

Preface

What's new

- The textbook has been updated in light of recent changes to relevant Hong Kong Financial Reporting Standards (HKFRSs).
- The textbook has been updated to incorporate the relevant provisions of new Hong Kong Companies Ordinance (Cap. 622) which becomes effective on 3 March 2014.
- In response to feedback from adopters, multiple choice questions have been included at the end of each chapter to test students' basic knowledge of the chapter materials.
- Additional examples have been included to assist students' learning where appropriate.
- All references, key terms and learning objectives have also been updated as appropriate.
- Additional review questions and exercises have been included to test students' understanding of the chapter materials.

This book is primarily intended to be an introductory text for students taking a degree in accounting or business studies with a substantial element of accounting. However, it also covers the financial accounting syllabus for the Association of Chartered Certified Accountants, the Chartered Institute of Management Accountants and the Certified Accounting Technicians.

Andrew Thomas is a former senior lecturer in accounting at the University of Birmingham and a Certified Accountant, and has been a member of the panel of examiners of one of the major professional accountancy bodies for over 15 years. Patrick Ng is a lecturer in accounting at the Hong Kong Institute of Vocational Education (Chai Wan) and a Certified Accountant, and has been teaching financial accounting for more than 20 years. He is the author/co-author of *Accounting in Hong Kong: Regulatory Framework and Advanced Accounting Practice*, *Examination Guide to ACCA Paper 13(H) Financial Reporting Environment (Hong Kong)*, *Financial Accounting, Advanced Accounting, Corporate Accounting—Business Combinations in Hong Kong*, *Financial Accounting for Hong Kong*, *Hong Kong Master GAAP Guide*, *Hong Kong Principles of Accounts Volumes 1 and 2*, *HKIAAT Paper 7 Financial Accounting*, *HKIAAT PBE Paper 1 Financial Accounting*, and *China Master GAAP Guide*.

The main aim of this book is to provide an in-depth detailed introduction to financial accounting with the greatest possible clarity of exposition and academic rigour. Another major aim is the provision of an appropriate balance between theory and the application of accounting methods. Each element in this balance is important. A proper understanding of accounting requires underpinning by an appreciation of its theoretical foundations. Although this may be readily recognized in the case of degree students, it is no less true of other students. Theory is often presented in textbooks in isolation, but this book integrates theory into understanding of accounting methods. The other side of this balance, represented by the application of accounting, depends upon a thorough grasp of the mechanics of financial accounting. The book therefore examines in depth many of what are normally regarded as the basic aspects of accounting, particularly where this involves applications of important points of principle.

The structure of the book follows a proven pattern based on the authors' not inconsiderable experience of teaching at this level. Each chapter deals with a specific aspect of accounting, irrespective of how brief or lengthy this might be. This is intended to permit lecturers

to choose that combination of chapters which fits their syllabus. However, it is important to appreciate that the order in which the chapters are presented is significant. There are also particular groupings of chapters, for example: Chapters 8 to 10 deal with books of prime entry; Chapters 17 to 21 examine aspects of internal control and accuracy.

The structure within each chapter also follows a deliberate pattern. These usually start by examining the purpose, theoretical foundation and practical relevance of the topic. This is followed by a description of the accounting methods and then comprehensive examples. A further unique feature of the book is that after most examples there is a series of notes. These are intended to explain the unfamiliar and more difficult aspects of the example in order that the reader is able to follow the example. The notes also provide guidance on further aspects of the topic that may be encountered in examination questions, such as alternative forms of wording.

Each chapter also contains a set of multiple choices, review questions and numerical exercises designed by the author to test whether the student has fulfilled the learning objectives set out in the chapter, as well as past questions from various examining bodies. The review questions and exercises are presented in a coherent, progressive sequence designed to test understanding of terminology, legal requirements, theoretical foundations, etc. The exercises are categorized into three levels according to their level of difficulty and level III questions are the most demanding. This is rather subjective for a book that focuses on the introductory level, but it is hoped that the following classification may be useful to students and lecturers:

Level I questions are of a standard lower than those commonly found in the first year of an undergraduate degree in accounting or the professional accountancy bodies examinations and can usually be completed in a relatively short time (i.e. less than about 35 minutes).

Level II questions are of a standard commonly found in the first year of an undergraduate degree in accounting or the professional accountancy bodies examinations and can usually be completed in about 35 minutes.

Level III questions are of a standard slightly higher than those commonly found in the first year of an undergraduate degree in accounting or the professional accountancy bodies examinations, and/or more advanced in the depth of knowledge required to answer them, and can usually be completed in about 45 minutes.

All users, especially lecturers, should also be aware that some exercises are extensions of other exercises in previous chapters. This is intended to provide a more comprehensive understanding of the relationship between different topics in accounting, such as day books and cash books, and accumulated depreciation and bad debts. Suggested solutions to some of the numerical exercises are in Appendix 2 for student self-study. The answers to the rest of the numerical exercises, multiple choices and review questions are contained in a *Teachers' Solutions Manual* that is available upon teachers' request.

Each chapter also includes learning objectives, learning activities, a summary, and a list of key terms and concepts. The learning objectives at the start of each chapter set out the abilities and skills that the student should be able to demonstrate after reading the chapter.

Students should also refer back to these after reading each chapter. Similarly, students should satisfy themselves that they can explain the meaning of the key terms and concepts listed at the end of each chapter. The summaries provide a comprehensive but concise review of the contents of each chapter that students should find useful for revision purposes. The learning activities are mostly real-life activities of a project/case study type which require students to apply their knowledge to practical situations. They frequently necessitate students collecting publicly available data from actual companies, or their own financial affairs.


The authors gratefully acknowledge the permission of the following bodies to reproduce copies of their past examination questions: The Association of Chartered Certified Accountants (ACCA), The Association of Accounting Technicians (AAT), The Associated Examining Board (AEB) and The Joint Matriculation Board (JMB).

Summary of Hong Kong Financial Reporting Standards covered by the book

Note: The versions referred to include all the changes made by the HKICPA up to 30 June 2014.

HKAS 1 *Presentation of Financial Statements*
HKAS 2 *Inventories*
HKAS 7 *Statement of Cash Flows*
HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
HKAS 10 *Events after the Reporting Period*
HKAS 16 *Property, Plant and Equipment*
HKAS 18 *Revenue*
HKAS 36 *Impairment of Assets*
HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
HKAS 38 *Intangible Assets*
HKFRS 3 *Business Combinations*
HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
HKFRS 13 *Fair Value Measurement*
Conceptual Framework for Financial Reporting

Andrew Thomas and Patrick Ng



2 Accounting Principles, Concepts and Policies

Learning objectives

After reading this chapter, you should be able to:

- 1 explain the meaning of the key terms and concepts listed at the end of this chapter;
- 2 explain the nature of accounting principles, accounting concepts, measurement bases, accounting policies and accounting estimates;
- 3 explain the nature of the going concern concept, the accruals concept, the matching concept, the entity concept, the materiality concept, the time period concept, the cost concept, the money measurement concept, the prudence concept, the duality concept, the substance over form concept, the consistency concept and the offsetting concept, including their implications for the preparation of financial statements;
- 4 outline the recognition criteria required before transactions can be included in financial statements;
- 5 describe the objectives against which an entity should judge the appropriateness of accounting policies, that is, relevance and reliability;
- 6 describe the requirements of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* with regard to the selection, review, change in and disclosure of accounting policies, accounting estimates and errors.

Introduction

An appreciation of the conceptual and theoretical foundations of financial accounting is fundamental to the preparation, understanding and interpretation of financial statements. The conceptual and theoretical foundations can be described as a set of rules, principles, postulates, conventions and methods. The first part of this chapter explains the nature of the underlying concepts of accounting. Some of the concepts are referred to specifically in the Hong Kong Institute of Certified Public Accountants' *Conceptual Framework for Financial Reporting (Conceptual Framework)*.¹ This conceptual framework is the main source of guidance underpinning the accounting for any transaction in financial statements that are prepared using Hong Kong Financial Reporting Standards. The *Conceptual Framework* is supported by HKAS 1 *Presentation of Financial Statements*² and by HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.³ HKAS 8 focuses on the selection, change in and disclosure of accounting policies, accounting estimates and errors. The latter part of this chapter provides a summary of the relevant parts of HKAS 8.

The nature of accounting principles

The *Conceptual Framework* provides conceptual guidance on international generally accepted **accounting principles**. Each chapter within the *Conceptual Framework* deals with a different principle. The chapters of the *Conceptual Framework* include the following topics:

- 1 The objective of financial reporting, as explained in Chapter 1, 'The Nature and Objectives of Financial Reporting'.
- 2 Underlying assumptions of accounting. These are explained in this chapter.
- 3 The qualitative characteristics of useful financial information. These are explained in Chapter 3, 'The Conceptual Framework of Accounting'.
- 4 The elements of financial statements such as assets, liabilities, equity, income and expense. These are explained briefly in this chapter.
- 5 Recognition of the elements of financial statements. This is explained briefly in this chapter.
- 6 Measurement of the elements of financial statements. This is explained briefly in this chapter.
- 7 Concepts of capital maintenance. This is explained briefly in Chapter 4, 'The Accounting Equation and Its Components'.

The *Conceptual Framework* does not address specifically the presentation of financial information such as in the form of a statement of comprehensive income and statement of financial position. Chapter 27, 'Presentation of Financial Statements—Further Issues' will explain the presentation of financial statements in detail.

Key accounting concepts

Accounting concepts are broad basic assumptions that underlie the periodic financial statements of business entities. The going concern concept is specifically singled out for

explicit mention in the *Conceptual Framework* as it is regarded as being fundamental for ensuring that financial statements meet their objective (i.e. providing useful financial information). Two other key accounting concepts are the accruals concept and matching concept.

Going concern

The **going concern concept** is the assumption that an entity will continue in operational existence for the foreseeable future. Any user, when looking at an entity's financial statements, has the right to assume that the company is not going to liquidate or curtail materially the scale of its operations. Users should be able to look at the financial implications of prior activity as captured in the financial statements and use this as an indication of future activity.

The implication of the going concern assumption is that assets are valued at their historical cost (or fair value), not their scrap value. It is assumed that the entity will continue to operate for the remaining useful life of the non-current assets; hence, the asset's cost will be allocated to the statement of comprehensive income over the useful life of the asset to match against the revenues that the asset helps to generate. If, however, the entity were going to close, the asset cost would have to be written down to the net revenue that it is expected to generate on sale; that is, the sales price less any costs associated with the sale. This may be significantly lower than the book value recorded in the statement of financial position, particularly where the asset is unique, bespoke or specialized, as there will be a limited second-hand market for the sale of the asset.

If there is reason to believe that the entity will not be able to continue in business, then the going concern principle no longer holds and the assets should be valued on a cessation basis; that is, at their net **realizable value**. For example, a \$100,000 machine, which can easily generate output for the next ten years, would be recognized in the statement of financial position at cost price less accumulated depreciation, if the company is a going concern. However, if the company decides to go into voluntary liquidation, then this machine is not going to produce revenue for the next ten years, and hence should be written down to the value expected to be received on its sale (its net realizable value). This may be zero.

Also, HKAS 1 requires that financial statements shall be prepared on a going concern basis, unless

- a management either intends to liquidate the entity or to cease trading, or
- b management has no realistic alternative but to do so.

Furthermore, HKAS 1 requires that 'when preparing financial statements, management shall make assessment of an entity's ability to continue as a going concern. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties shall be disclosed'.² When an entity does not prepare financial statements on a going concern basis, HKAS 1 requires the entity to disclose that fact, together with the basis on which it prepared the financial statements and the reasons why the entity is not regarded as a going concern.

Accruals concept

According to HKAS 1, 'an entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting'.²

The **accruals concept** is concerned with allocating expenses and income to the periods to which they relate (when the expenses were used by the entity, or when the income was earned, as distinctly different to when cash is paid out for expenses and when cash is received from a sale). The transactions should be recorded in the accounting records and reported in the financial statements in the periods to which they relate. In most instances, this refers to the accounting period in which the goods or services physically pass from the seller to the buyer. Accrual accounting provides useful information to users of financial statements as it identifies past payments involving the receipt (deferred income) or payment of cash (prepayments) and also highlights future commitments to pay cash in the future (e.g. trade payables) and resources that represent cash to be received in the future (e.g. trade receivables).

In the case of sales, this notion has traditionally been referred to as **revenue recognition**. It relates to the assumption that a sale is deemed to have taken place at that point in time at which the goods are delivered or services provided (i.e. when the revenue is earned), and not when the proceeds of sale are received. In practice this is normally also the date of the invoice. However, where the invoice is rendered some time after the date of delivery, the sale is deemed to have taken place on the date of delivery and not the date of the invoice. Though coming under the remit of the accruals concept, revenue recognition is such an important principle that a whole standard has been dedicated to providing guidance on the accounting for certain types of revenue: HKAS 18 *Revenue*.⁴ This standard applies to the accounting for revenue arising from the sale of goods, the rendering of services and the use by others of entity assets yielding interest, royalties and dividends.

Legislation has also had an impact on the interpretation of the accruals concept. It generally requires that only profit realized at the end of the reporting period be included in the profit or loss section of the statement of comprehensive income. It is generally accepted that profit should be treated as realized, for these purposes, only when realized in the form either of cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty. This is known as the **realization concept**. Unrealized profits are shown in the other comprehensive income section of the statement of comprehensive income.

The accruals concept also assumes that costs should be recognized when they occur, and not as cash is paid, that is, goods or services are deemed to have been purchased on the date they are received, and services consumed, for which no invoice has been received at the end of an accounting year (e.g. electricity, gas, telephone), are treated as a cost for that year. The amount due is treated as a liability. These are referred to as **accrued expenses**. In contrast, services paid for in advance (e.g. rent, insurance) that have not been received at the end of an accounting year are treated as a cost of the following accounting year, and thus carried forward as an asset at the end of the current year. These are referred to as **prepaid expenses** or **prepayments**. Accrued and prepaid expenses are dealt with in more depth in Chapter 14, 'Accruals and Prepayments'.

Matching concept

The **matching concept** refers to the assumption that in the measurement of profit, costs should be set against the revenue that they generate at the point in time when this arises. A classic example of the application of the matching concept is inventory. Where goods are bought in one accounting year but sold in the next, their cost is carried forward as inventory at the end of the year and set against the proceeds of sale in the accounting year in which it occurs. This is expounded in HKAS 2 *Inventories*⁵ as follows: 'When inventories are sold, the carrying amount of those inventories shall be recognized as an expense in the period in which the related revenue is recognized'.

In terms of the calculation of the gross profit, this process of carrying forward costs takes the form of the computation of the cost of sales. The cost is carried forward by being deducted from purchases in the form of the inventory at the end of the year. It is brought forward to the following year in the form of the opening inventory which is matched against the proceeds of sale by virtue of its being included in the cost of sales.

A more theoretical view of the matching concept is that it refers to ascertaining profit on the basis of a cause and effect relationship. Costs cause or give rise to certain effects that take the form of revenue. Matching is thus the determination of profit by attributing specific causes to particular effects at the point in time at which the effects occur.

The accruals concept and matching concept can be illustrated vividly by a simplified example (see Example 2.1.).

Example 2.1

Suppose a business only had the following transactions:

15 Jan	Purchased goods costing \$100 on credit
15 Feb	Paid for the goods purchased on 15 January
15 Mar	Sold on credit for \$150 the goods purchased on 15 January
15 Apr	Received payment for the goods sold on 15 March

The accruals (and matching) concept dictates that:

- 1 The cost of the goods was *incurred* in January.
- 2 The sales revenue was *earned* in March.
- 3 There was no profit or loss in January, February or April. The profit of \$50 arose in March, the cost of the goods being carried forward as inventory at the end of January and February.

Unfortunately the application of the accruals concept in general, and the revenue recognition concept and matching concept in particular, is not always as simple as implied above. Although the contents of this section thus far would usually be sufficient to answer most examination questions at this level, students might be expected to demonstrate an awareness of its relevance to current issues. There have recently been several high profile cases of large companies throughout the world abusing the revenue recognition and matching concepts, resulting in the overstating of profit, and in some cases, corporate bankruptcy. Moreover, standard-setting bodies have been reviewing revenue recognition rules for some years.

Many of the issues concerning revenue recognition arise where the revenue received in one accounting year relates to goods or services that the business will provide in the next, or future, accounting year(s). Examples include revenue from the installation of security and IT systems, different forms of prepayments associated with various mobile phone and other telecommunication services including television, extended warranties and maintenance agreements, etc. The latter provides a good illustration of the general issues and underlying principles.

When consumers purchase electrical goods they are often encouraged to buy an extended warranty. The consumer pays a one-off premium at the time of purchase, and the seller undertakes to maintain and/or repair the item for some fixed future period of often three or five years. The customer is invoiced at the time of sale. Thus applying the revenue recognition concept, as described above, might suggest that the premium would be treated as earned/realized in the statement of comprehensive income in the year of sale, which is a practice that some companies have sought to adopt in their financial statements.

However, this does not accord with the matching concept. The costs of the repairs that the seller is obliged to make under the extended warranty will be incurred over several future accounting years, and thus the matching concept dictates that the premium received should be spread over this period. This is referred to as **deferred income**.

This is not the end of the problem. The issue now arises as to how much of the premium should be recognized as revenue in each of the future accounting years. The repairs to the item in question are likely to be more common and more costly as the item becomes older. A proper matching would thus require a higher proportion of the premium to be recognized in each of the later years. The precise proportion to be recognized in each year will thus be highly subjective/arbitrary, which is where the further possibility of abuse arises (allocation limitation).

Furthermore, the extended warranty illustration does not highlight another very subjective decision. Extended warranties cover a fixed number of years, whereas other goods and services of a similar nature often do not relate to a given period of time. In applying the matching concept it will thus be necessary to determine over how many years the income should be recognized. This again gives scope for revenue manipulation.

Similar issues arise in deciding whether expenditure should be treated as capital (i.e. on non-current assets) or revenue (i.e. expenses), and in the case of capital expenditure, over what period to write off the asset and how much should be charged to each year (classification and allocation limitations). This is discussed further in Chapter 12, 'Depreciation and Non-Current Assets'.

Other concepts

The fundamental concepts (going concern and accruals) and the related concepts (revenue recognition, realization and matching) are discussed above. There are a number of other concepts that are implicit in the preparation of financial statements and are so engrained in the process of accounting that they are not explicitly mentioned in the *Conceptual Framework*. Some have already been mentioned in Chapter 1, 'The Nature and Objectives of Financial Reporting' and some will be focused on in later chapters. To be comprehensive, a short explanation of each is given in this chapter.

Entity concept

The first is the **entity concept**, otherwise known as the **accounting entity** or the **business entity concept**. In simple terms this concept allows the user to look at a reporting entity's financial statements and to know that these represent the performance and financial position of the business unit and do not include any assets, liabilities, income or expenditure that are not related to the business. Therefore, when a sole trader uses the business cheque book to buy a car for personal use, this car will not form part of the business's assets; it will be treated as the owner withdrawing equity capital. This is called a drawing.

Materiality concept

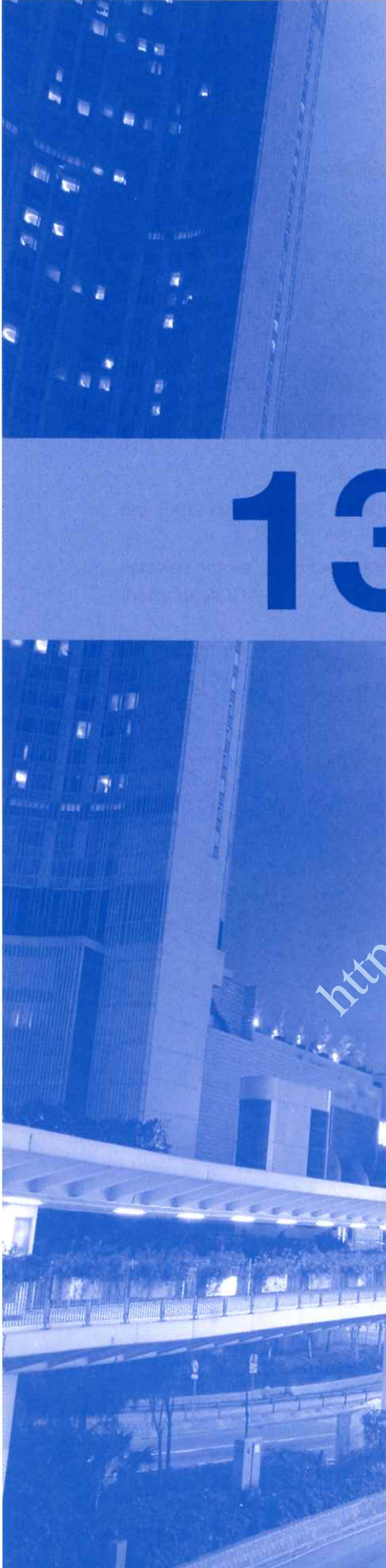
The **materiality concept** affects every transaction and every set of financial statements. This concept affects two main areas: presentation and application of accounting standards. In respect of the first, this concept assumes that only material items should be disclosed in financial statements. This is important for achieving the objective of financial statements, as attention being afforded to immaterial items can mislead the user. The user should be able to look at a set of financial statements and focus on the important figures, not see a mass of information, much of which is of no use for economic decision-making. For example, it is irrelevant to disclose a yearly spend on stationery of \$1,000 and a yearly spend on coffee of \$750, if the company has a turnover of \$100 million and total expenditure of \$80 million. The immaterial items need to be grouped together, or grouped into categories that are material. For example, the stationery and coffee could be combined into administrative expenses that might have a total of \$25 million. Knowing about the \$1,000 spending on stationery, or the \$750 spending on coffee, will not influence users' economic decision-making. Indeed, if such detail was provided, the user might not easily see that total expenses are \$80 million.

The second area of relevance is when deciding whether to comply with guidance given in accounting standards. As a rule of thumb, accounting standards only apply to material items. Therefore, a company that spends \$20,000 per year on heating oil (with other expenditure of \$80 million) does not have to apply the cost flow inventory valuation techniques as detailed in HKAS 2 *Inventories* (see Chapter 16, 'Financial Statements for Manufacturing Entities and the Valuation of Inventory') when valuing its oil inventories. This saves the company time, hence money. Whether the final value for the year ended up as \$20,000 or \$21,000 would not affect users' economic decision-making.

The only time that immaterial-sized items become 'material' is when the nature of the item makes them so. For example, when an entity experiences theft by staff or the directors have borrowed money from the entity, then even though the amounts may be small relative to the entity's overall performance and financial position, they indicate weaknesses that users should be aware of. Theft by staff indicates weak internal controls and directors borrowing money may highlight fiduciary problems.

Time period concept

Another concept, the **time period concept**, otherwise known as the **time interval concept**, refers to the practice of dividing the life of an entity into discrete periods for the purpose of preparing



13

Bad Debts and Allowance for Doubtful Debts

Learning objectives

After reading this chapter, you should be able to:

- 1 explain the meaning of the key terms and concepts listed at the end of the chapter;
- 2 explain the nature of bad debts, and allowance for doubtful debts;
- 3 distinguish between specific and general allowance for doubtful debts;
- 4 show the entries for bad debts and allowance for doubtful debts in the journal, ledger, statement of comprehensive income and statement of financial position.

The nature of, and ledger entries for, bad debts

When goods are sold on credit, it sometimes transpires that the customer is unwilling or unable to pay the amount owed. This is referred to as a **bad** or **irrecoverable debt**. The decision to treat a debt as bad is a matter of judgement. A debt may be regarded as irrecoverable for a number of reasons, such as being unable to trace the credit customer, it not being worth taking the credit customer to court, or the credit customer being bankrupt. However, if a credit customer is bankrupt, this does not necessarily mean that the whole of the debt is irrecoverable. When a person is bankrupt, his or her possessions are seized and sold in order to pay the creditors. Such payments are often made in instalments known as dividends. Frequently, the dividends do not consist of the repayment of the whole of the debt. Thus, when the final dividend is received, the remainder of the debt is irrecoverable.

When a debt is regarded as irrecoverable, the entries in the ledger are as follows:

Debit: Bad debts account
Credit: Trade receivables account (the individual credit customer's account would also be amended in the trade receivables' ledger)

Occasionally, debts previously written off as bad are subsequently paid. When this happens, the ledger entries are the reverse of the above, and the trade receivables account is credited with the money received in the normal way.

Debit: Trade receivables account (the individual credit customer's account would be amended in the trade receivables' ledger)
Credit: Bad debts account

At the end of the accounting year, the balance on the bad debts account is transferred to the statement of comprehensive income.

The nature of, and ledger entries for, allowance for doubtful debts

The need for an **allowance for doubtful debts** (also called a **provision for doubtful debts** in the UK) essentially arises because goods sold and recognized as sales in one accounting year may not become known to be a bad debt until the following accounting year. Thus, the profit of the year in which the goods are sold would be overstated by the amount of the bad debt. In order to adjust for this, an allowance in respect of probable bad debts is created in the year of sale.

An allowance for doubtful debts may consist of either a **specific allowance** or a **general allowance**, or both. A specific allowance involves ascertaining which particular credit customers at the year end are unlikely to pay their debts. A general allowance is an estimate of the total amount of bad debts computed using a percentage (based on previous years' figures) of the trade receivables at the end of the current year. Where both specific and general allowances are made, the two amounts are added together and the total is entered in the general ledger.

The accounting entries in respect of an allowance for doubtful debts are made after the trial balance has been extracted when the statement of comprehensive income is being prepared. It is important to appreciate that any balance on an allowance for doubtful debts account shown in a trial balance must therefore relate to the balance at the end of the previous year. A charge (or credit) is made to the statement of comprehensive income in each year, which consists of an amount necessary to increase (or decrease) the allowance at the end of the previous year to the amount required at the end of the current year.

An increase in an allowance always consists of:

Debit: Statement of comprehensive income (increase in allowance for doubtful debts)
 Credit: Allowance for doubtful debts account

A decrease in an allowance is entered:

Debit: Allowance for doubtful debts account
 Credit: Statement of comprehensive income (decrease in allowance for doubtful debts) -

The balance on the allowance for doubtful debts account at the end of the year is deducted from trade receivables in the statement of financial position to give the net amount that is expected to be received from credit customers; that is, their net realizable value. The principle is similar to that applied in the case of an accumulated depreciation where the accumulated depreciation at the end of the year, as shown by the balance on the accumulated depreciation account, is deducted from the cost of the non-current asset in the statement of financial position. The treatment of bad debts and allowance for doubtful debts is illustrated in Examples 13.1 and 13.2.

Example 13.1

A. Au has an accounting year ending on 30 November. As at 30 November 20X7, his ledger contained the following accounts:

	\$
Trade receivables	20,000
Allowance for doubtful debts	1,000

The trade receivables as at 30 November 20X8 were \$18,900. This includes an amount of \$300 owed by F. Sung which was thought to be irrecoverable. It also includes amounts of \$240 owed by C. Sin, \$150 owed by M. Chan and \$210 owed by A. Mung, all of which are regarded as doubtful debts.

You have been instructed to make an allowance for doubtful debts as at 30 November 20X8. This should include a specific allowance for debts regarded as doubtful and a general allowance of 5 per cent of trade receivables.

Show the ledger entries in respect of the above bad debts and allowance for doubtful debts and the statement of comprehensive income (extract) for the year ended 30 November 20X8 and the statement of financial position (extract) as at that date.

<i>Allowance for doubtful debts as at 30 November 20X8</i>		\$
Specific allowance—C. Sin		240
—M. Chan		150
—A. Mung		210
		600
General allowance—5 per cent × (\$18,900 – \$300 – \$600)		900
		1,500

The Ledger

(Note: Assume the individual customer accounts are maintained in the general ledger; A. Au does not keep a trade receivables' ledger.)

<i>E. Sung (trade receivable)</i>					
20X8		20X8			
30 Nov	Balance b/d	300	30 Nov	Bad debts	300

<i>Bad debts</i>					
20X8		20X8			
30 Nov	F. Sung	300	30 Nov	Statement of comprehensive income	300

<i>Allowance for doubtful debts</i>					
20X7					
		1 Dec	Balance b/d	1,000	
20X8					
20X8		20X8			
30 Nov	Balance c/d	1,500	30 Nov	Statement of comprehensive income	500
		1,500			1,500
20X8					
		1 Dec	Balance b/d	1,500	

Statement of comprehensive income (extract) for the year ended 30 November 20X8

Bad debts	300
Allowance for doubtful debts	500

Statement of financial position (extract) at at 30 November 20X8

Current assets

Trade receivables	
(18,900 – 300)	18,600
Less: Allowance for doubtful debts	
	1,500
	17,100

Notes

- 1 No entries are made in the accounts of those credit customers which comprise the specific allowance since these are only doubtful debts and thus not yet regarded as irrecoverable.

- 2 The balance carried down on the allowance for doubtful debts account at the end of the year is always the amount of the new allowance. The amount charged to the statement of comprehensive income is the difference between the allowance at the end of the current year and that at the end of the previous year. In this example the allowance is increased from \$1,000 to \$1,500 by a means of credit to the allowance for doubtful debts account of \$500 and a corresponding debit to the statement of comprehensive income.
- 3 In computing the amount of the general allowance, any bad debts and specific allowances must be deducted from the trade receivables. Otherwise, the specific allowance would be duplicated and an allowance would be made for debts already written off as bad.
- 4 The bad debts written off must also be removed from trade receivables in preparing the statement of financial position.
- 5 There is another method of accounting for bad debts and allowance for doubtful debts which essentially involves combining these two accounts. This is shown below.

<i>(Allowance for) doubtful debts</i>			
		20X7	
		1 Dec	Balance b/d
			1,000
20X8		20X8	
30 Nov	F. Sung	300	30 Nov
30 Nov	Balance c/d	1,500	Statement of
		<u>1,800</u>	comprehensive income
			<u>800</u>
			<u>1,800</u>
		20X8	
		1 Dec	Balance b/d
			1,500

Statement of comprehensive income (extract) for the year ended 30 November 20X8

Bad and doubtful debts 800

The combined charge to the statement of comprehensive income for the year in respect of bad debts and the allowance for doubtful debts is the difference between the two sides of the (allowance for) doubtful debts account after inserting the amount of the allowance as at 30 November 20X8 as a balance carried down. The charge to the statement of comprehensive income under both methods is always the same in total.

Example 13.2

This is a continuation of Example 13.1.

During the year ended 30 November 20X9, C. Sin was declared bankrupt and a first dividend of \$140 was received from the trustee. M. Chan was also declared bankrupt and a first and final dividend of \$30 was received from the trustee. A. Mung paid his debt in full. A further debt of \$350 owed by R. Lee that is included in the trade receivables as at 30 November 20X8 proved to be bad.

The trade receivables as at 30 November 20X9 were \$24,570. This figure is after recording all money received but does not take into account bad debts.

You have been instructed to make an allowance for doubtful debts as at 30 November 20X9. This should include a specific allowance for doubtful debts and a general allowance of 5 per cent of trade receivables.

Show the ledger entries in respect of the above bad debts and allowance for doubtful debts and the statement of comprehensive income (extract) for the year ended 30 November 20X9 and the statement of financial position (extract) as at that date.

Allowance for doubtful debts as at 30 November 20X9

	\$
Specific allowance—C. Sin (\$240 – \$140)	100
General allowance—5 per cent × (\$24,570 – \$120 – \$350 – \$100)	1,200
	<u>1,300</u>

The ledger

(Note: Assume the individual customer accounts are maintained in the general ledger; A. Au does not keep a trade receivables' ledger.)

<i>C. Sin (trade receivable)</i>			
20X8		20X9	
1 Dec	Balance b/d	30 Nov	Bank
	240	30 Nov	Balance c/d
	<u>240</u>		100
			<u>240</u>
20X9			
1 Dec	Balance b/d		
	100		
<i>M. Chan (trade receivable)</i>			
20X8		20X9	
1 Dec	Balance b/d	30 Nov	Bank
	150	30 Nov	Bad debts
	<u>150</u>		30
			<u>120</u>
			<u>150</u>
<i>R. Lee (trade receivable)</i>			
20X8		20X9	
1 Dec	Balance b/d	30 Nov	Bad debts
	<u>350</u>		<u>350</u>
<i>Bad debts</i>			
20X9		20X9	
30 Nov	M. Chan	30 Nov	Statement of
	120		comprehensive income
30 Nov	R. Lee		470
	<u>350</u>		<u>470</u>
	<u>470</u>		
<i>Allowance for doubtful debts</i>			
20X9		20X8	
30 Nov	Statement of	1 Dec	Balance b/d
	comprehensive income		1,500
	200		
30 Nov	Balance c/d		
	<u>1,300</u>		
	<u>1,500</u>		<u>1,500</u>
		20X9	
		1 Dec	Balance b/d
			1,300

Statement of comprehensive income (extract) for the year ended 30 November 20X9

Bad debts	470	Allowance for doubtful debts	200
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*Statement of financial position (extract) as at 30 November 20X9***Current assets**

Trade receivables

(24,570 – 120 – 350)	24,100
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Less: Allowance for doubtful debts	1,300
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<u>22,800</u>

*Alternative method**(Allowance for) doubtful debts*

			20X8		
			1 Dec	Balance b/d	1,500
20X9			20X9		
30 Nov	M. Chan	120	30 Nov	Statement of	
30 Nov	R. Lee	350		comprehensive	
30 Nov	Balance c/d	<u>1,300</u>		income	270
		<u>1,770</u>			<u>1,770</u>
			20X9		
			1 Dec	Balance b/d	1,300

Notes

- 1 The amount due from M. Chan is written off as a bad debt because the final dividend in bankruptcy was declared, which means that no more money will be received in respect of this debt. However, the amount due from C. Sin is not written off as a bad debt, despite the fact that he was declared bankrupt, because further dividends are expected. Thus, this debt is the subject of a specific allowance in respect of the amount still outstanding.
- 2 No entries are required where a debt that was previously treated as a specific allowance is subsequently paid, as in the case of A. Mung.
- 3 The main method shown above (that has separate bad debts and allowance for doubtful debts accounts) is the most common in practice. However, this tends to obscure the logic behind allowance for doubtful debts, because it accounts for the allowance separately from the bad debts. The alternative method shown above allows the logic to be demonstrated as follows. The bad debts for the year ($\$120 + \$350 = \$470$) are set against the allowance at the end of the previous year ($\$1,500$). Any under- or over-allowance ($\$1,500 - \$470 =$ over-allowance of $\$1,030$) is written back to the statement of comprehensive income. The amount of the allowance required at the end of the current year ($\$1,300$) is then created in full by debiting the statement of comprehensive income with this amount. This can be illustrated as follows.

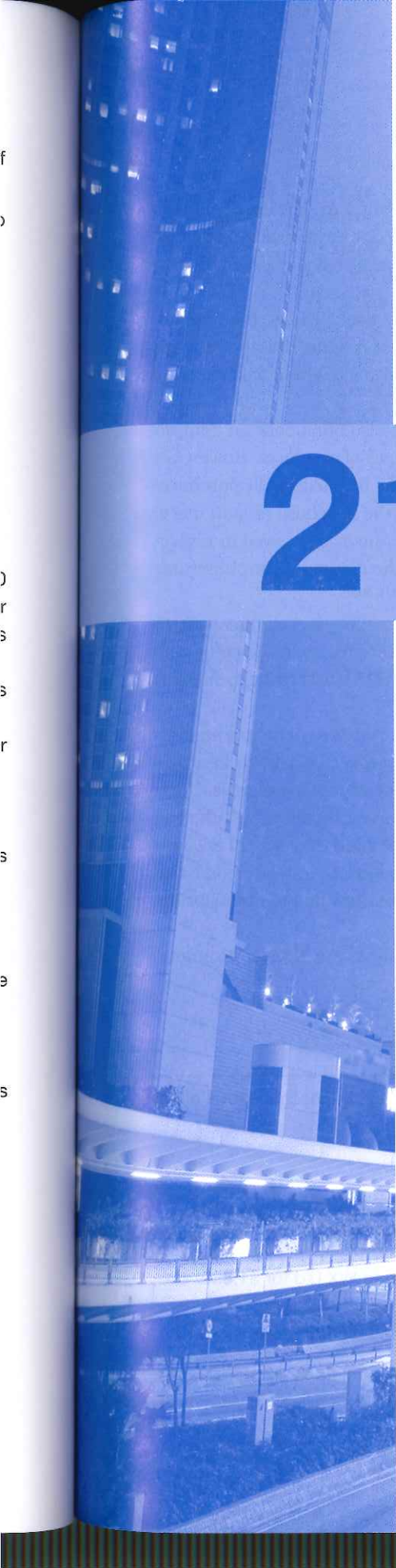
		<i>(Allowance for) doubtful debts</i>		
			20X8	
			1 Dec	Balance b/d 1,500
20X9			20X9	
30 Nov	M. Chan	120	30 Nov	Statement of
30 Nov	R. Lee	350		comprehensive
30 Nov	Statement of			income 1,300
	comprehensive			
	income—reversal of			
	over-allowance	1,030		
30 Nov	Balance c/d	<u>1,300</u>		
		<u>2,800</u>		<u>2,800</u>
			20X9	
			1 Dec	Balance b/d 1,300

The debit entry of \$1,030 is the reversal of the over-allowance. The credit entry of \$1,300 is the creation of the new allowance. The net effect is the same as in the previous answer—a debit to the statement of comprehensive income of \$270 and a balance on the (allowance for) doubtful debts account of \$1,300. However, it should be observed that the over-allowance of \$1,030 as calculated above is an over-simplification. This is not usually readily identifiable since the bad debts normally comprise not only those relating to sales in the previous year for which an allowance was created, but also bad debts arising from sales in the current year. The charge to the statement of comprehensive income shown in the alternative method therefore usually comprises (a) a reversal of the under- or over-allowance; (b) the bad debts arising from sales in the current year; and (c) the amount of the new allowance at the end of the current year.

Furthermore, it should be stressed that nobody would prepare an (allowance) for doubtful debts account in the manner shown immediately above since it involves the unnecessary calculation of the under- or over-allowance. However, the illustration serves to demonstrate that (a) the underlying logic behind the allowance for doubtful debts is essentially to shift the bad debts back into the year in which the goods were sold; (b) this requires an estimate of the allowance; and (c) the estimate usually gives rise to an under- or over-allowance that has to be reversed. However, this can be done without identifying the under- or over-allowance separately by means of a single charge to the statement of comprehensive income when the new allowance for doubtful debts at the end of the current year has been created.

Summary

A debt is treated as irrecoverable if a credit customer is unwilling or unable to pay, and the entity decides that it is uneconomical to pursue the matter further. The ledger entry for irrecoverable debts is to credit the credit customer's trade receivables personal account and debit a bad debts account. The balance on the bad debts account is transferred to the statement of comprehensive income at the end of the accounting year.



21

Columnar Books of Prime Entry and the Payroll

Learning objectives

After reading this chapter, you should be able to:

- 1 explain the meaning of the key terms and concepts listed at the end of the chapter;
- 2 explain the purpose of columnar books of prime entry;
- 3 show the entries in columnar day books and the cash book, and the posting of these entries to the ledger;
- 4 prepare a simple payroll and explain its contents;
- 5 show the journal and ledger entries relating to the items usually contained in a payroll;
- 6 understand what is meant by value added tax (VAT);
- 7 show the entries in the books of prime entry and ledger in respect of VAT.

Columnar books of prime entry

A **columnar book of prime entry** is one which contains analysis columns. The use of analysis columns in a petty cash book was described in Chapter 10, 'The Petty Cash Book'. In practice, most of the other books of prime entry, namely the day books and cash book, also frequently contain analysis columns. Each is described below.

The simplest are the sales day book and sales returns day book. These often contain analysis columns relating to the different departments or types of product that the business sells. This makes it possible to compute the gross profit of each department in departmental trading account.

The purchases day book and purchases returns day book also often contain analysis columns. These may relate to the different departments or types of products. However, a more common form of columnar purchases day book contains not just credit purchases of goods for resale, but also expenses incurred on credit (e.g. the purchase of stationery) and the purchase of non-current assets on credit. Indeed, any invoice received in respect of goods or services purchased on credit is often recorded in the columnar purchases day book.

Lastly, the cash book frequently also contains memorandum analysis columns on both the debit and credit sides. Those on the credit side are much the same as in the petty cash book. The columns on the debit side are used in the same way but obviously relate to different types of receipts.

As explained in the context of columnar petty cash books, the purpose of having analysis columns in books of prime entry is to facilitate the posting of the ledger. Each column relates to a particular type of income or expenditure such as stationery or motor expenses. Every transaction is entered in the total column and an appropriate analysis column. At the end of each calendar month, the total of each analysis column is posted to the relevant account in the ledger. Thus, instead of posting each transaction to the ledger separately, income and expenditure of the same type is collected together in analysis columns and the total for the period posted to the relevant account.

Illustrations of the use of columnar day books and cash books are given in Examples 21.1 and 21.2, respectively. The latter is a continuation of the former.

Example 21.1

A. Shing is in business as a builders' merchant. The following credit transactions took place during August 20X5:

- 2 Aug Purchased goods for resale from AB Ltd for \$658.
- 5 Aug Bought stationery from CD Ltd for \$141.
- 10 Aug Purchased fixtures and fittings for the shop from EF Ltd for \$2,350.
- 18 Aug Sold goods to YZ Ltd for \$1,175.
- 23 Aug Sold some old loose tools previously used in the shop to WX Ltd for \$1,880.
- 25 Aug Returned goods costing \$235 to AB Ltd and received a credit note.
- 29 Aug Returned stationery costing \$47 to CD Ltd and received a credit note.

You are required to make the necessary entries in the relevant columnar books of prime entry and the ledger.

Purchases day book (PDB)

Date	Name of credit supplier	Total	Purchases	Stationery	Miscellaneous
20X5		\$	\$	\$	\$
2 Aug	AB Ltd	658	658		
5 Aug	CD Ltd	141		141	
10 Aug	EF Ltd	<u>2,350</u>			<u>2,350</u>
		<u>3,149</u>	<u>658</u>	<u>141</u>	<u>2,350</u>

Sales day book (SDB)

Date	Name of credit customer	Total	Sales	Miscellaneous
20X5		\$	\$	\$
18 Aug	YZ Ltd	1,175	1,175	
23 Aug	WX Ltd	<u>1,880</u>		<u>1,880</u>
		<u>3,055</u>	<u>1,175</u>	<u>1,880</u>

Purchases returns day book (PRDB)

Date	Name of credit supplier	Total	Purchases	Stationery	Miscellaneous
20X5		\$	\$	\$	\$
25 Aug	AB Ltd	235	235		
29 Aug	CD Ltd	<u>47</u>		<u>47</u>	
		<u>282</u>	<u>235</u>	<u>47</u>	<u>—</u>

The ledger

		<i>Purchases</i>			
20X5					
31 Aug	Total per PDB	658			
		<i>Stationery</i>			
31 Aug	Total per PDB	141	31 Aug	Total per PRDB	47
		<i>Fixtures and fittings</i>			
10 Aug	EF Ltd	2,350			
		<i>AB Ltd</i>			
25 Aug	Returns	235	2 Aug	Purchases	658
		<i>CD Ltd</i>			
29 Aug	Stationery	47	5 Aug	Stationery	141
		<i>EF Ltd</i>			
			10 Aug	Fixtures and fittings	2,350
		<i>Purchases returns</i>			
			31 Aug	Total per PRDB	235

(continued)

(continued)

		<i>Sales</i>	
	31 Aug	Total per SDB	1,175
		<i>Loose tools</i>	
	23 Aug	WX Ltd	1,880
		<i>YZ Ltd</i>	
18 Aug	Sales	1,175	
		<i>WX Ltd</i>	
23 Aug	Loose tools	1,880	

Note

- 1 The amount of each invoice shown in the total columns of the day books is posted individually to the credit customers' and credit suppliers' personal accounts in the normal way. Similarly, the total of each of the other analysis columns in the day books is posted to the relevant ledger account. The only exception to this is the miscellaneous column, where each entry would often have to be posted separately because they normally involve more than one ledger account.

Example 21.2

A. Shing had the following cheque receipts and payments during September 20X5:

- 1 Sep Balance at bank \$8,000.
- 3 Sep Introduced additional capital of \$900.
- 7 Sep Sold goods for \$470.
- 12 Sep Received a cheque from YZ Ltd for \$1,140 after deducting \$35 cash discount.
- 20 Sep Drawings \$250.
- 22 Sep Purchased goods for resale costing \$376.
- 23 Sep Bought stationery costing \$235.
- 25 Sep Purchased a motor vehicle for \$5,875.
- 27 Sep Paid AB Ltd \$398 after deducting \$25 cash discount.

You are required to make the necessary entries in a columnar cash book and the ledger.

The columnar cash book (debit side) (CB)

Date	Details	Total	Credit customers	Discount allowed	Sales	Miscellaneous
20X5		\$	\$	\$	\$	\$
1 Sep	Balance b/d	8,000				8,000
3 Sep	Capital	900				900
7 Sep	Sales	470			470	
12 Sep	YZ Ltd	1,140	1,140	35		
		<u>10,510</u>	<u>1,140</u>	<u>35</u>	<u>470</u>	<u>8,900</u>

The columnar cash book (credit side) (CB)

Date	Details	Total	Credit suppliers	Discount received	Purchases	Stationery	Miscellaneous
20X5		\$	\$	\$	\$	\$	\$
20 Sep	Drawings	250					250
22 Sep	Purchases	376			376		
23 Sep	Stationery	235				235	
25 Sep	Motor vehicles	5,875					5,875
27 Sep	AB Ltd	<u>398</u>	<u>398</u>	<u>25</u>			
	Totals	<u>7,134</u>	<u>398</u>	<u>25</u>	<u>376</u>	<u>235</u>	<u>6,125</u>
30 Sep	Balance c/d	<u>3,376</u>					
		<u>10,510</u>					

The ledger

				<i>Capital</i>		
				20X5		
				3 Sep	Bank	900
				<i>Sales</i>		
				31 Aug	Total per SDB	1,175
				30 Sep	Total per CB	470
				<i>YZ Ltd (trade receivable)</i>		
18 Aug	Sales		1,175	12 Sep	Bank	1,140
				12 Sep	Discount allowed	<u>35</u>
			<u>1,175</u>			<u>1,175</u>
				<i>Discount allowed</i>		
30 Sep	Total per CB		35			
				<i>Drawings</i>		
20 Sep	Bank		250			
				<i>Purchases</i>		
31 Aug	Total per PDB		658			
30 Sep	Total per CB		376			
				<i>Stationery</i>		
31 Aug	Total per PDB		141	31 Aug	Total per PRDB	47
30 Sep	Total per CB		235			
				<i>Motor vehicles</i>		
25 Sep	Bank		5,875			

(continued)

(continued)

		<i>AB Ltd (trade payable)</i>		
25 Aug	Returns	235	2 Aug	Purchases
27 Sep	Bank	398		
27 Sep	Discount received	<u>25</u>		
		<u>658</u>		<u>658</u>
			<i>Discount received</i>	
			30 Sep	Total per CB
				25

Notes

- 1 The total of all the analysis columns on the debit side of the cash book except the discount allowed column should equal the total of the total column. Similarly, the total of all the analysis columns on the credit side of the cash book except the discount received column should equal the total of the total column.
- 2 The total of each analysis column in the cash book is posted to the relevant ledger account. The exceptions to this are the miscellaneous, credit customers and credit suppliers columns, where each item has to be posted to the ledger individually.
- 3 Where cheques are received from credit customers and paid to credit suppliers, the total amount of the cheque is entered in the credit customers and credit suppliers columns of the cash book and posted to the personal accounts.

Accounting for wages

The main purpose of this section is to explain the ledger entries relating to wages and salaries, including the source of the data.

The term 'wages' is usually taken to refer to payments to employees that are made weekly and/or computed using an hourly rate. The term 'salaries' is usually taken to refer to payments that are made monthly and/or computed by reference to an annual remuneration. However, the distinction is not critical in that both are often entered in a wages and salaries account.

What is referred to as an employee's **gross pay** is usually computed in one of three ways:

- 1 The employee's annual salary divided by 12 if paid monthly, or by 52 if paid weekly.
- 2 On an hourly basis comprising the basic pay plus any overtime. The basic pay is the number of hours worked by an employee in a given week (excluding any overtime) multiplied by his or her hourly rate (e.g. 40 hours \times \$6 per hour = \$240). The overtime pay is the number of hours worked by an employee in excess of the basic hours multiplied by the hourly overtime rate, which is often something like one and a half times the basic hourly rate [e.g. 5 hours \times $(1\frac{1}{2} \times \$6)$ = \$45].
- 3 On a piecework basis, whereby the number of units of output produced by an employee in a given week is multiplied by his or her piecework rate per unit of output (e.g. 200 units \times \$1 per unit = \$200).

The gross pay may also include any bonus based on some measure of performance. Bonus schemes vary considerably between businesses but a performance measure may take the form of time saved, cost reductions, profit increases, etc.

FIGURE 21.1 Payroll.

Payroll No.	Employee's name	Gross pay \$	MPF Deductions (5%) \$	Net pay \$	Employer's MPF Contributions (5%) \$
1002	J. Lam	8,360	418	7,942	418
1003	R. So	8,240	412	7,828	412
1005	G. Ho	8,320	416	7,904	416
1008	P. Ma	8,380	419	7,961	419
		33,300	1,665	31,635	1,665

The amount of money that an employee actually receives is referred to as the **net pay**. This is the gross pay less various deductions, which in Hong Kong include the Mandatory Provident Fund (MPF) contributions that take 5 per cent of the employee's gross pay.

In Hong Kong, the employer is required to pay MPF contributions in respect of each employee. Similarly, an employer may make superannuation contributions on behalf of each of its employees. Neither of these is deducted from the employee's gross pay. From the employer's point of view, they represent wage costs that are additional to the gross pay.

Employees' wages are computed using a document known as the **payroll**. An illustration of a payroll is given in Figure 21.1.

Some people regard the payroll as a book of prime entry rather than a basic document. Others argue that the ledger entries relating to wages and salaries should first be recorded in the journal.

Before examining the ledger entries, it is important to understand some basic principles. The wages and salaries account (or accounts) is used to determine the total wages costs to the employer which will be charged to the statement of comprehensive income. This consists of the total gross pay plus the employer's MPF and any superannuation contributions it has to make. This is not immediately obvious from the ledger entries because the entries representing the gross pay take the form of the net pay and the MPF contributions deducted from the employees' gross pay.

An illustration of the ledger entries for wages and salaries is given in Example 21.3, which uses the data in Figure 21.1.

Example 21.3

	<i>Wages and salaries</i>		
Bank/cash—net pay	31,635		
Employees' MPF contributions	<u>1,665</u>		
Gross pay	33,300		
Employer's MPF contributions	1,665	Statement of comprehensive	
		income	<u>34,965</u>
	<u>34,965</u>		<u>34,965</u>
		<i>Bank/cash</i>	
		Wages and salaries	31,635

MPF contributions payable

Wages and salaries –	
employees' MPF contributions	1,665
employer's MPF contributions	1,665

The balance on the wages and salaries account at the end of the accounting year (i.e. \$34,965) will be transferred to the statement of comprehensive income.

Value added tax

Value added tax (VAT) is a **sales tax** that is ultimately borne by the consumer. In Hong Kong, the government has not yet introduced a comprehensive sales tax system. Hence, the subsequent paragraphs will briefly describe the value added tax and its accounting in the context of the UK.

In the UK, most businesses charge their customer with (output) VAT and buy goods and services which are subject to (input) VAT. However, these businesses do not usually suffer VAT as a cost of inputs, in that the input VAT is set off against the output VAT and periodically the difference is paid to the government or a refund obtained. Consequently, none of the items shown in the final financial statements normally includes VAT. The only exceptions to this are trade receivables and trade payables. Furthermore, there may be a current liability for VAT at the end of an accounting year that represents the difference between output and input VAT which has not been paid to the government as at that date.

The accounting entries for VAT are relatively straightforward in principle. When goods that are subject to VAT are purchased for cash, the price including VAT is credited in the cash book. The pricing including VAT is called the **gross price**. The corresponding debit consists of two entries: the cost excluding VAT is debited to the purchases account, and the amount of VAT is debited to a VAT account.

The price excluding VAT is called the **net price**.

Debit: Purchases, or expense account, or non-current asset account (net amount)
 Debit: VAT account (input VAT)
 Credit: Cash book (with the gross amount)

Similarly, when goods that are subject to VAT are purchased on credit, the price including VAT is credited to the credit suppliers' account. The corresponding debit consists of two entries: the cost excluding VAT is debited to the purchases account, and the amount of VAT is debited to a VAT account, which is essentially a personal account.

Debit: Purchases, or expense account, or non-current asset account (net amount)
 Debit: VAT account (input VAT)
 Credit: Credit suppliers' account (with the gross amount)

Conversely, when goods which are subject to VAT are sold on credit, the price including VAT is debited to the credit customers' account. The corresponding credit consists of two entries: the price excluding VAT is credited to the sales account, and the amount of VAT is credited to the VAT account.

Debit: Credit customers' account (gross amount)
 Credit: VAT account (output VAT)
 Credit: Sales account (with the net amount)

A simple illustration is given in Example 21.4.

Example 21.4

A. Ltd buys goods on credit from B. Ltd at a price of \$200 plus 20 per cent VAT. A. Ltd then sells these goods to C. Ltd for \$320 plus 20 per cent VAT. Show the ledger entries in the book of A. Ltd.

		<i>B. Ltd (trade payable)</i>	
		Purchases + VAT	240
		<i>Purchases</i>	
B. Ltd	200		
		<i>VAT</i>	
B. Ltd	40	C. Ltd	64
		<i>C. Ltd (trade receivable)</i>	
Sales + VAT	384		
		<i>Sales</i>	
		C. Ltd	320

Periodically, the VAT account is balanced and the difference between the two sides paid to the government where there is a credit balance, or a refund obtained where there is a debit balance.

Columnar books of prime entry and ledger with VAT

A company needs to maintain accounting records to identify all output and input VAT so that the correct settlement can be made. This can be done by identifying and recording separately the VAT element of trading of goods and services in a separate column of the books of prime entry. Thus, the column books of prime entry described in an earlier section is further expanded as follows:

- 1 The sales and sales returns day books contain an analysis column in respect of VAT.
- 2 The purchases and purchases returns day books contain an analysis column relating to VAT.
- 3 The cash book contains an analysis column on each side relating to VAT.

Example 21.5 and Example 21.6 are modified from Example 21.1 and Example 21.2 respectively to illustrate the preparation of columnar books of prime entry (day books and cash book) and ledger incorporating the impact of VAT.