand at end of} \\ \text{period} \end{array} = \begin{array}{r} \text{Cost of} \\ \text{supplies used} \end{array}$$

This process is carried out in the general ledger by closing the opening stock of supplies and purchases of supplies to an expense account called cost of supplies used.

### Closing stock of supplies

The closing stock of supplies also needs to be recorded as an adjustment to the cost of supplies used to determine the overall expense for the accounting period. Once the cost of supplies expense is determined, the account is closed to the profit and loss account along with all the other revenue and expense accounts.

Some organisations may primarily provide a service, but may also sell goods to customers. For example, while a hairdresser is primarily a service organisation, it may also sell haircare products to its customers. This is a combination of both a trading and a service organisation and the accounting required for such a combination is beyond the scope of this unit.

## Example: deal with the cost of supplies

The following trial balance has been extracted from the general ledger of Sparky Electrics after balance-day adjustments have been recorded for 30 June 2016.

Note that the adjustment for closing stock of electrical supplies on hand has not yet been recorded.

The stock of electrical supplies on hand as at 30 June 2016 is \$4,200.

| <b>Sparky Electrics</b>                                  |                     |                      |
|--|---------------------|----------------------|
| <b>Trial balance as at 30 June 2016</b>                  |                     |                      |
| <b>Account name</b>                                      | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Electrical fees revenue                                  |                     | 64,000               |
| Bank   | 13,175              |                      |
| Debtors  | 7,000               |                      |
| Provision for doubtful debts                             |                     | 150                  |
| Creditors  |                     | 11,000               |
| Input tax credits  | 125                 |                      |
| GST payable  |                     | 300                  |
| Motor vehicle  | 37,000              |                      |
| Accumulated depreciation – motor vehicle                 |                     | 16,000               |
| Tools  | 24,000              |                      |
| Accumulated depreciation – tools                         |                     | 19,000               |
| Office equipment   | 5,000               |                      |
| Accumulated depreciation – office equipment              |                     | 3,200                |
| Loan from bank   |                     | 21,000               |
| Prepaid expenses   | 800                 |                      |
| Prepaid revenue  |                     | 5,000                |
| Accrued expenses   |                     | 900                  |
| Purchase of electrical supplies                          | 21,000              |                      |
| Purchases, returns and allowances of electrical supplies |                     | 1,000                |
| Freight inwards  | 1,500               |                      |
| Rent   | 5,200               |                      |
| Stock of electrical supplies (1/07/15)                   | 3,000               |                      |
| Discount allowed   | 260                 |                      |
| Stationery   | 315                 |                      |
| Depreciation – motor vehicle                             | 4,500               |                      |

*continued ...*

... continued

|                                 |                |                |
|---------------------------------|----------------|----------------|
| Depreciation – tools            | 4,200          |                |
| Depreciation – office equipment | 800            |                |
| Advertising                     | 2,407          |                |
| Motor vehicle expenses          | 3,604          |                |
| Wages                           | 8,400          |                |
| Telephone                       | 1,869          |                |
| Electricity                     | 912            |                |
| Gas                             | 352            |                |
| Insurance                       | 1,124          |                |
| Postage                         | 95             |                |
| Bank fees                       | 305            |                |
| Doubtful debts                  | 175            |                |
| Staff amenities                 | 360            |                |
| Interest on loan                | 1,500          |                |
| Rates                           | 842            |                |
| Accounting expenses             | 600            |                |
| Discount received               |                | 180            |
| Drawings                        | 18,000         |                |
| Capital                         |                | 26,700         |
|                                 | <b>168,420</b> | <b>168,420</b> |

## Example: calculate the cost of supplies used

The first stage of the closing process for service organisations is to prepare the entries required to calculate the cost of supplies used.

| General journal – Sparky Electrics |   |       |          |           |
|------------------------------------|---|-------|----------|-----------|
| Date                               | Particulars   | Folio | Debit \$ | Credit \$ |
| 30/6/16                            | Cost of electrical supplies used                                |       | 25,500   |           |
|                                    | Stock of electrical supplies on hand<br>(opening stock 1/7/15)  |       |          | 3,000     |
|                                    | Purchase of electrical supplies                                 |       |          | 21,000    |
|                                    | Freight inwards   |       |          | 1,500     |
|                                    | <i>Transfer to cost of electrical supplies used<br/>account</i> |       |          |           |
| 30/6/16                            | Stock of electrical supplies on hand (30/6/16)                  |       | 4,200    |           |
|                                    | Purchases, returns and allowances of electrical<br>supplies     |       | 1,000    |           |
|                                    | Cost of electrical supplies used                                |       |          | 5,200     |
|                                    | <i>Transfer to cost of electrical supplies used<br/>account</i> |       |          |           |

The general ledger accounts, after the closing entries above have been posted, will be as follows.

| General ledger – Sparky Electrics       |  |             |             |              |               |
|---|--|-------------|-------------|--------------|---------------|
| Date                                    | Particulars  | Jnl<br>ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
| <b>Cost of electrical supplies used</b> |  |             |             |              |               |
| 30/6/16                                 | Stock of electrical supplies<br>(opening stock 1/7/15) | GJ          | 3,000       |              | 3,000 Dr      |
|   | Purchases of electrical supplies                       | GJ          | 21,000      |              | 24,000 Dr     |
|   | Freight inwards  | GJ          | 1,500       |              | 25,500 Dr     |
|   | Purchases, returns and<br>allowances                   | GJ          |             | 1,000        | 24,500 Dr     |
|   | Stock (closing stock 30/6/16)                          | GJ          |             | 4,200        | 20,300 Dr     |
| <b>Stock of electrical supplies</b>     |  |             |             |              |               |
| 1/7/16                                  | Balance  |             |             |              | 3,000 Dr      |
| 30/6/16                                 | Cost of electrical supplies used                       | GJ          |             | 3,000        | Nil           |
|   | Cost of electrical supplies used                       | GJ          | 4,200       |              | 4,200 Dr      |

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| Date  | Particulars                      | Jnl<br>ref. | Debit<br>\$ | Credit<br>\$ | Balance<br>\$ |
|---|----------------------------------|-------------|-------------|--------------|---------------|
| <b>Purchases of electrical supplies</b>                         |                                  |             |             |              |               |
| 30/6/16   | Balance                          |             |             |              | 21,000 Dr     |
|   | Cost of electrical supplies used | GJ          |             | 21,000       | Nil           |
| <b>Purchases, returns and allowances of electrical supplies</b> |                                  |             |             |              |               |
| 30/6/16   | Balance                          |             |             |              | 1,000 Cr      |
|   | Cost of electrical supplies used | GJ          | 1,000       |              | Nil           |
| <b>Freight inwards</b>  |                                  |             |             |              |               |
| 30/6/16   | Balance                          |             |             |              | 1,500 Dr      |
|   | Cost of electrical supplies used | GJ          |             | 1,500        | Nil           |

- All of the accounts relating to the electrical supplies have now been closed to the cost of electrical supplies used account and have a nil balance.
- The stock of electrical supplies account has a debit balance of \$4,200 representing the value of the unused stock (unused purchases expense) to be used in the next accounting period and will be shown as an asset on the statement of financial position.
- The cost of electrical supplies used account has a debit balance of \$20,300. This represents the expense incurred for the use of the electrical supplies when providing the electrical service for this accounting period.

Now that the cost of electrical supplies used has been determined, this and all the other revenue and expense accounts can be closed to the profit and loss account. It is from this stage onwards that the closing process for service organisations is the same as that for trading organisations.

## Example: the closing process

Sparky Electrics will now close all revenue and expense accounts to the profit and loss account.

| General journal – Sparky Electrics |                                  |       |          |           |
|------------------------------------|----------------------------------|-------|----------|-----------|
| Date                               | Particulars                      | Folio | Debit \$ | Credit \$ |
| 30/6/16                            | Profit and loss                  |       | 58,120   |           |
|                                    | Cost of electrical supplies used |       |          | 20,300    |
|                                    | Rent                             |       |          | 5,200     |
|                                    | Discount allowed                 |       |          | 260       |
|                                    | Stationery                       |       |          | 315       |
|                                    | Depreciation – motor vehicle     |       |          | 4,500     |
|                                    | Depreciation – tools             |       |          | 4,200     |
|                                    | Depreciation – office equipment  |       |          | 800       |
|                                    | Advertising                      |       |          | 2,407     |
|                                    | Motor vehicle expenses           |       |          | 3,604     |
|                                    | Wages                            |       |          | 8,400     |
|                                    | Telephone                        |       |          | 1,869     |
|                                    | Electricity                      |       |          | 912       |
|                                    | Gas                              |       |          | 352       |
|                                    | Insurance                        |       |          | 1,124     |
|                                    | Postage                          |       |          | 95        |
|                                    | Bank fees                        |       |          | 305       |
|                                    | Doubtful debts                   |       |          | 175       |
|                                    | Staff amenities                  |       |          | 360       |
|                                    | Interest on loan                 |       |          | 1,500     |
|                                    | Rates                            |       |          | 842       |
|                                    | Accounting expenses              |       |          | 600       |
|                                    | <i>Closing entry</i>             |       |          |           |
| 30/6/16                            | Electrical fees revenue          |       | 64,000   |           |
|                                    | Discount received                |       | 180      |           |
|                                    | Profit and loss                  |       |          | 64,180    |
|                                    | <i>Closing entry</i>             |       |          |           |

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The general ledger accounts, after the closing entries above have been posted, will be as follows.

| <b>General ledger – Sparky Electrics</b> |   |          |          |           |            |
|--|---|----------|----------|-----------|------------|
| Date                                     | Particulars   | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Cost of electrical supplies used</b>  |   |          |          |           |            |
| 30/6/16                                  | Stock of electrical supplies (opening stock 1/7/15) | GJ       | 3,000    |           | 3,000 Dr   |
|  | Purchases of electrical supplies                    | GJ       | 21,000   |           | 24,000 Dr  |
|  | Freight inwards                                     | GJ       | 1,500    |           | 25,500 Dr  |
|  | Purchases, returns and allowances                   | GJ       |          | 1,000     | 24,500 Dr  |
|  | Stock (closing stock 30/6/16)                       | GJ       |          | 4,200     | 20,300 Dr  |
|  | Profit and loss                                     | GJ       |          | 20,300    | Nil        |
| <b>Profit and loss</b>                   |   |          |          |           |            |
| 30/6/16                                  | Cost of electrical supplies used                    | GJ       | 20,300   |           | 20,300 Dr  |
|  | Rent  | GJ       | 5,200    |           | 25,500 Dr  |
|  | Discount allowed                                    | GJ       | 260      |           | 25,760 Dr  |
|  | Stationery  | GJ       | 315      |           | 26,075 Dr  |
|  | Depreciation – motor vehicle                        | GJ       | 4,500    |           | 30,575 Dr  |
|  | Depreciation – tools                                | GJ       | 4,200    |           | 34,775 Dr  |
|  | Depreciation – office equipment                     | GJ       | 800      |           | 35,575 Dr  |
|  | Advertising   | GJ       | 2,407    |           | 37,982 Dr  |
|  | Motor vehicle expense                               | GJ       | 3,604    |           | 41,586 Dr  |
|  | Wages   | GJ       | 8,400    |           | 49,986 Dr  |
|  | Telephone   | GJ       | 1,869    |           | 51,855 Dr  |
|  | Electricity   | GJ       | 912      |           | 52,767 Dr  |
|  | Gas   | GJ       | 352      |           | 53,119 Dr  |
|  | Insurance   | GJ       | 1,124    |           | 54,243 Dr  |
|  | Postage   | GJ       | 95       |           | 54,338 Dr  |
|  | Bank fees   | GJ       | 305      |           | 54,643 Dr  |
|  | Doubtful debts                                      | GJ       | 175      |           | 54,818 Dr  |

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|  |                         |    |       |        |           |
|--|-------------------------|----|-------|--------|-----------|
|  | Staff amenities         | GJ | 360   |        | 55,178 Dr |
|  | Interest on loan        | GJ | 1,500 |        | 56,678 Dr |
|  | Rates                   | GJ | 842   |        | 57,520 Dr |
|  | Accounting expenses     | GJ | 600   |        | 58,120 Dr |
|  | Electrical fees revenue | GJ |       | 64,000 | 5,880 Cr  |
|  | Discount received       | GJ |       | 180    | 6,606 Cr  |

All other revenue and expense accounts will now have a nil balance. The profit and loss account and the drawings account are now closed to the capital account.

| General journal – Sparky Electrics |                                    |       |          |           |
|------------------------------------|------------------------------------|-------|----------|-----------|
| Date                               | Particulars                        | Folio | Debit \$ | Credit \$ |
| 30/6/16                            | Profit and loss                    |       | 6,060    |           |
|                                    | Capital                            |       |          | 6,060     |
|                                    | <i>Close net profit to capital</i> |       |          |           |
| 30/6/16                            | Capital                            |       | 18,000   |           |
|                                    | Drawings                           |       |          | 18,000    |
|                                    | <i>Close drawings to capital</i>   |       |          |           |

The general ledger accounts, after the entries above have been posted, will be as follows.

| General ledger – Sparky Electrics |                                  |          |          |           |            |
|-----------------------------------|----------------------------------|----------|----------|-----------|------------|
| Date                              | Particulars                      | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Profit and loss</b>            |                                  |          |          |           |            |
| 30/6/16                           | Cost of electrical supplies used | GJ       | 20,300   |           | 20,300 Dr  |
|                                   | Rent                             | GJ       | 5,200    |           | 25,500 Dr  |
|                                   | Discount allowed                 | GJ       | 260      |           | 25,760 Dr  |
|                                   | Stationery                       | GJ       | 315      |           | 26,075 Dr  |
|                                   | Depreciation – motor vehicle     | GJ       | 4,500    |           | 30,575 Dr  |
|                                   | Depreciation – tools             | GJ       | 4,200    |           | 34,775 Dr  |
|                                   | Depreciation – office equipment  | GJ       | 800      |           | 35,575 Dr  |
|                                   | Advertising                      | GJ       | 2,407    |           | 37,982 Dr  |
|                                   | Motor vehicle expense            | GJ       | 3,604    |           | 41,586 Dr  |

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|                 |                         |    |        |        |           |
|-----------------|-------------------------|----|--------|--------|-----------|
|                 | Wages                   | GJ | 8,400  |        | 49,986 Dr |
|                 | Telephone               | GJ | 1,869  |        | 51,855 Dr |
|                 | Electricity             | GJ | 912    |        | 52,767 Dr |
|                 | Gas                     | GJ | 352    |        | 53,119 Dr |
|                 | Insurance               | GJ | 1,124  |        | 54,243 Dr |
|                 | Postage                 | GJ | 95     |        | 54,338 Dr |
|                 | Bank fees               | GJ | 305    |        | 54,643 Dr |
|                 | Doubtful debts          | GJ | 175    |        | 54,818 Dr |
|                 | Staff amenities         | GJ | 360    |        | 55,178 Dr |
|                 | Interest on loan        | GJ | 1,500  |        | 56,678 Dr |
|                 | Rates                   | GJ | 842    |        | 57,520 Dr |
|                 | Accounting expenses     | GJ | 600    |        | 58,120 Dr |
|                 | Electrical fees revenue | GJ |        | 64,000 | 5,880 Cr  |
|                 | Discount received       | GJ |        | 180    | 6,606 Cr  |
|                 | Capital                 | GJ | 6,606  |        | Nil       |
| <b>Drawings</b> |                         |    |        |        |           |
| 30/6/16         | Balance                 |    |        |        | 18,000 Dr |
|                 | Capital                 | GJ |        | 18,000 | Nil       |
| <b>Capital</b>  |                         |    |        |        |           |
| 30/6/16         | Balance                 |    |        |        | 26,700 Cr |
|                 | Profit and loss         | GJ |        | 6,060  | 32,760 Cr |
|                 | Drawings                | GJ | 18,000 |        | 14,760 Cr |

Once all revenue and expense account balances have been transferred to the profit determination accounts and the net profit or loss, and drawings transferred to the owner's capital account, the remaining accounts in the general ledger will consist of assets, liabilities and owner's equity.

A post-closing trial balance can be prepared with these accounts, from which a statement of financial position could be prepared.

The post-closing statement of financial position of Sparky Electrics shows the following accounts and their balances.

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| <b>Sparky Electrics</b>                               |                     |                      |
|---|---------------------|----------------------|
| <b>*Post-closing trial balance as at 30 June 2008</b> |                     |                      |
| <b>Account name</b>                                   | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Bank  | 13,175              |                      |
| Debtors   | 7,000               |                      |
| Provision for doubtful debts                          |                     | 140                  |
| Creditors   |                     | 11,000               |
| Input tax credits                                     | 125                 |                      |
| GST payable   |                     | 300                  |
| Motor vehicle   | 37,000              |                      |
| Accumulated depreciation – motor vehicle              |                     | 16,000               |
| Tools   | 24,000              |                      |
| Accumulated depreciation – tools                      |                     | 19,000               |
| Office equipment                                      | 5,000               |                      |
| Accumulated depreciation – office equipment           |                     | 3,200                |
| Loan from bank  |                     | 21,000               |
| Prepaid expenses                                      | 800                 |                      |
| Prepaid revenue                                       |                     | 5,000                |
| Accrued expenses                                      |                     | 900                  |
| Stock of electrical supplies                          | 4,200               |                      |
| Capital   |                     | 14,760               |
|   | <b>91,300</b>       | <b>91,300</b>        |

\*The post-closing trial balance will only show the items to be included in the statement of financial position; that is, assets, liabilities and owner's equity.

## Summary

1. At the end of the accounting period, once all the balance-day adjustments have been posted, it is necessary to finalise the accounts in the general ledger to produce financial reports.
2. Balances in the revenue and expense accounts in the general ledger need to be transferred or closed to profit determination accounts in the general ledger, thereby closing off the revenue and expenses to a nil balance. These profit determination accounts, known as the trading account and the profit and loss account, are temporary clearing accounts that are set up and used for the purpose of determining profits/losses.
3. The trading account is used by organisations that buy and sell goods to determine their gross profit/loss. The trading result is calculated by deducting the cost of purchasing the goods and getting them ready for sale, from the revenue earned from selling the goods.
4. A gross profit results where the trading revenue earned is greater than the total of all the cost of goods sold expenses. A gross loss results where the total of the cost of goods sold expenses is greater than the trading revenue earned.
5. Because the trading account is a temporary or clearing account, the balance remaining in the account (gross profit/loss) must be transferred to another temporary or clearing account called profit and loss account to determine the overall net profit or loss for the accounting period. The profit and loss account is a temporary or clearing account that is used to determine the organisation's net profit/loss.
6. Net profit/loss is calculated by adding any non-trading revenue earned in this accounting period to the gross profit, then deducting all other operating expenses. All remaining revenue (non-trading) and expense (operating) accounts that do not have a nil balance are transferred to the profit and loss account. A net profit results where the total revenue earned is greater than the total of all the expenses incurred. A net loss results where the total of all expenses incurred is greater than the total revenue earned.
7. As the profit and loss account is a temporary or clearing account, the balance remaining in the account (net profit/loss) must be closed to the owner's equity account, as the organisation's net profits or losses belong to the owner/s.
8. The final stage of the closing procedure is to identify the closing balance at the end of this accounting period for the capital account/s. The final account that must be closed and transferred is the drawings account. Drawings represent the value of the total withdrawals made by the owner during this accounting period and must be deducted from the overall capital balance.
9. Once all accounts have been closed, a post-closing trial balance is prepared prior to the preparation of the financial reports to ensure the general ledger is in balance.

## Learning checkpoint 3 Prepare final general ledger accounts

This learning checkpoint allows you to review your skills and knowledge in preparing final general ledger accounts. Templates for the accountancy tables are available at <http://chilp.it/ee80e58> or by scanning the QR code.



### Part A

Identify which of the accounts shown below will be closed to the trading account (t) and the profit and loss account (p). Use a dash (-) to indicate which accounts will not be closed to either the trading or profit and loss accounts.

| Account   | T or P | Account                                  | T or P |
|---|--------|--|--------|
| Motor vehicle                                     |        | Petty cash advance                       |        |
| Advertising                                       |        | Sales salaries                           |        |
| Office expenses                                   |        | Investment in shares                     |        |
| Loss from flood damage                            |        | Customs duty                             |        |
| Freight inwards                                   |        | Discount revenue                         |        |
| Net profit  |        | Opening stock                            |        |
| Motor vehicle expenses                            |        | Purchases                                |        |
| Loan from CBC Finance                             |        | Travel expenses                          |        |
| Depreciation – equipment                          |        | Dividends received                       |        |
| Buying expenses                                   |        | Gross profit                             |        |
| Drawings  |        | Accumulated depreciation – motor vehicle |        |
| Freight outwards                                  |        | Interest on overdraft                    |        |
| Sales   |        | Purchases returns and allowances         |        |
| Closing stock                                     |        | Commission revenue                       |        |
| Computer system                                   |        | Sales returns and allowances             |        |
| Administration salaries                           |        | Discount allowed                         |        |
| Land and buildings                                |        | Capital                                  |        |
| Accumulated depreciation – furniture and fixtures |        | Loan to PM Industries                    |        |

## Part B

From the information provided in the adjusted trial balance that follows, you are required to:

- prepare general journal entries to close the ledger
- post the general journal entries to the general ledger
- prepare a post-closing trial balance as at 30 June 2016.

Note: stock on hand as at 30 June 2016 is \$3,200.

| <b>Sammy's Bric-a-Brac</b>                       |                     |                      |
|--|---------------------|----------------------|
| <b>Adjusted trial balance as at 30 June 2016</b> |                     |                      |
| <b>Account name</b>                              | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Bank   |                     | 621                  |
| Debtors  | 1,500               |                      |
| Advertising                                      | 870                 |                      |
| Trade creditors control                          |                     | 905                  |
| Input tax credits                                | 126                 |                      |
| GST payable                                      |                     | 79                   |
| Land and buildings                               | 50,000              |                      |
| Mortgage on land and buildings                   |                     | 32,000               |
| Discount allowed                                 | 350                 |                      |
| Salaries   | 3,800               |                      |
| Accounting expenses                              | 700                 |                      |
| Commission expenses                              | 1,800               |                      |
| Interest on mortgage                             | 1,850               |                      |
| Petty cash                                       | 150                 |                      |
| Insurance  | 1,000               |                      |
| Freight inwards                                  | 300                 |                      |
| Stock (1/7/15)                                   | 2,500               |                      |
| Postage  | 150                 |                      |
| Purchases  | 26,500              |                      |
| Purchases returns and allowances                 |                     | 1,500                |
| Sales  |                     | 39,050               |
| Sales returns and allowances                     | 1,425               |                      |
| Drawings   | 740                 |                      |

*continued ...*

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| Account name                                      | Debit<br>\$    | Credit<br>\$   |
|---|----------------|----------------|
| Subscriptions                                     | 140            |                |
| Capital   |                | 34,026         |
| Vehicle expenses                                  | 1,800          |                |
| Electricity                                       | 490            |                |
| Bank fees   | 550            |                |
| Stationery  | 300            |                |
| Commission revenue                                |                | 425            |
| Telephone   | 800            |                |
| Motor vehicle                                     | 15,000         |                |
| Accumulated depreciation – motor vehicle          |                | 5,000          |
| Furniture and fittings                            | 700            |                |
| Accumulated depreciation – furniture and fittings |                | 35             |
| Depreciation – motor vehicles                     | 465            |                |
| Depreciation – furniture and fittings             | 35             |                |
| Prepaid expenses                                  | 35             |                |
| Accrued revenue                                   | 125            |                |
| Accrued expenses                                  |                | 560            |
| Annual leave                                      | 700            |                |
| Provision for annual leave                        |                | 700            |
|   | <b>114,901</b> | <b>114,901</b> |

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## Topic 4

# Prepare the end-of-period financial reports

At the end of the year (calendar or financial) after all closing procedures have been finalised, it is necessary to prepare the end-of-period financial reports.

The two main reports prepared for a sole trader business are the income (profit and loss) statement, which shows the net profit (loss), and the statement of financial position, which discloses the balances of asset, liability and owner's equity accounts.

In this topic you will learn how to:

- 4A Prepare the income (profit and loss) statement
- 4B Prepare the statement of financial position (balance sheet)

# 4A

## Prepare the income (profit and loss) statement

The income statement, commonly referred to as the profit and loss statement, reports on the revenues and expenses for the year and has the following features.

### Title

The title of the statement must show the organisation's name and the accounting period for which the statement is being prepared; for example, for the year ending or for the months ending.

### Trading section

All revenues and expenses shown in the general ledger trading account are reported in the trading section of the statement to show the organisation's gross profit or loss.

### Profit and loss section

All revenues and expenses shown in the general ledger profit and loss account are included in the statement to show the organisation's net profit or loss.

## Example: format of a statement

Here is an example that shows the format of an income (profit and loss) statement.

| <b>R James Bag Manufacturer</b>       |              |               |                |
|---------------------------------------|--------------|---------------|----------------|
| <b>Income statement</b>               |              |               |                |
| <b>For year ended 30 June 2016</b>    |              |               |                |
|                                       | \$           | \$            | \$             |
| Sales                                 |              | 200,000       |                |
| Less sales returns and allowances     |              | <u>3,000</u>  |                |
| <b>Net sales</b>                      |              |               | <b>197,000</b> |
| Less cost of goods sold               |              |               |                |
| Opening stock                         |              | 25,000        |                |
| Add purchases                         | 65,000       |               |                |
| Less purchases returns and allowances | <u>2,000</u> | <u>63,000</u> |                |
| Cost of goods available for sale      |              | 88,000        |                |
| Less closing stock 30/6/16            |              | <u>45,000</u> |                |
| Total cost of goods sold              |              |               | <u>43,000</u>  |
| <b>Gross profit</b>                   |              |               | <b>154,000</b> |
| Add other revenue                     |              | 20,000        |                |
| Rent earned                           |              | <u>2,000</u>  | <u>22,000</u>  |
| Interest earned                       |              |               | 176,000        |
|                                       |              |               |                |
| Less other operating expenses         |              |               |                |
| Administration expenses               |              | 5,000         |                |
| Financial expenses                    |              | 10,000        |                |
| Selling expenses                      |              | <u>15,000</u> | <u>30,000</u>  |
| <b>Net Profit (Loss)</b>              |              |               | <b>146,000</b> |

## Example: prepare a trading, profit and loss statement

Here is an example that shows how to prepare a trading, profit and loss statement.

Possum Magic has closed its revenue and expense accounts to the trading and profit and loss accounts in the general ledger. From these accounts, the business will now prepare its income statement for the year ended 30 June 2016.

The trading and profit and loss accounts are as follows.

| General ledger – Possum Magic |                                  |          |          |           |            |
|-------------------------------|----------------------------------|----------|----------|-----------|------------|
| Date                          | Particulars                      | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Trading</b>                |                                  |          |          |           |            |
| 30/6/16                       | Stock (opening stock 1/7/15)     |          | 3,500    |           | 3,500 Dr   |
|                               | Stock (closing stock 30/6/16)    |          |          | 2,800     | 700 Dr     |
|                               | Sales returns and allowances     | GJ       | 2,000    |           | 2,700 Dr   |
|                               | Purchases                        | GJ       | 21,000   |           | 23,700 Dr  |
|                               | Freight inwards                  | GJ       | 1,500    |           | 25,200 Dr  |
|                               | Insurance on stock               | GJ       | 1,200    |           | 26,400 Dr  |
|                               | Customs duty                     | GJ       | 1,300    |           | 27,700 Dr  |
|                               | Wharfage fees                    | GJ       | 900      |           | 28,600 Dr  |
|                               | Sales                            | GJ       |          | 64,000    | 35,400 Cr  |
|                               | Purchases returns and allowances | GJ       |          | 1,000     | 36,400 Cr  |
|                               | Profit and loss                  | GJ       | 36,400   |           | Nil        |
| <b>Profit and loss</b>        |                                  |          |          |           |            |
| 30/6/16                       | Trading                          | GJ       |          | 36,400    | 36,400 Cr  |
|                               | Rent                             | GJ       | 5,200    |           | 31,200 Cr  |
|                               | Freight outwards                 | GJ       | 308      |           | 30,892 Cr  |
|                               | Discount allowed                 | GJ       | 260      |           | 30,632 Cr  |
|                               | Stationery                       | GJ       | 315      |           | 30,317 Cr  |
|                               | Depreciation – motor vehicles    | GJ       | 1,350    |           | 28,967 Cr  |
|                               | Depreciation – shop fittings     | GJ       | 250      |           | 28,717 Cr  |
|                               | Depreciation – office equipment  | GJ       | 800      |           | 27,917 Cr  |
|                               | Advertising                      | GJ       | 2,407    |           | 25,510 Cr  |
|                               | Motor vehicle expenses           | GJ       | 3,604    |           | 21,906 Cr  |

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| Date | Particulars         | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
|------|---------------------|----------|----------|-----------|------------|
|      | Wages               | GJ       | 8,400    |           | 13,506 Cr  |
|      | Telephone           | GJ       | 1,869    |           | 11,637 Cr  |
|      | Electricity         | GJ       | 912      |           | 10,725 Cr  |
|      | Gas                 | GJ       | 352      |           | 10,373 Cr  |
|      | Insurance           | GJ       | 1,124    |           | 9,249 Cr   |
|      | Postage             | GJ       | 95       |           | 9,154 Cr   |
|      | Bank fees           | GJ       | 305      |           | 8,849 Cr   |
|      | Doubtful debts      | GJ       | 175      |           | 8,674 Cr   |
|      | Staff amenities     | GJ       | 360      |           | 8,314 Cr   |
|      | Interest on loan    | GJ       | 1,500    |           | 6,814 Cr   |
|      | Rates               | GJ       | 842      |           | 5,972 Cr   |
|      | Accounting expenses | GJ       | 600      |           | 5,372 Cr   |
|      | Discount received   | GJ       |          | 180       | 5,552 Cr   |
|      | Interest revenue    | GJ       |          | 198       | 5,750 Cr   |
|      | Capital             | GJ       | 5,750    |           | Nil        |

**Step 1**

Using the accounts disclosed in the trading account, prepare the trading section of the income statement as follows.

| <b>Possum Magic</b><br><b>Income statement</b><br><b>For year ended 30 June 2016</b> |              |              |        |
|--|--------------|--------------|--------|
|  | \$           | \$           | \$     |
| Sales  |              | 64,000       |        |
| Less sales returns and allowances  |              | <u>2,000</u> |        |
| <b>Net sales</b>   |              |              | 62,000 |
| Less cost of goods sold  |              |              |        |
| Stock (opening stock 1/7/15)   |              | 3,500        |        |
| Add purchases  | 21,000       |              |        |
| Less purchases returns and allowances  | <u>1,000</u> | 20,000       |        |
| Add direct purchasing costs  |              |              |        |
| Freight inwards  | 1,500        |              |        |

continued ...

... continued

|                                    |            |              |               |
|------------------------------------|------------|--------------|---------------|
| Insurance on stock                 | 1,200      |              |               |
| Customs duty                       | 1,300      |              |               |
| Wharfage fees                      | <u>900</u> | <u>4,900</u> |               |
| Cost of goods available for sale   |            | 28,400       |               |
| Less stock (closing stock 30/6/16) |            | <u>2,800</u> |               |
| Total cost of goods sold           |            |              | <u>25,600</u> |
| <b>Gross profit</b>                |            |              | <b>36,400</b> |

You should notice that the format is set out as follows:

- The revenue is presented first; that is, sales – sales returns = net sales.
- The cost of goods sold is calculated and totalled. To determine the cost of goods sold, the following format should be followed:

|  |
|--|
| Stock (at start of year)                 |
| Add purchases                            |
| Less purchases returns                   |
| Add other expenses                       |
| Equals cost of goods available for sales |
| Less stock (at end of year)              |
| Equals cost of goods sold                |

- The gross profit is calculated by deducting the cost of goods sold total from the net sales figure.

When preparing an income statement, there can be confusion about which column to place the amounts in. Generally:

- only use the right-hand column for major subtotals
- as a rule of thumb, it is best to record most figures in the second column
- the first column is mainly used to deduct purchase returns from purchases.

The information disclosed in Magic Possum's profit and loss account would be added to the income statement as follows.

### Step 2

Using the accounts disclosed in the profit and loss account, include other revenues and other operating expenses to determine the net profit.

continued ...

... continued

| <b>Possum Magic</b>                   |              |              |               |
|---------------------------------------|--------------|--------------|---------------|
| <b>Income statement</b>               |              |              |               |
| <b>For year ended 30 June 2016</b>    |              |              |               |
|                                       | \$           | \$           | \$            |
| Sales                                 |              | 64,000       |               |
| Less sales returns and allowances     |              | <u>2,000</u> |               |
| <b>Net sales</b>                      |              |              | <b>62,000</b> |
| Less cost of goods sold               |              |              |               |
| Stock (opening stock 1/7/15)          |              | 3,500        |               |
| Add purchases                         | 21,000       |              |               |
| Less purchases returns and allowances | <u>1,000</u> | 20,000       |               |
| Add direct purchasing costs           |              |              |               |
| Freight inwards                       | 1,500        |              |               |
| Insurance on stock                    | 1,200        |              |               |
| Customs duty                          | 1,300        |              |               |
| Wharfage fees                         | <u>900</u>   | <u>4,900</u> |               |
| Cost of goods available for sale      |              | 28,400       |               |
| Less stock (closing stock 30/6/16)    |              | <u>2,800</u> |               |
| Total cost of goods sold              |              |              | <u>25,600</u> |
| <b>Gross profit</b>                   |              |              | <b>36,400</b> |
| Add other revenue                     |              |              |               |
| Discount received                     |              | 180          |               |
| Interest revenue                      |              | <u>198</u>   | <u>378</u>    |
|                                       |              |              | 36,778        |
| Less other operating expenses         |              |              |               |
| Rent                                  |              | 5,200        |               |
| Freight outwards                      |              | 308          |               |
| Discount allowed                      |              | 260          |               |
| Stationery                            |              | 315          |               |
| Depreciation – motor vehicles         |              | 1,350        |               |
| Depreciation – shop fittings          |              | 250          |               |
| Depreciation – office equipment       |              | 800          |               |
| Advertising                           |              | 2,407        |               |

continued ...

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|                        |  |            |               |
|------------------------|--|------------|---------------|
| Motor vehicle expenses |  | 3,604      |               |
| Wages                  |  | 8,400      |               |
| Telephone              |  | 1,869      |               |
| Electricity            |  | 912        |               |
| Gas                    |  | 352        |               |
| Insurance              |  | 1,124      |               |
| Postage                |  | 95         |               |
| Bank fees              |  | 305        |               |
| Doubtful debts         |  | 175        |               |
| Staff amenities        |  | 360        |               |
| Interest on loan       |  | 1,500      |               |
| Rates                  |  | 842        |               |
| Accounting expenses    |  | <u>600</u> | <u>31,028</u> |
| <b>Net profit</b>      |  |            | <b>5,750</b>  |

You should take particular notice of the following:

The gross profit reported in the trading account and the net profit (loss) reported in the profit and loss statement must both be reported in the income statement.

## Practice task 11

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

A business, Malstrom Traders, has closed its revenue and expense accounts to the trading and profit and loss accounts in the general ledger.

From these accounts, prepare the trading and profit and loss statement for the year ended 30 June 2016.



| General ledger – Malstrom Traders |                               |          |          |          |            |
|-----------------------------------|-------------------------------|----------|----------|----------|------------|
| Date                              | Particulars                   | Jnl ref. | Debit \$ | Debit \$ | Balance \$ |
| <b>Trading</b>                    |                               |          |          |          |            |
| 30/6/16                           | Stock (opening stock 1/7/15)  | GJ       | 10,000   |          | 10,000 Dr  |
|                                   | Stock (closing stock 30/6/16) | GJ       |          | 12,000   | 2,000 Cr   |
|                                   | Sales returns and allowances  | GJ       | 3,000    |          | 1,000 Dr   |

continued ...

continued ...

| Date                   | Particulars                      | Jnl ref. | Debit \$ | Debit \$ | Balance \$ |
|------------------------|----------------------------------|----------|----------|----------|------------|
|                        | Purchases                        | GJ       | 107,000  |          | 108,000 Dr |
|                        | Freight inwards                  | GJ       | 2,600    |          | 110,600 Dr |
|                        | Customs duty                     | GJ       | 7,300    |          | 117,900 Dr |
|                        | Sales                            | GJ       |          | 250,000  | 132,100 Cr |
|                        | Purchases returns and allowances | GJ       |          | 5,000    | 137,100 Cr |
|                        | Profit and loss                  | GJ       | 137,100  |          | Nil        |
| <b>Profit and loss</b> |                                  |          |          |          |            |
| 30/6/16                | Trading                          | GJ       |          | 137,100  | 137,100 Cr |
|                        | Administration wages             | GJ       | 28,400   |          | 108,700 Cr |
|                        | Telephone                        | GJ       | 1,850    |          | 106,850 Cr |
|                        | Discount allowed                 | GJ       | 3,560    |          | 103,290 Cr |
|                        | Advertising                      | GJ       | 3,800    |          | 99,490 Cr  |
|                        | Stationery                       | GJ       | 2,500    |          | 96,990 Cr  |
|                        | Motor vehicle expenses           | GJ       | 11,500   |          | 85,490 Cr  |
|                        | Salesperson's salaries           | GJ       | 65,000   |          | 20,490 Cr  |
|                        | Depreciation – office equipment  | GJ       | 1,800    |          | 18,690 Cr  |
|                        | Rent                             | GJ       | 15,200   |          | 3,490 Cr   |
|                        | Bank fees                        | GJ       | 815      |          | 2,675 Cr   |
|                        | Freight outwards                 | GJ       | 5,000    |          | 2,325 Dr   |
|                        | Depreciation – motor vehicle     | GJ       | 2,450    |          | 4,775 Dr   |
|                        | Doubtful debts                   | GJ       | 560      |          | 5,335 Dr   |
|                        | Postage                          | GJ       | 195      |          | 5,530 Dr   |
|                        | Insurance                        | GJ       | 1,700    |          | 7,230 Dr   |
|                        | Interest on loan                 | GJ       | 1,200    |          | 8,430 Dr   |
|                        | Electricity                      | GJ       | 878      |          | 9,308 Dr   |
|                        | Commission received              | GJ       |          | 27,400   | 18,092 Cr  |
|                        | Discount received                | GJ       |          | 2,300    | 20,392 Cr  |
|                        | Capital                          | GJ       | 20,392   |          | Nil        |

# 4B

## Prepare the statement of financial position (balance sheet)

The statement of financial position is a listing of the organisation's assets, liabilities and owner's equity balances and is presented in a format that is similar to the accounting equation:

$$\text{Owner's equity} = \text{assets} - \text{liabilities}$$

The statement of financial position has the following features.

### Title

The title of the statement must show the name of the organisation and the date at which the statement has been prepared; for example, as at 30 June 2016. The words 'as at' must be used, as the statement of financial position shows the account balances at a particular date, unlike an income statement, which shows the profit (loss) over a period of time.

### Owner's equity

The full details of the amounts owing to and taken by the owner must be reported, hence the opening balance, drawings and net profit/loss are listed as shown in the general ledger capital account.

### Working capital

Working capital is the term used to refer to the organisation's liquidity. This is the organisation's ability to meet its current liabilities from current assets available. The balances of all the current asset and current liability general ledger accounts are listed. The difference between the total of current assets and current liabilities represents working capital.

### Current assets

Current assets are assets that are either cash or convertible to cash within the ensuing 12 months. Examples of current assets include cash at bank, input tax credits, debtors, stock, prepaid expenses and accrued revenue. Provision for doubtful debts is also included, as it is a negative current asset that is deducted from debtors to determine a net debtor's balance.

### Current liabilities

Current liabilities are liabilities that are expected to be repaid within the ensuing 12 months. Examples of current liabilities include creditors, GST payable, accrued expenses, prepaid revenues and provision for annual leave.

**Net assets**

Net assets represents the final balance of all assets less all liabilities and should equal the owner's equity balance. In the narrative form of the statement of financial position, net assets is determined by adding non-current assets to the working capital balance and then deducting deferred liabilities.

**Non-current assets**

Non-current assets are assets that are held for longer than 12 months and are used by the business for generating revenue in the future. Examples of non-current assets include land, buildings and motor vehicles. Accumulated depreciation of assets is also included as a negative non-current asset to be deducted from the capital cost of the assets to determine written-down values.

**Deferred (non-current) liabilities**

Deferred (non-current) liabilities are liabilities that are unlikely to be repaid within the next 12 months. Examples of deferred liabilities include mortgages on land and buildings, loans (due in over a year) and provision for long service leave.

## Example: prepare a statement of financial position

Here is an example that shows how to prepare a statement of financial position.

Magic Possum has prepared its income statement and will now prepare its statement of financial position as at 30 June 2016. From the general ledger, the following accounts still have remaining balances after all closing entries have been recorded for 30 June 2016.

The accounts have been classified to assist in their presentation in the statement of financial position.

| Account name  | Balance \$ | Classification             |
|---|------------|----------------------------|
| Bank  | 15,325 Dr  | Current asset              |
| Debtors   | 3,750 Dr   | Current asset              |
| Provision for doubtful debts                        | 150 Cr     | Negative current asset     |
| Stock (30/6/16)                                     | 2,800 Dr   | Current asset              |
| Stock of stationery                                 | 15 Dr      | Current asset              |
| Input tax credits                                   | 325 Dr     | Current asset              |
| Motor vehicle                                       | 15,867 Dr  | Non-current asset          |
| Accumulated depreciation – motor vehicle            | 5,400 Cr   | Negative non-current asset |
| Shop fittings                                       | 3,500 Dr   | Non-current asset          |
| Accumulated depreciation – shop fittings            | 500 Cr     | Negative non-current asset |
| Office equipment                                    | 9,000 Dr   | Non-current asset          |
| Accumulated depreciation – office equipment         | 1,600 Cr   | Negative non-current asset |
| Prepaid expenses                                    | 135 Dr     | Current asset              |
| Accrued revenue                                     | 75 Dr      | Current asset              |
| Fixed-term investment (3 years to maturity)         | 10,000 Dr  | Non-current asset          |
| Loan from Newtyn Finance (due to be repaid by 2020) | 15,000 Cr  | Non-current liability      |
| Creditors   | 1,150 Cr   | Current liability          |
| GST payable   | 450 Cr     | Current liability          |
| Accrued expenses                                    | 475 Cr     | Current liability          |
| Prepaid revenue                                     | 95 Cr      | Current liability          |

The capital account as it appears in the general ledger is shown below.

| General ledger – Possum Magic |                 |          |          |           |            |
|-------------------------------|-----------------|----------|----------|-----------|------------|
| Date                          | Particulars     | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Capital</b>                |                 |          |          |           |            |
| 1/7/15                        | Balance         |          |          |           | 33,522 Cr  |
| 30/6/16                       | Profit and loss | GJ       |          | 5,750     | 39,272 Cr  |
|                               | Drawings        | GJ       | 3,300    |           | 35,972 Cr  |

*continued ...*

... continued

Here is the statement of financial position.

| <b>Possum Magic</b>                    |            |              |              |               |
|--|------------|--------------|--------------|---------------|
| <b>Statement of financial position</b> |            |              |              |               |
| <b>as at 30 June 2016</b>              |            |              |              |               |
|  | \$         | \$           | \$           | \$            |
| <b>Owner's equity</b>                  |            |              |              |               |
| Capital                                |            |              | 33,522       |               |
| Less drawings                          |            |              | <u>3,300</u> |               |
|  |            |              | 30,222       |               |
| Add net profit                         |            |              | <u>5,750</u> |               |
|  |            |              |              | <b>35,972</b> |
| This is represented by:                |            |              |              |               |
| Bank                                   |            | 15,325       |              |               |
| Debtors                                | 3,750      |              |              |               |
| Less provision for doubtful debts      | <u>150</u> | 3,600        |              |               |
| Stock (30/6/16)                        |            | 2,800        |              |               |
| Stock of stationery                    |            | 15           |              |               |
| Input tax credits                      |            | 325          |              |               |
| Prepaid expenses                       |            | 135          |              |               |
| Accrued revenue                        |            | <u>75</u>    | 22,275       |               |
| <b>Less current liabilities</b>        |            |              |              |               |
| Creditors                              |            | 1,150        |              |               |
| GST payable                            |            | 450          |              |               |
| Accrued expenses                       |            | 475          |              |               |
| Prepaid revenue                        |            | <u>95</u>    | <u>2,170</u> |               |
| <b>Working capital</b>                 |            |              |              | 20,105        |
| Add non-current assets                 |            |              |              |               |
| Motor vehicle                          |            | 15,867       |              |               |
| Less accumulated depreciation          |            | <u>5,400</u> | 10,467       |               |
| Shop fittings                          |            | 3,500        |              |               |
| Less accumulated depreciation          |            | <u>500</u>   | 3,000        |               |

continued ...

... continued

|                                     |  |              |               |               |
|-------------------------------------|--|--------------|---------------|---------------|
| Office equipment                    |  | 9,000        |               |               |
| Less accumulated depreciation       |  | <u>1,600</u> | 7,400         |               |
| Fixed term investment               |  |              | <u>10,000</u> | <u>30,867</u> |
|                                     |  |              |               | 50,972        |
| <b>Less non-current liabilities</b> |  |              |               |               |
| Loan from Newtyn Finance            |  |              |               | <u>15,000</u> |
| <b>Net assets</b>                   |  |              |               | <b>35,972</b> |

### Example: prepare a statement of financial position using a different formula

In the previous example, the assets and liabilities were classified into current and non-current. It is important to classify the assets and liabilities prior to preparing the statement of financial position.

A statement of financial position may also be presented in a format using the formula:

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity}$$

The statement of financial position for Magic Possum presented in this format would appear as follows.

| <b>Magic Possum</b>                    |              |           |        |
|--|--------------|-----------|--------|
| <b>Statement of financial position</b> |              |           |        |
| <b>as at 30 June 2016</b>              |              |           |        |
|  | \$           | \$        | \$     |
| <b>Assets</b>                          |              |           |        |
| <b>Current assets</b>                  |              |           |        |
| Bank                                   |              | 15,325    |        |
| Debtors                                | 3,750        |           |        |
| Less provision for doubtful debts      | <u>150</u>   | 3,600     |        |
| Stock (30/6/16)                        |              | 2,800     |        |
| Stock of stationery                    |              | 15        |        |
| Input tax credits                      |              | 325       |        |
| Prepaid expenses                       |              | 135       |        |
| Accrued revenue                        |              | <u>75</u> | 22,275 |
| <b>Non-current assets</b>              |              |           |        |
| Motor vehicle                          | 15,867       |           |        |
| Less accumulated depreciation          | <u>5,400</u> | 10,467    |        |

continued ...

continued ...

|                                     |              |               |               |
|-------------------------------------|--------------|---------------|---------------|
| Shop fittings                       | 3,500        |               |               |
| Less accumulated depreciation       | <u>500</u>   | 3,000         |               |
| Office equipment                    | 9,000        |               |               |
| Less accumulated depreciation       | <u>1,600</u> | 7,400         |               |
| Fixed term investment               |              | <u>10,000</u> | <u>30,867</u> |
| <b>Total assets</b>                 |              |               | <b>53,142</b> |
| <b>Liabilities</b>                  |              |               |               |
| <b>Current liabilities</b>          |              |               |               |
| Creditors                           | 1,150        |               |               |
| GST payable                         | 450          |               |               |
| Accrued expenses                    | 475          |               |               |
| Prepaid revenue                     | <u>95</u>    | 2,170         |               |
| <b>Non-current liabilities</b>      |              |               |               |
| Loan from Newtyn Finance            |              | <u>15,000</u> |               |
| <b>Total liabilities</b>            |              |               | 17,170        |
| <b>Owner's equity</b>               |              |               |               |
| Capital                             |              | 33,522        |               |
| Less drawings                       |              | <u>3,300</u>  |               |
|                                     |              | 30,222        |               |
| Add/Less net profit/loss            |              | <u>5,750</u>  |               |
| Total owner's equity                |              |               | <u>35,972</u> |
| <b>Total liabilities and equity</b> |              |               | <b>53,142</b> |

## Practice task 12

Templates for practice tasks for this topic can be found at <http://chilp.it/ee80e58> or by scanning the QR code. Keep your solutions to this practice task as you will use them for later practice tasks.

Malstrom Traders has prepared its income statement for the year ended 30 June 2016.

Prepare the statement of financial position as at 30 June 2016 from the post-closing trial balance and information from the capital account, which are available here.



| <b>Malstrom Traders</b>                              |                     |                      |
|--|---------------------|----------------------|
| <b>Post-closing trial balance as at 30 June 2016</b> |                     |                      |
| <b>Account name</b>                                  | <b>Debit<br/>\$</b> | <b>Credit<br/>\$</b> |
| Bank   |                     | 12,780               |
| Debtors  | 17,000              |                      |
| Provision for doubtful debts                         |                     | 385                  |
| Creditors  |                     | 12,730               |
| Motor vehicle  | 34,500              |                      |
| Accumulated depreciation - motor vehicle             |                     | 12,800               |
| GST payable  |                     | 2,875                |
| Input tax credits                                    | 1,255               |                      |
| Office equipment                                     | 21,200              |                      |
| Accumulated depreciation - office equipment          |                     | 4,600                |
| Prepaid expenses                                     | 285                 |                      |
| Accrued revenue                                      | 785                 |                      |
| Fixed-term investment (4 years to maturity)          | 35,000              |                      |
| Loan from GSA (due to be repaid by 2018)             |                     | 31,700               |
| Stock (30/6/16)                                      | 12,000              |                      |
| Stock of stationery                                  | 756                 |                      |
| Accrued expenses                                     |                     | 560                  |
| Capital  |                     | 43,495               |
| Prepaid revenue                                      |                     | 856                  |
|  | <b>122,781</b>      | <b>122,781</b>       |

*continued ...*

... continued

The capital account as it appears in the general ledger is shown below.

| <b>General ledger – Malstrom Traders</b> |                    |                 |                 |                  |                   |
|--|--------------------|-----------------|-----------------|------------------|-------------------|
| <b>Date</b>                              | <b>Particulars</b> | <b>Jnl ref.</b> | <b>Debit \$</b> | <b>Credit \$</b> | <b>Balance \$</b> |
| <b>Capital</b>                           |                    |                 |                 |                  |                   |
| 1/7/14                                   | Balance            |                 |                 |                  | 29,993 Cr         |
| 30/6/15                                  | Profit and loss    | GJ              |                 | 20,392           | 50,385 Cr         |
|  | Drawings           | GJ              | 6,890           |                  | 43,495 Cr         |

## Summary

1. At the end of the year, after all closing procedures have been finalised, it is necessary to prepare the two main financial reports – the income (profit and loss) statement and the statement of financial position.
2. The income statement, commonly referred to as the profit and loss statement, reports on the revenues and expenses for the year. All revenues and expenses shown in the general ledger trading account are reported in the trading section of the income statement to show the organisation's gross profit or loss. All revenues and expenses shown in the general ledger profit and loss account are included in the income statement to show the organisation's net profit or loss.
3. The statement of financial position is a listing of the organisation's assets, liabilities and owner's equity balances. The statement of financial position shows the account balances 'as at' a particular date, unlike an income statement, which shows the profit over a period of time. The full details of the amounts owing to and taken by the owner must be reported in the statement of financial position – hence, the opening balance, drawings and net profit/loss are listed as shown in the general ledger capital account.
4. The difference between the total of current assets and current liabilities represents working capital. Working capital is the term used to refer to the organisation's liquidity. This is the ability of the organisation to meet its current liabilities from current assets available. Current assets are assets that are either cash, or convertible to cash within the ensuing 12 months. Examples of current assets include cash at bank, input tax credits, debtors, stock, prepaid expenses and accrued revenue. Current liabilities are liabilities that are expected to be repaid within the ensuing 12 months. Examples of current liabilities include creditors, GST payable, accrued expenses, prepaid revenues and provision for annual leave.
5. Net assets represents the final balance of all assets less all liabilities and should equal the owner's equity balance.
6. Non-current assets are assets that will be held for longer than 12 months and are used by the business for generating revenue in the future. Examples of non-current assets include land, buildings and motor vehicles.
7. Deferred (non-current) liabilities are liabilities that are unlikely to be repaid within the next 12 months. Examples of deferred liabilities include mortgages on land and buildings, loans (due in over a year) and provision for long service leave.

## Learning checkpoint 4 Prepare the end-of-period financial reports

This learning checkpoint allows you to review your skills and knowledge in preparing the end-of-period financial reports. Templates for the accountancy tables are available at <http://chilp.it/ee80e58> or by scanning the QR code.



### Part A

The following statement of financial position contains errors and is not presented correctly. Prepare a correct version.

| <b>T Drape</b>  |        |                |
|---|--------|----------------|
| <b>Statement of financial position as at 30 June 2015</b> |        |                |
|   | \$     | \$             |
| <b>Current assets</b>                                     |        |                |
| Bank overdraft  |        | 15,000         |
| Accounts receivable                                       |        | 20,000         |
| Inventory   |        | 28,000         |
| Profit on sale of plant                                   |        | 9,000          |
| <b>Non-current assets</b>                                 |        |                |
| Prepaid insurance expense                                 |        | 4,000          |
| Accrued expenses  |        | 6,000          |
| Prepaid revenue   |        | 7,000          |
| Delivery vehicles   | 12,000 |                |
| Less accumulated depreciation                             | 3,000  | 9,000          |
| Buildings   |        | 50,000         |
| <b>Total assets</b>                                       |        | <b>148,000</b> |
| <b>Liabilities</b>  |        |                |
| Accounts payable  |        | 28,000         |
| Prepaid wages   |        | 9,000          |
| Mortgage loan   |        | 25,000         |
| <b>Owner's equity</b>                                     |        |                |
| Capital   | 34,000 |                |
| Net profit  | 13,000 |                |
|   | 21,000 |                |
| Drawings  | 8,000  | 29,000         |
| <b>Total liabilities and owner's equity</b>               |        | <b>91,000</b>  |

## Part B

Classify each of the items in the table as one of the following:

- Current asset (CA)
- Non-current asset (NCA)
- Current liability (CL)
- Non-current liability (NCL)
- Owner's equity (OE)
- Revenue (R)
- Expense (E)

| Account                          | Classification |
|----------------------------------|----------------|
| Accrued expenses                 |                |
| Capital                          |                |
| Cash at bank                     |                |
| Plant and machinery              |                |
| Mortgage loan                    |                |
| Depreciation office equipment    |                |
| Prepaid revenue                  |                |
| Long-term loan from LDS Finances |                |
| Loan repayable in nine months    |                |
| Accrued revenue                  |                |
| Rent                             |                |
| Office expenses                  |                |
| Debtors                          |                |
| Shares in BCG Ltd                |                |
| Motor vehicles                   |                |
| Prepaid expenses                 |                |
| Stock                            |                |
| Creditors                        |                |
| Bank overdraft                   |                |
| Goodwill                         |                |
| Buildings                        |                |
| Drawings                         |                |
| Interest received                |                |
| Sales                            |                |

## Part C

From the information provided below for Sammy's Bric-a-Brac, prepare an income statement for the year ending 30 June 2016 and a statement of financial position as at 30 June 2016.

| General ledger – Sammy's Bric-a-Brac |                                       |          |          |           |            |
|--------------------------------------|---------------------------------------|----------|----------|-----------|------------|
| Date                                 | Particulars                           | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
| <b>Trading</b>                       |                                       |          |          |           |            |
| 30/6/16                              | Stock (30/6/16)                       |          |          | 3,200     | 3,200 Cr   |
|                                      | Stock (1/7/15)                        |          | 2,500    |           | 700 Cr     |
|                                      | Purchases                             |          | 26,500   |           | 25,800 Dr  |
|                                      | Freight inwards                       |          | 300      |           | 26,100 Dr  |
|                                      | Sales returns and allowances          |          | 1,425    |           | 27,525 Dr  |
|                                      | Sales                                 |          |          | 39,050    | 11,525 Cr  |
|                                      | Purchases returns and allowances      |          |          | 1,500     | 13,025 Cr  |
|                                      | Profit and loss                       |          | 13,025   |           | Nil        |
| <b>Profit and loss</b>               |                                       |          |          |           |            |
| 30/6/16                              | Trading                               |          |          | 13,025    | 13,025 Cr  |
|                                      | Advertising                           |          | 870      |           | 12,155 Cr  |
|                                      | Discount allowed                      |          | 350      |           | 11,805 Cr  |
|                                      | Salaries                              |          | 3,800    |           | 8,005 Cr   |
|                                      | Accounting expenses                   |          | 700      |           | 7,305 Cr   |
|                                      | Commission expense                    |          | 1,800    |           | 5,505 Cr   |
|                                      | Interest on mortgage                  |          | 1,850    |           | 3,655 Cr   |
|                                      | Insurance                             |          | 1,000    |           | 2,655 Cr   |
|                                      | Postage                               |          | 150      |           | 2,505 Cr   |
|                                      | Subscriptions                         |          | 140      |           | 2,365 Cr   |
|                                      | Vehicle expenses                      |          | 1,800    |           | 565 Cr     |
|                                      | Electricity                           |          | 490      |           | 75 Cr      |
|                                      | Bank fees                             |          | 550      |           | 475 Dr     |
|                                      | Stationery                            |          | 300      |           | 775 Dr     |
|                                      | Telephone                             |          | 800      |           | 1,575 Dr   |
|                                      | Depreciation – motor vehicle          |          | 465      |           | 2,040 Dr   |
|                                      | Depreciation – furniture and fixtures |          | 35       |           | 2,075 Dr   |

*continued ...*

... continued

| Date           | Particulars          | Jnl ref. | Debit \$ | Credit \$ | Balance \$ |
|----------------|----------------------|----------|----------|-----------|------------|
|                | Annual leave expense |          | 700      |           | 2,775 Dr   |
|                | Commission revenue   |          |          | 425       | 2,350 Dr   |
|                | Capital              |          |          | 2,350     | Nil        |
| <b>Capital</b> |                      |          |          |           |            |
| 30/6/16        | Balance              |          |          |           | 34,026 Cr  |
|                | Profit and loss      |          | 2,350    |           | 31,676 Cr  |
|                | Drawings             |          | 740      |           | 30,936 Cr  |

| <b>Sammy's Bric-a-Brac</b>                           |               |               |
|--|---------------|---------------|
| <b>Post-closing trial balance as at 30 June 2016</b> |               |               |
| Account name   | Debit \$      | Credit \$     |
| Bank   |               | 621           |
| Trade debtors control                                | 1,500         |               |
| Trade creditors control                              |               | 905           |
| Input tax credits                                    | 126           |               |
| GST payable  |               | 79            |
| Land and buildings                                   | 50,000        |               |
| Mortgage on land and buildings                       |               | 32,000        |
| Petty cash   | 150           |               |
| Stock (30/6/16)                                      | 3,200         |               |
| Capital  |               | 30,936        |
| Motor vehicle  | 15,000        |               |
| Accumulated depreciation – motor vehicle             |               | 5,000         |
| Furniture and fixtures                               | 700           |               |
| Prepaid expenses                                     | 35            |               |
| Accrued revenue                                      | 125           |               |
| Accrued expenses                                     |               | 560           |
| Accumulated depreciation – furniture and fixtures    |               | 35            |
| Provision for annual leave                           |               | 700           |
|  | <b>70,836</b> | <b>70,836</b> |