

FINAL ACCOUNTS PREPARATION

STUDY TEXT

Qualifications and Credit Framework

AQ2016

This Study Text supports study for the following AAT qualifications:

AAT Advanced Diploma in Accounting – Level 3

AAT Advanced Certificate in Bookkeeping – Level 3

AAT Advanced Diploma in Accounting at SCQF – Level 6

British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library.

Published by
Kaplan Publishing UK
Unit 2, The Business Centre
Molly Millars Lane
Wokingham
Berkshire
RG41 2QZ

ISBN: 978-1-78740-512-7

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INTRODUCTION

HOW TO USE THESE MATERIALS

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chance of success in your AAT assessments.

They contain a number of features to help you in the study process.

The sections on the Unit Guide, the Assessment and Study Skills should be read before you commence your studies.

They are designed to familiarise you with the nature and content of the assessment and to give you tips on how best to approach your studies.

STUDY TEXT

This study text has been specially prepared for the revised AAT qualification introduced in September 2016.

It is written in a practical and interactive style:

- key terms and concepts are clearly defined
- all topics are illustrated with practical examples with clearly worked solutions based on sample tasks provided by the AAT in the new examining style
- frequent activities throughout the chapters ensure that what you have learnt is regularly reinforced
- 'pitfalls' and 'examination tips' help you avoid commonly made mistakes and help you focus on what is required to perform well in your examination
- 'Test your understanding' activities are included within each chapter to apply your learning and develop your understanding

ICONS

The chapters include the following icons throughout.

They are designed to assist you in your studies by identifying key definitions and the points at which you can test yourself on the knowledge gained.



Definition

These sections explain important areas of knowledge which must be understood and reproduced in an assessment



Example

The illustrative examples can be used to help develop an understanding of topics before attempting the test your understanding exercises



Test your understanding

These are exercises which give the opportunity to assess your understanding of all the assessment areas.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Progression

There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

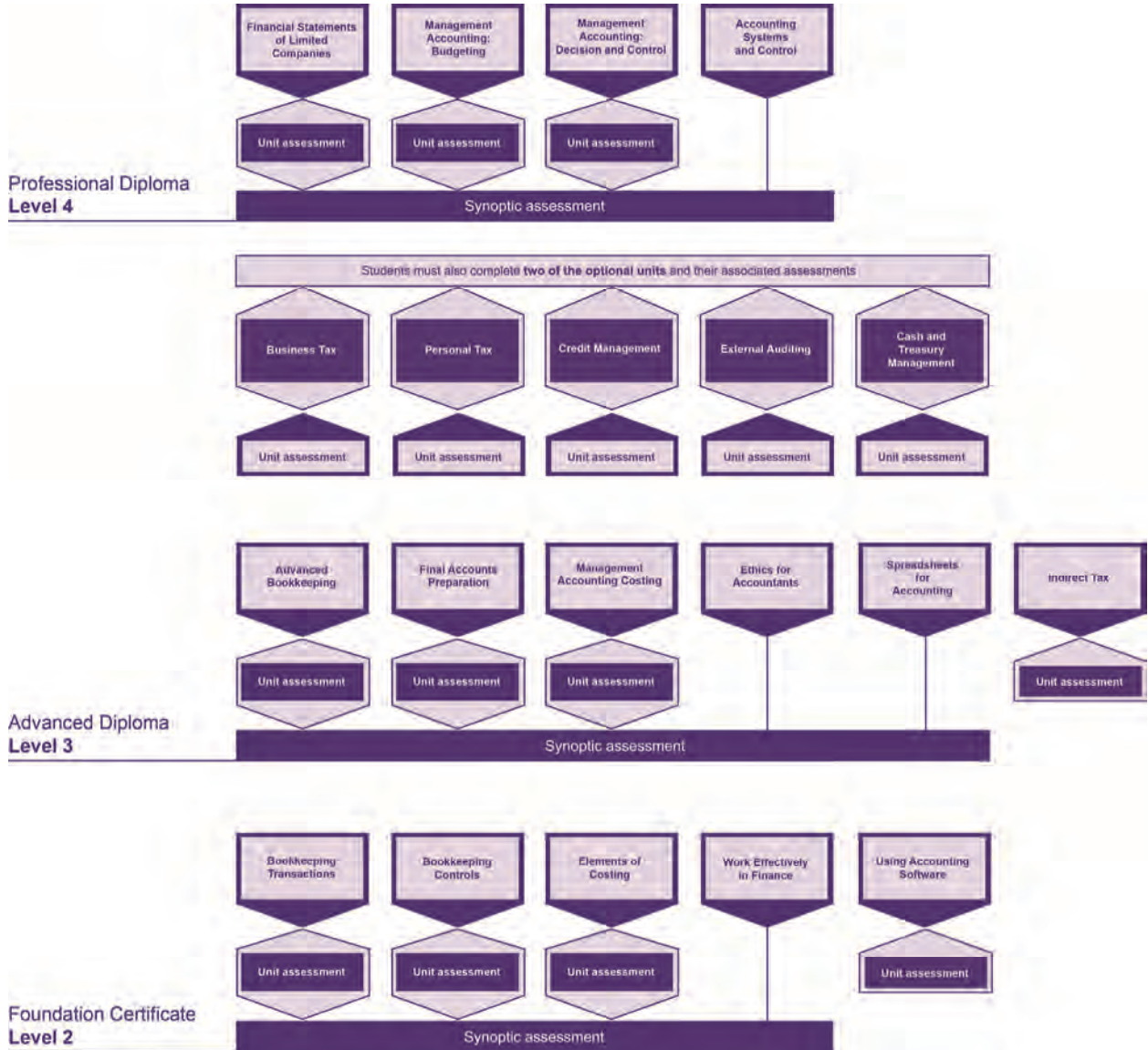
Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.

FINAL ACCOUNTS PREPARATION



UNIT GUIDE

Introduction

This Advanced level unit is about preparing final accounts for sole traders and partnerships, and helping students to become aware of alternative business organisation structures.

This purpose of this unit is to provide the background knowledge and skills that a student needs in order to be capable of drafting accounts for sole traders and partnerships, and it provides the background knowledge of the regulations governing company accounts. A successful student will be able to complete tasks while being aware of potential ethical issues and know how to report information effectively. The student should become an accomplished member of the accounting team who is able to work with little supervision and who can see a financial picture of the organisation as a whole.

Students will be able to recognise the different types of organisations that need to prepare financial statements and will understand why such statements are important to users in the business environment. The financial accounting techniques and knowledge that they have already acquired will be developed to prepare accounting records when the records are incomplete, and students will become familiar with mark-up and margin.

Students will recognise special accounting requirements for partnerships. They will become aware of legislation and regulations governing financial statements, and will be able to recall and apply ethical knowledge to situations arising during the preparation of accounts. This unit also introduces students to the terminology and formats used by accountants in the financial statements of companies, working with the International Financial Reporting Standards (IFRS) terminology that is utilised across AAT.

Using all of this, the student will be able to prepare final accounts for sole traders and partnerships from an initial trial balance and present these to their line manager. They will then gain awareness of the more detailed requirements for the preparation of company financial statements.

Final Accounts Preparation is a mandatory unit in this qualification.

It is closely linked to the Advanced level financial accounting unit, Advanced Bookkeeping, as well as to the Foundation level units, Bookkeeping Transactions and Bookkeeping Controls. In addition, it draws on the ethical principles from the Advanced level unit, Ethics for Accountants. On completion of this unit, students are prepared to start the Professional level unit, Financial Statements of Limited Companies.

It is recommended that this unit is taken after Advanced Bookkeeping and with or after Ethics for Accountants.

Learning outcomes

On completion of this unit the learner will be able to:

- Distinguish between the financial recording and reporting requirements of different types of organisation
- Explain the need for final accounts and the accounting and ethical principles underlying their preparation
- Prepare accounting records from incomplete information
- Produce accounts for sole traders
- Produce accounts for partnerships
- Recognise the key differences between preparing accounts for a limited company and a sole trader

Scope of content

Note on the Conceptual Framework

The Conceptual Framework for Financial Reporting 2010 identifies one assumption underlying the preparation of financial statements – the going concern assumption. However, the AAT have confirmed that the unit specification for Final Accounts Preparation departs from this and states that there are two underlying assumptions – going concern and the accruals basis.

To perform this unit effectively you will need to know and understand the following:

	Chapter
1 Distinguish between the financial recording and reporting requirements of different types of organisation	
1.1 Describe the types of organisation that need to prepare final accounts	4
Students need to know:	
<ul style="list-style-type: none"> • brief descriptions of business organisations: <ul style="list-style-type: none"> – for profit: sole traders, partnerships, limited companies, limited liability partnerships (LLPs) – not for profit: charities • the basic differences between the structure and financial characteristics of these organisations: <ul style="list-style-type: none"> – who owns the organisation/public benefit requirement – who manages the organisation – where responsibility lies for debts that the organisation cannot pay, and the amount of exposure – whether, and how, any tax is paid • for commercial organisations, the different terms used to represent ownership in the statement of financial position (capital and equity) and amounts taken by the owners (drawings and dividends) 	

Delivering this unit

Unit Name	Content links	Suggested order of delivery
Advanced Bookkeeping	This unit builds on the knowledge and skills acquired from studying Advanced Bookkeeping.	It is recommended that Final Accounts Preparation is delivered after Advanced Bookkeeping.
Ethics for Accountants	Ethics and ethical principles are embedded within this unit.	It is recommended that Final Accounts Preparation is delivered either at the same time as or after Ethics for Accountants.
Management Accounting: Costing. Spreadsheets for Accounting and Indirect Tax	Three Advanced level units – Management Accounting: Costing, Spreadsheets for Accounting and Indirect Tax – have links to Final Accounts Preparation.	Not applicable.

THE ASSESSMENT

Test specification for this unit

Assessment type	Marking type	Duration of exam
Computer based unit assessment	Computer marked	2 hours

The assessment for this unit consists of 6 compulsory tasks.

The competency level for AAT assessments is 70%.

Learning outcomes	Weighting
1 Distinguish between the financial recording and reporting requirements of different types of organisation	10%
2 Explain the need for final accounts and the accounting and ethical principles underlying their preparation	7%
3 Prepare accounting records from incomplete information	27%
4 Produce accounts for sole traders	31%
5 Produce accounts for partnerships	20%
6 Recognise the key differences between preparing accounts for a limited company and a sole trader	5%
Total	100%

UNIT LINK TO THE SYNOPTIC ASSESSMENT

AAT AQ16 introduced a Synoptic Assessment, which students must complete if they are to achieve the appropriate qualification upon completion of a qualification. In the case of the Advanced Diploma in Accounting, students must pass all of the mandatory assessments and the Synoptic Assessment to achieve the qualification.

As a Synoptic Assessment is attempted following completion of individual units, it draws upon knowledge and understanding from those units. It may be appropriate for students to retain their study materials for individual units until they have successfully completed the Synoptic Assessment for that qualification.

With specific reference to this unit, the following learning objectives are also relevant to the Advanced Diploma in Accounting Synoptic Assessment:

- LO1 Distinguish between the financial recording and reporting requirements of different types of organisation
- LO2 Explain the need for final accounts and the accounting and ethical principles underlying their preparation
- LO3 Prepare accounting records from incomplete information
- LO4 Produce accounts for sole traders
- LO5 Produce accounts for partnerships
- LO6 Recognise the key differences between preparing accounts for a limited company and a sole trader

STUDY SKILLS

Preparing to study

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the assessment and set yourself targets for each period of study – in your sessions make sure you cover the whole course, activities and the associated questions in the workbook at the back of the manual.

If you are studying more than one unit at a time, try to vary your subjects as this can help to keep you interested and see subjects as part of wider knowledge.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the assessment and develop good practice.

A good technique is to use SQ3Rs – Survey, Question, Read, Recall, Review:

1 Survey the chapter

Look at the headings and read the introduction, knowledge, skills and content, so as to get an overview of what the chapter deals with.

2 Question

Whilst undertaking the survey ask yourself the questions you hope the chapter will answer for you.

Preparation of accounts for a sole trader

1

Introduction

For Final Accounts Preparation you need to be able to prepare the financial statements; a statement of profit or loss and a statement of financial position for a sole trader.

These financial statements may be prepared directly from the extended trial balance or from a trial balance plus various adjustments.

In this chapter we will consider the step by step approach to the financial statements preparation, firstly from an extended trial balance and then directly from an initial trial balance.

The knowledge for this unit has been acquired in Advanced Bookkeeping but within this unit, you will be expected to apply the skills to complete the financial statements.

ASSESSMENT CRITERIA

- Calculate opening and/or closing capital for a sole trader (4.1)
- Describe the components of a set of final accounts for a sole trader (4.2)
- Prepare a statement of profit or loss for a sole trader in the given format (4.3)
- Prepare a statement of financial position for a sole trader in the given format (4.4)

CONTENTS

- 1 Statement of profit or loss for a sole trader
- 2 The statement of financial position for a sole trader
- 3 Preparing financial statements from the trial balance

1 Statement of profit or loss for a sole trader

1.1 Introduction

In Advanced Bookkeeping we considered in outline the layout of a statement of profit or loss for a sole trader. Now we will consider it in more detail.

1.2 Statement of profit or loss

The statement of profit or loss is split into two elements:

- the trading account to determine gross profit;
- the statement of profit or loss to determine net profit.

Generally the whole statement is referred to as the statement of profit or loss. The statement of profit or loss shows business performance over a specific period of time, the accounting period.

1.3 Trading account

The trading account calculates the gross profit or loss that has been made from the trading activities of the sole trader – the buying and selling of goods.



Definition

The gross profit (or loss) is the profit (or loss) from the trading activities of the sole trader.

The trading account looks like this:

	£	£
Sales revenue		X
Less: Cost of goods sold		
Opening inventory	X	
Purchases	X	
	—	
	X	
Less: Closing inventory	(X)	
	—	(X)
Gross profit (loss)		X

1.4 Profit or loss

The remaining content of the statement of profit or loss is a list of any sundry income and the expenses of the business. These are deducted from the gross profit to give the profit for the year (or the net profit).



Definition

The net profit or loss is the profit or loss after deduction of all of the expenses of the business.

**Test your understanding 1****Statement of profit or loss for the year ended 31 December 20X2.**

Calculate the sales revenue and the cost of goods sold (complete the boxes).

	£	£
Sales revenue		
Less: Cost of goods sold		
Opening inventory	37,500	
Purchases	158,700	
	196,200	
Less: Closing inventory	(15,000)	
	111,300	
Gross profit		111,300

A typical statement of profit or loss is shown below.

Statement of profit or loss of Stanley for the year-ended 31 December 20X2

Sales revenue	£	£
Less: Cost of goods sold		X
Inventory on 1 January (opening inventory)	X	
Add: Purchases of goods	X	
	X	
Less: Inventory on 31 December (closing inventory)	(X)	
	—	(X)
Gross profit		X
Sundry income:		
Discounts received	X	
Commission received	X	
Rent received	X	
Interest received	X	
	—	X
		X

FINAL ACCOUNTS PREPARATION

Less: Expenses:

Rent	X	
Rates	X	
Lighting and heating	X	
Telephone	X	
Postage	X	
Insurance	X	
Stationery	X	
Payroll expenses	X	
Depreciation	X	
Accountancy and audit fees	X	
Bank charges and interest	X	
Irrecoverable debts	X	
Allowance for doubtful debts adjustment	X	
Delivery costs	X	
Van running expenses	X	
Selling expenses	X	
Discounts allowed	X	
	—	(X)
Profit/(loss) for the year		X/(X)

1.5 Preparation of the statement of profit or loss

The statement of profit or loss is prepared by listing all of the entries from the ETB that are in the profit or loss columns.



Example

Given below is the final ETB for Lyttleton

Account name	Trial balance		Adjustments		Statement of profit or loss		Statement of financial position	
	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £
Capital		7,830						7,830
Cash	2,010						2,010	
Non-current assets	9,420						9,420	
Accumulated depreciation		3,470		942				4,412
SLCA	1,830						1,830	
Opening inventory	1,680				1,680			
PLCA		390						390
Sales		14,420				14,420		
Purchases	8,180			1,500	6,680			

Rent	1,100		100		1,200			
Electricity	940		400		1,340			
Rates	950			200	750			
Depreciation expense			942		942			
Allowance for doubtful debts adjustments			55		55			
Allowance for doubtful debts				55				55
Drawings			1,500				1,500	
Accruals				500				500
Prepayments			200				200	
Closing inventory SFP			1,140				1,140	
Closing inventory SPL				1,140		1,140		
Profit					2,913			2,913
	26,110	26,110	4,337	4,337	15,560	15,560	16,100	16,100

We will now show how the final statement of profit or loss for Lyttleton would look.

Solution

Statement of profit or loss of Lyttleton for the year-ended 31 December 20X5

		£	£
Sales revenue			14,420
Less:	Cost of goods sold		
	Opening inventory	1,680	
	Purchases	6,680	
		8,360	
Less:	Closing inventory	(1,140)	(7,220)
		7,200	
Gross profit			7,200
Less: Expenses			
	Rent	1,200	
	Electricity	1,340	
	Rates	750	
	Depreciation	942	
	Allowance for doubtful debts increase	55	
		(4,287)	
Total expenses			(4,287)
Net profit for the year			2,913

All of the figures in the statement of profit or loss columns in the ETB have been used to prepare this statement of profit or loss.

The final net profit is the profit figure calculated as a balancing figure in the ETB.

2 The statement of financial position for a sole trader

2.1 Introduction

Definition

A statement of financial position is a list of the assets and liabilities of the sole trader at the end of the accounting period.

The assets are split into non-current assets and current assets.

Definition

Non-current assets are assets that will be used within the business over a long period (usually greater than one year), e.g. land and buildings

Definition

Current assets are assets that are expected to be realised within the business in the normal course of trading (usually a period less than one year) e.g. inventory.

The liabilities are split into current liabilities and non-current liabilities.

Definition

Current liabilities are the short term payables of a business. This generally means payables that are due to be paid within twelve months of the statement of financial position date e.g. trade payables

**Definition**

Non-current liabilities are payables that will be paid over a longer period, which is normally in excess of one year, e.g. loans

An example of a typical sole trader's statement of financial position is given below:

Statement of financial position of Stanley at 31 December 20X2

	<i>Cost</i>	<i>Accumulated Depreciation</i>	<i>Carrying amount</i>
	£	£	£
Non-current assets			
Freehold factory	X	X	X
Machinery	X	X	X
Motor vehicles	X	X	X
	<hr/>	<hr/>	<hr/>
	X	X	X
Current assets			
Inventory		X	
Trade receivables	X		
Less: Allowance for doubtful debts	(X)		
	<hr/>	X	
Prepayments		X	
Cash at bank		X	
Cash in hand		X	
		<hr/>	
		X	
Current liabilities			
Trade payables	X		
Accruals	X		
	<hr/>	(X)	
Net current assets			X
Total assets less current liabilities			<hr/>
			X
Non-current liabilities			
12% loan			(X)
			<hr/>

Net assets	X	—
Capital at 1 January	X	
Net profit for the year	X	
		—
	X	
Less: Drawings	(X)	
		—
Closing capital (proprietor's funds)	X	—

2.2 Assets and liabilities

The assets and liabilities in a formal statement of financial position are listed in a particular order:

- Firstly the non-current assets less the accumulated depreciation (remember that this net total is known as the carrying amount). It should be noted that when preparing final accounts for a limited company, only the carrying amounts of the non-current assets are shown on the face of the statement of financial position. A breakdown of the cost and accumulated depreciation for each type of asset are shown in the notes to the accounts.
- Next the current assets in the following order – inventory, receivables, prepayments then bank and cash balances.
- Next the current liabilities – payables and accruals that are payable within 12 months.
- Finally the long-term payables such as loan accounts.

The assets are all added together and the liabilities are then deducted. This gives the statement of financial position total.

2.3 Capital balances

The total of the assets less liabilities of the sole trader should be equal to the capital of the sole trader.

The capital is shown in the statement of financial position as follows:

	£
Opening capital at the start of the year	X
Add: Capital invested during the year	X
Add: Net profit/(loss) for the year	X
	—
Less: Drawings	X (X)
	—
Closing capital	X
	—

This closing capital should equal the total of all of the assets less all liabilities, as shown in the accounting equation $\text{assets} - \text{liabilities} = \text{capital}$. (NB: this formula can be rearranged as $\text{assets} = \text{capital} + \text{liabilities}$).

The capital balance represents the owner's (proprietor's) funds, i.e. what the owner will be left with if the business is wound up and all the assets are sold and all the liabilities paid off.



Example

Given below is the completed ETB for Lyttleton. This time the statement of financial position will be prepared.

Account name	Trial balance		Adjustments		Statement of profit or loss		Statement of financial position	
	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £
Capital		7,830						7,830
Cash	2,010						2,010	
Non-current assets	9,420						9,420	
Accumulated depreciation		3,470		942				4,412
SLCA	1,830						1,830	
Inventory	1,680				1,680			
PLCA		390						390
Revenue		14,420				14,420		
Purchases	8,180			1,500	6,680			
Rent	1,100		100		1,200			
Electricity	940		400		1,340			
Rates	950			200	750			
Depreciation expense			942		942			
Allowance for doubtful debts adjustments			55		55			
Allowance for doubtful debts				55				55
Drawings			1,500				1,500	
Accruals				500				500
Prepayments			200				200	
Closing inventory: SPL				1,140		1,140		
Closing inventory: SFP			1,140				1,140	
Profit (15,560 – 12,647)					2,913			2,913
	26,110	26,110	4,337	4,337	15,560	15,560	16,100	16,100

Each of the assets and liabilities that appear in the statement of financial position columns will appear in the statement of financial position.

Solution**Statement of financial position of Lyttleton at 31 December 20X5**

	<i>Cost</i>	<i>Accumulated depreciation</i>	<i>Carrying amount</i>
	£	£	£
Non-current assets	9,420	4,412	5,008
Current assets			
Inventory		1,140	
Trade receivables	1,830		
Less: Allowance for doubtful debts	(55)		
	—————	1,775	
Prepayments		200	
Cash		2,010	
		—————	
		5,125	
Less:			
Current liabilities			
Payables	390		
Accruals	500		
	—————	(890)	
Net current assets			4,235
Net assets			————— 9,243
Capital 1 January			7,830
Net profit for the year			2,913
			————— 10,743
Less: Drawings			(1,500)
Closing capital			————— 9,243

Note:

- the non-current assets are shown at their carrying amounts;
- the current assets are sub-totalled as are the current liabilities – the current liabilities are then deducted from the current assets to give net current assets;
- the net current assets are added to the non-current asset carrying amount to reach the statement of financial position total, net assets.

The statement of financial position total of net assets should be equal to the closing capital; the statement of financial position balances (it used to be referred to as a 'balance sheet'). If the statement of financial position does not balance check the arithmetic and that there are no omissions.



Test your understanding 2

Given below is a completed extended trial balance.

Extended trial balance at 31 December 20X6

Account name	Trial balance		Adjustments		Statement of profit or loss		Statement of financial position	
	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £	Dr £	Cr £
Fittings	7,300						7,300	
Accumulated depreciation 1.1.X6		2,500		400				2,900
Leasehold	30,000						30,000	
Accumulated depreciation 1.1.X6		6,000		1,000				7,000
Inventory 1 January 20X6	15,000				15,000			
Sales ledger control account	10,000			500			9,500	
Allowance for doubtful debts 1.1.X6		800	515					285
Cash in hand	50						50	
Cash at bank	1,250						1,250	
Purchases ledger control account		18,000						18,000
Capital		19,050						19,050
Drawings	4,750		1,200				5,950	
Purchases	80,000			1,200	78,800			
Sales		120,000				120,000		
Wages	12,000			200	11,800			
Advertising	4,000		200		4,200			
Rates	1,800			360	1,440			
Bank charges	200				200			
Depreciation charge			1,400		1,400			

Allowance for doubtful debts adjustments				515		515		
Irrecoverable debts			500		500			
Prepayments			360				360	
Closing inventory SFP			21,000				21,000	
Closing inventory SPL				21,000		21,000		
					113,340	141,515		
Net profit					28,175			28,175
	166,350	166,350	25,175	25,175	141,515	141,515	75,410	75,410

Prepare the statement of profit or loss for the business.

Select the appropriate account headings from the options below.

Statement of profit or loss for the year-ended 31 December 20X6

	£	£
Sales revenue		
Less: Cost of goods sold		
Opening inventory/Closing inventory/Purchases		
Purchases/Opening inventory/Closing inventory	_____	
Opening inventory/Closing inventory/Purchases	_____	

Gross profit		
Less: Expenses		
Trade receivables/Wages		
Advertising/Prepayments		
Drawings/Rates		
Bank charges/Capital		
Depreciation charge		
Allowance for doubtful debts adjustment		
Irrecoverable debts		

Total expenses		_____
Profit for the year		_____

Prepare the statement of financial position for the business.

Select the appropriate account headings from the options below.

Statement of financial position as at 31 December 20X6

	£	£	£
Non-current assets:			
Fittings/Closing inventory	_____	_____	_____
Trade receivables/Leasehold	_____	_____	_____
Current assets:			
Closing inventory/Opening inventory	_____	_____	_____
Trade payables/Trade receivables	_____	_____	_____
Less: Allowance for doubtful debts	_____	_____	_____
Accruals/Prepayments	_____	_____	_____
Cash at bank/Drawings	_____	_____	_____
Capital/Cash in hand	_____	_____	_____
Current liabilities:			
Trade receivables/Trade payables	_____	_____	_____
Owner's capital			
Capital at 1.1.X6	_____	_____	_____
Drawings/Net profit for the year	_____	_____	_____
Less: Capital/Drawings	_____	_____	_____

3 Preparing financial statements from the trial balance

3.1 Introduction

As seen in Advanced Bookkeeping, the extended trial balance is a useful working paper for the eventual preparation of the financial statements of a sole trader. However, in the examination you may be required to prepare a set of financial statements directly from the initial trial balance.

In this section we will work through a comprehensive example which will include the extraction of the initial trial balance, correction of errors and clearing a suspense account, accounting for year-end adjustments and finally the preparation of the financial statements.



Example

Given below are the balances taken from a sole trader's ledger accounts on 31 March 20X4

	£
Sales ledger control account	30,700
Telephone	1,440
Purchases ledger control account	25,680
Heat and light	2,480
Motor vehicles at cost	53,900
Computer equipment at cost	4,500
Carriage inwards	1,840
Carriage outwards	3,280
Wages	67,440
Loan interest	300
Capital	48,000
Drawings	26,000
Allowance for doubtful debts	450
Bank overdraft	2,880
Purchases	126,800
Petty cash	50
Sales	256,400
Insurance	3,360
Accumulated depreciation – motor vehicles	15,000
Accumulated depreciation – computer equipment	2,640
Inventory at 1 April 20X3	13,200
Loan	8,000
Rent	23,760

The following information is also available:

- (i) The value of inventory at 31 March 20X4 was £14,400.
- (ii) Motor vehicles are to be depreciated at 30% on a diminishing balance basis and computer equipment at 20% on cost.
- (iii) A telephone bill for £180 for the three months to 31 March 20X4 did not arrive until after the trial balance had been drawn up.
- (iv) Of the insurance payments, £640 is for the year-ending 31 March 20X5.
- (v) An irrecoverable debt of £700 is to be written off and an allowance of 2% is required against the remaining receivables.

Solution

Step 1

The first stage is to draw up the initial trial balance. Remember that assets and expenses are debit balances and liabilities and income are credit balances.

	£	£
Sales ledger control account	30,700	
Telephone	1,440	
Purchases ledger control account		25,680
Heat and light	2,480	
Motor vehicles at cost	53,900	
Computer equipment at cost	4,500	
Carriage inwards	1,840	
Carriage outwards	3,280	
Wages	67,440	
Loan interest	300	
Capital		48,000
Drawings	26,000	
Allowance for doubtful debts		450
Bank overdraft		2,880
Purchases	126,800	
Petty cash	50	
Sales		256,400
Insurance	3,360	
Accumulated depreciation – motor vehicles		15,000
Accumulated depreciation – computer equipment		2,640
Inventory at 1 April 20X3	13,200	
Loan		8,000
Rent	23,760	
	359,050	359,050

Step 2

Now to deal with the year-end adjustments:

- (a) The value of inventory at 31 March 20X4 was £14,400.

Closing inventory – statement of profit or loss

£	£
	Closing inventory – statement of financial position
	14,400

Closing inventory – statement of financial position

£	£
Closing inventory – statement of profit or loss	14,400

- We now have the closing inventory for the statement of profit or loss.
- (b) The motor vehicles and computer equipment have yet to be depreciated for the year. Motor vehicles are depreciated at 30% on a diminishing balance basis and computer equipment at 20% on cost.

Motor vehicles depreciation $(53,900 - 15,000) \times 30\% = £11,670$

Computer equipment depreciation $4,500 \times 20\% = £900$

Depreciation charges

£	£
Accumulated depreciation – motor vehicles	11,670
Accumulated depreciation – computer equipment	900
<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
12,570	12,570
<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
Balance b/d	12,570

Accumulated depreciation account – motor vehicles

£	£
Balance c/d	26,670
<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
26,670	26,670
<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
	Balance b/d
	15,000
	Depreciation charges
	11,670
	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
	26,670
	<hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
	26,670

Accumulated depreciation account – computer equipment

	£		£
		Balance b/d	2,640
Balance c/d	3,540	Depreciation charges	900
	3,540		3,540
		Balance b/d	3,540

- (c) A telephone bill for £180 for the three months to 31 March 20X4 did not arrive until after the trial balance had been drawn up.

This needs to be accrued for:

Debit	Telephone	£180
Credit	Accruals	£180

Telephone expenses

	£		£
Balance b/d	1,440		
Accrual	180	Balance c/d	1,620
	1,620		1,620
Balance b/d	1,620		

Accruals

	£		£
		Telephone expenses	180

- (d) Of the insurance payments £640 is for the year-ending 31 March 20X5.

This must be adjusted for as a prepayment:

Debit	Prepayment	£640
Credit	Insurance	£640

Prepayments

	£		£
Insurance expenses	640		

Insurance expenses

	£		£
Balance b/d	3,360	Prepayment	640
		Balance c/d	2,720
	<hr/>		<hr/>
	3,360		3,360
	<hr/>		<hr/>
Balance b/d	2,720		

- (e) An irrecoverable debt of £700 is to be written off and an allowance of 2% is required against the remaining receivables.

Firstly, the irrecoverable debt must be written off in order to find the amended balance on the sales ledger control account.

Debit Irrecoverable debts expense £700

Credit Sales ledger control account £700

Irrecoverable debts expense

	£		£
Sales ledger control account	700		

Sales ledger control account

	£		£
Balance b/d	30,700	Irrecoverable debts expense	700
		Balance c/d	30,000
	<hr/>		<hr/>
	30,700		30,700
	<hr/>		<hr/>
Balance b/d	30,000		

Now we can determine the allowance for doubtful debts required at $£30,000 \times 2\% = £600$. The balance on the allowance account in the trial balance is £450, therefore an increase of £150 is required.

Debit Allowance for doubtful debts adjustment (SPL) £150

Credit Allowance for doubtful debts account (SFP) £150

Allowance for doubtful debts adjustment account

	£		£
Allowance for doubtful debts	150	Balance c/d	150
	<hr/>		<hr/>
	150		150
	<hr/>		<hr/>
Balance b/d	150		

Allowance for doubtful debts account

	£		£
Balance c/d	600	Balance b/d	450
	<hr/>	Allowance for doubtful debts adjustment	150
	600		<hr/>
	<hr/>		600
		Balance b/d	600

Step 5

Now that all of the adjustments have been put through the ledger accounts, an amended trial balance can be drawn up as a check and as a starting point for preparing the financial statements.

Remember to consider the adjustments just identified as required when preparing the trial balance.

Trial balance at 31 March 20X4

	£	£
Sales ledger control account	30,000	
Telephone	1,620	
Purchases ledger control account		25,680
Heat and light	2,480	
Motor vehicles at cost	53,900	
Computer equipment at cost	4,500	
Carriage inwards	1,840	
Carriage outwards	3,280	
Wages	67,440	
Loan interest	300	
Capital		48,000
Drawings	26,000	
Allowance for doubtful debts		600
Bank overdraft		2,880
Purchases	126,800	
Petty cash	50	
Sales		256,400
Insurance	2,720	
Accumulated depreciation – motor vehicles		26,670
Accumulated depreciation – computer equipment		3,540
Inventory at 1 April 20X3	13,200	
Loan		8,000
Rent	23,760	
Inventory at 31 March 20X4	14,400	14,400
Depreciation charges	12,570	
Accruals		180
Prepayments	640	
Allowance for doubtful debt adjustment	150	
Irrecoverable debts expense	700	
	386,350	386,350

Step 6

We are now in a position to prepare the financial statements for the sole trader. Take care with the carriage inwards and carriage outwards which are expenses of the business. Carriage inwards is treated as part of cost of goods sold, whereas carriage outwards is one of the list of expenses.

Statement of profit or loss for the year-ended 31 March 20X4

	£	£
Sales revenue		256,400
Less: Cost of goods sold		
Opening inventory	13,200	
Carriage inwards	1,840	
Purchases	126,800	
	141,840	
Less: Closing inventory	(14,400)	
	127,440	127,440
Gross profit		128,960
Less: Expenses		
Telephone	1,620	
Heat and light	2,480	
Carriage outwards	3,280	
Wages	67,440	
Loan interest	300	
Insurance	2,720	
Rent	23,760	
Depreciation charge	12,570	
Irrecoverable debts	700	
Allowance for doubtful debts adjustment	150	
	115,020	115,020
Total expenses		
Profit for the year		13,940

Statement of financial position as at 31 March 20X4

	<i>Cost</i>	<i>Accumulated depreciation</i>	<i>Carrying amount</i>
	£	£	£
Non-current assets			
Motor vehicles	53,900	26,670	27,230
Computer equipment	4,500	3,540	960
	<hr/>	<hr/>	<hr/>
	58,400	30,210	28,190
	<hr/>	<hr/>	
Current assets			
Inventory		14,400	
Trade receivables	30,000		
Less: Allowance for doubtful debts	(600)		
	<hr/>	29,400	
Prepayment		640	
Petty cash		50	
		<hr/>	
		44,490	
Current liabilities			
Bank overdraft	2,880		
Trade Payables	25,680		
Accruals	180		
	<hr/>	28,740	
		<hr/>	
Net current assets			15,750
			<hr/>
Total assets less current liabilities			43,940
Non-current liability:			
Loan			(8,000)
			<hr/>
Net assets			35,940
			<hr/>
Capital			
Opening capital			48,000
Net profit for the year			13,940
			<hr/>
			61,940
Less: Drawings			26,000
			<hr/>
Closing capital (proprietor's funds)			35,940
			<hr/>



Test your understanding 3

Given below is the list of ledger balances for a sole trader at 30 June 20X4 after all year-end adjustments have been put through.

	£
Sales	165,400
Sales ledger control account	41,350
Wages	10,950
Bank	1,200
Rent	8,200
Capital	35,830
Purchases ledger control account	15,100
Purchases	88,900
Electricity	1,940
Telephone	980
Drawings	40,000
Inventory at 1 July 20X3	9,800
Motor vehicles at cost	14,800
Accumulated depreciation – motor vehicles	7,800
Fixtures at cost	3,200
Accumulated depreciation – fittings	1,800
Accruals	100
Prepayments	210
Inventory at 30 June 20X4 – statement of financial position	8,300
Inventory at 30 June 20X4 – statement of profit or loss	8,300
Depreciation charges	4,500

You are required to:

- (i) Draw up a trial balance to check that it balances (you should find that the trial balance does balance).
- (ii) Prepare the financial statements for the sole trader for the year-ending 30 June 20X4.

(i) Trial balance as at 30 June 20X4

	£	£
Sales		
Sales ledger control account		
Wages		
Bank		
Rent		
Capital		
Purchases ledger control account		
Purchases		
Electricity		
Telephone		
Drawings		
Inventory at 1 July 20X3		
Motor vehicles at cost		
Accumulated depreciation – motor vehicles		
Fixtures at cost		
Accumulated depreciation – fittings		
Accruals		
Prepayments		
Inventory at 30 June 20X4 – SFP		
Inventory at 30 June 20X4 – SPL		
Depreciation charges		
	_____	_____
	_____	_____

(ii) Statement of profit or loss for the year-ending 30 June 20X4

	£	£
Sales revenue		
Less: Cost of goods sold		

Less:		

Gross profit		_____
Less: Expenses		

Total expenses		_____
Net profit		_____

Statement of financial position as at 30 June 20X4

	<i>Cost</i>	<i>Accumulated Depreciation</i>	<i>Carrying amount</i>
	£	£	£
Non-current assets	_____	_____	_____
	_____	_____	_____
Current assets		_____	
Current liabilities	_____	_____	
Net current assets			_____
Net assets			_____
Capital			_____
Net profit for the year			_____
Drawings			_____
Closing capital (proprietor's funds)			_____



Test your understanding 4

Tick as appropriate.

- 1 Opening inventory is recorded in the statement of profit or loss as
 - An expense
 - Cost of goods sold

- 2 Indicate where the drawings should be shown in the financial statements
 - Statement of profit or loss expenses
 - Statement of financial position as a deduction to capital

- 3 Payroll expenses are recorded as
 - A liability in the statement of financial position
 - An expense in the statement of profit or loss

- 4 Does the allowance for doubtful debt adjustment appear in the statement of profit or loss or the statement of financial position?
 - Statement of profit or loss
 - Statement of financial position

- 5 Irrecoverable debt expenses are recorded in the statement of financial position as an increase in the allowance for doubtful debts
 - True
 - False

**Test your understanding 5****David Pedley**

The following information is available for David Pedley's business for the year-ended 31 December 20X8. He started his business on 1 January 20X8.

	£
Payables	6,400
Receivables	5,060
Purchases	16,100
Sales	28,400
Motor van	1,700
Drawings	5,100
Insurance	174
General expenses	1,596
Rent and rates	2,130
Salaries	4,162
Inventory at 31 December 20X8	2,050
Sales returns	200
Cash at bank	2,628
Cash in hand	50
Capital introduced	4,100

Required:

Prepare a statement of profit or loss for the year-ended 31 December 20X8 and a statement of financial position at that date.



Test your understanding 6

Karen Finch

On 1 April 20X7 Karen Finch started a business with capital of £10,000 which she paid into a business bank account.

The following is a summary of the cash transactions for the first year.

	£
Amounts received from customers	17,314
Salary of assistant	2,000
Cash paid to suppliers for purchases	10,350
Purchase of motor van on 31 March 20X8	4,000
Drawings during the year	2,400
Amounts paid for electricity	560
Rent and rates for one year	1,100
Postage and stationery	350

At the end of the year, Karen was owed £4,256 by her customers and owed £5,672 to her suppliers. She has promised her assistant a bonus for the year of £400. At 31 March 20X8 this had not been paid.

At 31 March 20X8 there was closing inventory of £4,257 and the business owed £170 for electricity for the last quarter of the year. A year's depreciation is to be charged on the motor van at 25% on cost.

Required:

Prepare a statement of profit or loss for the year-ended 31 March 20X8 and a statement of financial position at that date.

**Test your understanding 7**

The trial balance of Elmdale at 31 December 20X8 is as follows

	<i>Dr</i>	<i>Cr</i>
	£	£
Capital		8,602
Inventory	2,700	
Sales		21,417
Purchases	9,856	
Rates	1,490	
Drawings	4,206	
Electricity	379	
Freehold shop	7,605	
Receivables	2,742	
Payables		3,617
Cash at bank		1,212
Cash in hand	66	
Sundry expenses	2,100	
Wages and salaries	3,704	
	34,848	34,848

In addition, Elmdale provides the following information:

- (i) Closing inventory has been valued for accounts purposes at £3,060.
- (ii) An electricity bill amounting to £132 in respect of the quarter to 28 February 20X9 was paid on 7 March 20X9.
- (iii) Rates include a payment of £1,260 made on 10 April 20X8 in respect of the year to 31 March 20X9.

Tasks

- (a) Show the adjustments to the ledger accounts for the end-of-period adjustments (i) to (iii).
- (b) Prepare a statement of profit or loss for the year-ended 31 December 20X8.

4 Summary

The unit Final Accounts Preparation requires the preparation of the financial statements for a sole trader.

The statement of profit or loss summarises the transactions during the period and leads to a net profit or loss.

The statement of financial position lists the assets and liabilities of the business on the last day of the accounting period in a particular order.

If you have to prepare the financial statements from an extended trial balance each balance will have been categorised as either a profit or loss item or a statement of financial position item.

If you are preparing the financial statements from an initial trial balance, you will have to recognise whether the balances should appear in the statement of profit or loss or in the statement of financial position.

Test your understanding answers**Test your understanding 1****Statement of profit or loss extract for the year-ended 31 December 20X2**

Calculate the sales revenue and the cost of goods sold.

	£	£
Sales revenue		292,500
Less: Cost of goods sold		
Opening inventory	37,500	
Purchases	158,700	
	<u>196,200</u>	
Less: Closing inventory	(15,000)	
	<u>(181,200)</u>	
Gross profit		<u>111,300</u>

**Test your understanding 2****Statement of profit or loss for the year-ended 31 December 20X6**

	£	£
Sales revenue		120,000
Less: Cost of goods sold		
Opening inventory	15,000	
Purchases	78,800	
	<u>93,800</u>	
Less: Closing inventory	(21,000)	
	<u>(72,800)</u>	
Gross profit		<u>47,200</u>

Less: Expenses

Wages	11,800
Advertising	4,200
Rates	1,440
Bank charges	200
Depreciation charges	1,400
Allowance for doubtful debts adjustment	(515)
Irrecoverable debts	500

Total expenses (19,025)

Profit for the year 28,175

Statement of financial position at 31 December 20X6

	£	£	£
Non-current assets			
Fittings	7,300	2,900	4,400
Leasehold	30,000	7,000	23,000
	_____	_____	_____
	37,300	9,900	27,400
	_____	_____	
Current assets			
Inventory		21,000	
Trade receivables	9,500		
Less: Allowance for doubtful debts	(285)		
	_____	9,215	
Prepayments		360	
Cash at bank		1,250	
Cash in hand		50	

		31,875	
Current liabilities			
Trade payables		(18,000)	

Net current assets			13,875

Net assets			41,275

Owner's capital			
Capital at 1.1.X6			19,050
Net profit for the year			28,175
Less: Drawings			(5,950)

Closing capital (proprietor's funds)			41,275

**Test your understanding 3****(i) Trial balance as at 30 June 20X4**

	£	£
Sales		165,400
Sales ledger control account	41,350	
Wages	10,950	
Bank	1,200	
Rent	8,200	
Capital		35,830
Purchases ledger control account		15,100
Purchases	88,900	
Electricity	1,940	
Telephone	980	
Drawings	40,000	
Inventory at 1 July 20X3	9,800	
Motor vehicles at cost	14,800	
Accumulated depreciation – motor vehicles		7,800
Fixtures at cost	3,200	
Accumulated depreciation – fittings		1,800
Accruals		100
Prepayments	210	
Inventory at 30 June 20X4 – SPL		8,300
Inventory at 30 June 20X4 – SFP	8,300	
Depreciation charges	4,500	
	234,330	234,330

(ii) Statement of profit or loss for the year-ending 30 June 20X4

	£	£
Sales revenue		165,400
Less: Cost of goods sold		
Opening inventory	9,800	
Purchases	88,900	
	<u>98,700</u>	
Less: Closing inventory	(8,300)	
	<u>(90,400)</u>	
Gross profit		75,000
Less: Expenses		
Wages	10,950	
Rent	8,200	
Electricity	1,940	
Telephone	980	
Depreciation charges	4,500	
	<u>(26,570)</u>	
Total expenses		(26,570)
Net profit		48,430

Statement of financial position as at 30 June 20X4

	<i>Cost</i>	<i>Accumulated Depreciation</i>	<i>Carrying amount</i>
	£	£	£
Non-current assets			
Motor vehicles	14,800	7,800	7,000
Fittings	3,200	1,800	1,400
	<hr/>	<hr/>	<hr/>
	18,000	9,600	8,400
	<hr/>	<hr/>	
Current assets			
Inventory		8,300	
Trade receivables		41,350	
Prepayments		210	
Bank		1,200	
		<hr/>	
		51,060	
Current liabilities			
Trade payables	15,100		
Accruals	100		
	<hr/>	<hr/>	
		(15,200)	
		<hr/>	
Net current assets			35,860
			<hr/>
Net assets			44,260
			<hr/>
Capital			35,830
Net profit for the year			48,430
			<hr/>
			84,260
Drawings			(40,000)
			<hr/>
Closing capital (proprietor's funds)			44,260
			<hr/>



Test your understanding 4

- 1 Opening inventory is recorded in the statement of profit or loss as
Cost of goods sold
- 2 Indicate where the drawings should be shown in the financial
statements
Statement of financial position
- 3 Payroll expenses are recorded as
An expense in the statement of profit or loss
- 4 Does the allowance for doubtful debt adjustment appear in the
statement of profit or loss or statement of financial position?
Statement of profit or loss
- 5 Irrecoverable debt expenses are recorded in the statement of
financial position as an increase in the allowance for doubtful debts
False

**Test your understanding 5****David Pedley****Statement of profit or loss for the year ended 31 December 20X8**

	£	£
Sales revenue		28,400
Less: Returns		(200)
		<hr/> 28,200
Opening inventory	–	
Purchases	16,100	
Less: Closing inventory	(2,050)	
	<hr/>	
Cost of goods sold		(14,050)
		<hr/>
Gross profit		14,150
Salaries	4,162	
Rent and rates	2,130	
Insurance	174	
General expenses	1,596	
	<hr/>	
Total expenses		(8,062)
		<hr/>
Profit for the year		6,088
		<hr/>

Statement of financial position as at 31 December 20X8

	£	£
Non-current assets		
Motor van		1,700
Current assets		
Closing inventory	2,050	
Trade receivables	5,060	
Cash at bank	2,628	
Cash in hand	50	
	<hr/>	
	9,788	
Trade payables	(6,400)	
	<hr/>	
Net current assets		3,388
		<hr/>
Net assets		5,088
		<hr/>

Capital account

Capital introduced	4,100
Profit for the year (per income statement)	6,088
Less: Drawings	(5,100)
	<hr/>
Closing capital (proprietor's funds)	5,088
	<hr/>



Test your understanding 6

Karen Finch

Statement of profit or loss for the year ended 31 March 20X8

	£	£
Sales revenue (£17,314 + £4,256)		21,570
Purchases (£10,350 + £5,672)	16,022	
Closing inventory	(4,257)	
	<hr/>	(11,765)
Gross profit		<hr/> 9,805
Assistant's salary plus bonus (£2,000 + £400)	2,400	
Electricity (£560 + £170)	730	
Rent and rates	1,100	
Postage and stationery	350	
Depreciation charge	1,000	
	<hr/>	
Total expenses		<hr/> (5,580)
Profit for the year		<hr/> 4,225
		<hr/>

Statement of financial position at 31 March 20X8

	£	£
Non-current assets		
Motor van at cost		4,000
Accumulated depreciation		(1,000)
		<hr/>
Carrying amount		3,000
Current assets		
Inventory	4,257	
Trade receivables	4,256	
Cash (W1)	6,554	
	<hr/>	
	15,067	
	<hr/>	
Current liabilities		
Trade payables	5,672	
Accruals (400 + 170)	570	
	<hr/>	
	6,242	
	<hr/>	
Net current assets		8,825
		<hr/>
Net assets		11,825
		<hr/>
Capital		10,000
Capital introduced at 1 April 20X7		
Profit for the year	4,225	
Less Drawings	(2,400)	
	<hr/>	
Retained profit for the year		1,825
		<hr/>
Closing capital (proprietor's funds)		11,825
		<hr/>

(W1)

Cash

	£		£
Capital	10,000	Salary	2,000
SLCA	17,314	PLCA	10,350
		Motor van	4,000
		Drawings	2,400
		Electricity	560
		Rent and rates	1,100
		Postage and stationery	350
		Balance c/d	6,554
	<u>27,314</u>		<u>27,314</u>

**Test your understanding 7****(a) Ledger accounts**

(i) Closing inventory (SPL)			
	£		£
Statement of profit or loss	3,060	Closing inventory SFP	3,060
	<u> </u>		<u> </u>
Closing inventory (SFP)			
Closing inventory SPL	3,060	Balance c/d	3,060
	<u> </u>		<u> </u>
	3,060		3,060
	<u> </u>		<u> </u>
Balance b/d	3,060		
(ii) Electricity			
	£		£
Per trial balance	379	Statement of profit or loss	423
Accrual	44		
	<u> </u>		<u> </u>
	423		423
	<u> </u>		<u> </u>
Rates			
	£		£
Per trial balance	1,490	Statement of profit or loss	1,175
	<u> </u>	Prepayment	315
	1,490		<u> </u>
	<u> </u>		1,490
	<u> </u>		<u> </u>

Points to note:

- As regards electricity the accrual of £44 is shown on the statement of financial position as a current liability and increases the charge to the statement of profit or loss for electricity for expenses incurred but not yet paid.
- The rates prepayment of £315 is shown on the statement of financial position as a current asset and reduces the charge to the statement of profit or loss. This reflects the fact that some of the expense recorded relates to the next accounting year.

(b)

Elmdale
Statement of profit or loss for the year ended
31 December 20X8

	£	£
Sales revenue		21,417
Opening inventory	2,700	
Purchases	9,856	
	<u>12,556</u>	
Closing inventory	(3,060)	
	<u> </u>	
Cost of goods sold		<u>9,496</u>
Gross profit		11,921
Rates	1,175	
Electricity	423	
Wages and salaries	3,704	
Sundry expenses	2,100	
	<u> </u>	
Total expenses		<u>7,402</u>
Profit for the year		<u>4,519</u>