

AAT LEVEL 2

Certificate in Accounting

Introduction to Bookkeeping (ITBK)

COURSE NOTES

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Using your resources



This symbol signifies an online lecture is available in respect of this topic. These lectures are available if you have purchased our Online, Online Live or Classroom course.

To find out more about upgrading to one of these courses, please go to www.firstintuition.co.uk/fihub/fi-online/ or email us at aat@fi.co.uk.

ILLUSTRATION

Illustrations show you how to complete a task step by step. If you are studying by yourself, these will get you ready for attempting the Lecture Examples.

LECTURE EXAMPLE

Lecture Examples give you the chance to apply your knowledge to a question. If you are watching the online lectures or studying in the classroom, your tutor will guide you through these. Detailed solutions can be found at the end of each chapter.

PRACTICE EXAMPLE

At the end of each chapter, you will find a bank of Practice Example questions to attempt by yourself. These are designed to test your understanding of the material you have just learned. Detailed solutions are then given to each question.

REVISION EXAMPLE

The Revision Example questions in the Task Bank are designed to prepare you for your assessment. They have been written in the style and standard of the assessment, although question types will vary in the real assessment.

Aim of this unit

This unit provides students with an understanding of manual and digital bookkeeping systems, including the associated documents and processes. Students will learn the basic principles that underpin the double-entry bookkeeping system and will learn that digital accounting systems are automating some of the stages in the process.

Students will learn how to check the accuracy of invoices, credit notes, remittance advices, statements of account and petty cash vouchers. They will know how to use these documents to make entries in sales and purchases daybooks, sales and purchases returns daybooks, and discounts allowed and received daybooks using account codes, as well as how to transfer those totals to the sales, purchases and general ledgers. They will learn that entering these into a digital bookkeeping system is the same process as entering the transactions manually, although the way they are entered will vary from system to system.

The United Kingdom (UK) government department responsible for collecting taxes, HM Revenue & Customs (HMRC), offers more than one method of accounting treatment when prompt payment discount (PPD) is allowed and received. However, students at this level are only required to use credit notes to adjust for PPD. Using this approach, credit notes are recorded in separate daybooks, a discounts allowed daybook and/or a discounts received daybook, which removes the need for discount columns in the cash book. There is no requirement at this level for students to understand how to account for PPD by any other method. This unit refers to value added tax or VAT. This is an indirect tax operating in the UK, but this type of tax may also operate and be known by another name in other countries.

The cash book and petty cash book are also covered in this unit, including making entries into both and transferring totals to the ledgers. Students will learn that entering transactions into the cash book of a digital bookkeeping system serves the same purpose as entering the transactions into a manual bookkeeping system. Students will make appropriate checks on the accuracy of supplier invoices and credit notes, reconcile supplier statements with the purchases ledger account and calculate payments due to suppliers. They will also calculate sales invoice and credit note amounts and check receipts from customers.

Students will have learnt all stages necessary to process transactions using both manual and digital systems. Reference to digital systems includes applications as well as both desktop and cloud accounting software.

Introduction to Bookkeeping is a mandatory unit in this qualification.

The learning outcomes from this unit are:

Learning outcomes	Weighting
1. Understand how to set up bookkeeping systems	20%
2. Process customer transactions	20%
3. Process supplier transactions	20%
4. Process receipts and payments	20%
5. Process transactions into the ledger accounts	20%

The assessment

This unit will be a 1.5 hour computer based assessment (CBA).

Competency for this unit is set at 70%.

More details on the assessment structure and CBA instructions are given in your Task Bank.

Scope of content

This section illustrates the depth and breadth of content to be delivered for this unit.

1. Understand how to set up bookkeeping systems	
1.1	The purpose of business documents
	Learners need to understand:
1.1.1	the purpose of business documents: <ul style="list-style-type: none"> - petty cash voucher - invoice - credit note (including for PPD) - remittance advice - statement of account - bank statement.
1.2	The process of recording bookkeeping transactions
	Learners need to understand:
1.2.1	the role of the books of prime entry: <ul style="list-style-type: none"> - sales daybook - sales returns daybook - purchase daybook - purchase returns daybook - discounts allowed daybook - discounts received daybook
1.2.2	the role of the cash book and petty cash book: <ul style="list-style-type: none"> - as a book of prime entry only, or as a book of prime entry and part of the double-entry bookkeeping system
1.2.3	the ledgers: <ul style="list-style-type: none"> - receivables - payables - general
1.2.4	the purpose of the trial balance
1.2.5	the purpose of financial statements: <ul style="list-style-type: none"> - statement of profit or loss - statement of financial position.
1.2.6	the importance of ensuring that bookkeeping transactions are entered accurately: <ul style="list-style-type: none"> - the consequences of inaccurate entry in manual systems - the consequences of inaccurate entry in digital systems
1.2.7	that digital systems can import transactions from a number of sources: <ul style="list-style-type: none"> - bank records - csv files - third party software

	<p>1.2.8 the benefits and drawbacks of using digital bookkeeping systems:</p> <ul style="list-style-type: none"> - automatically balances the cash book - automatically completes the transfer of data from the books of prime entry to the ledgers - automatically completes the transfer of data into the control accounts - automatically reconciles the receivables and payables ledgers to their respective control accounts - automatically creates a trial balance from the general ledger accounts - processes recurring entries - saves time - reduces errors and omissions - makes duplication of automated and manual entries possible - can create errors when the amount or frequency of a recurring entry changes - automatically balances but doesn't mean the entries are automatically correct 		
1.3	<p>Create and use coding systems</p> <table border="1"> <tr> <td data-bbox="344 784 858 1397"> <p>Learners need to understand:</p> <p>1.3.1 the different types of code:</p> <ul style="list-style-type: none"> - customer account - supplier account - product - general ledger <p>1.3.2 where to use codes:</p> <ul style="list-style-type: none"> - sales daybook - sales returns daybook - discounts allowed daybook - purchase daybook - purchase returns daybook - discounts received daybook - receivables ledger - payables ledger </td><td data-bbox="858 784 1426 1397"> <p>Learners need to be able to:</p> <p>1.3.3 create codes:</p> <ul style="list-style-type: none"> - alphabetical - numerical - alphanumerical. </td></tr> </table>	<p>Learners need to understand:</p> <p>1.3.1 the different types of code:</p> <ul style="list-style-type: none"> - customer account - supplier account - product - general ledger <p>1.3.2 where to use codes:</p> <ul style="list-style-type: none"> - sales daybook - sales returns daybook - discounts allowed daybook - purchase daybook - purchase returns daybook - discounts received daybook - receivables ledger - payables ledger 	<p>Learners need to be able to:</p> <p>1.3.3 create codes:</p> <ul style="list-style-type: none"> - alphabetical - numerical - alphanumerical.
<p>Learners need to understand:</p> <p>1.3.1 the different types of code:</p> <ul style="list-style-type: none"> - customer account - supplier account - product - general ledger <p>1.3.2 where to use codes:</p> <ul style="list-style-type: none"> - sales daybook - sales returns daybook - discounts allowed daybook - purchase daybook - purchase returns daybook - discounts received daybook - receivables ledger - payables ledger 	<p>Learners need to be able to:</p> <p>1.3.3 create codes:</p> <ul style="list-style-type: none"> - alphabetical - numerical - alphanumerical. 		
1.4	<p>Set up bookkeeping systems</p> <table border="1"> <tr> <td data-bbox="344 1456 858 1756"> <p>Learners need to know:</p> <p>1.4.1 the dual effect of transactions i.e. debits and credits</p> <p>1.4.2 the accounting equation (calculation of assets, liabilities and capital)</p> </td><td data-bbox="858 1456 1426 1756"> <p>Learners need to be able to:</p> <p>1.4.3 classify the following items:</p> <ul style="list-style-type: none"> - assets - liabilities - equity (capital) - income (revenue) - expense (cost). </td></tr> </table>	<p>Learners need to know:</p> <p>1.4.1 the dual effect of transactions i.e. debits and credits</p> <p>1.4.2 the accounting equation (calculation of assets, liabilities and capital)</p>	<p>Learners need to be able to:</p> <p>1.4.3 classify the following items:</p> <ul style="list-style-type: none"> - assets - liabilities - equity (capital) - income (revenue) - expense (cost).
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2. Process customer transactions	
2.1	Calculate invoice and credit note amounts
<div> <div>Learners need to understand:</div> <div> <div>2.1.1 the documents to be used:</div> <ul style="list-style-type: none"> - quotation - discount policy - customer order - delivery note - price list </div> <div> <div>2.1.2 the difference between discounts offered:</div> <ul style="list-style-type: none"> - prompt payment discount (PPD) - trade discount - bulk discount </div> <div> <div>2.1.3 how discounts are shown on invoices:</div> <ul style="list-style-type: none"> - PPD - trade discount - bulk discount </div> <div> <div>2.1.4 how to use credit notes to adjust for PPD and how PPD is recorded once taken:</div> <ul style="list-style-type: none"> - discounts allowed daybook - customer account - receivables ledger control account - discounts allowed account - value added tax (VAT) account. </div> </div> <div> <div>Learners need to be able to:</div> <div> <div>2.1.5 calculate invoice amounts:</div> <ul style="list-style-type: none"> - item price - net - VAT - total - trade discount - bulk discount </div> <div> <div>2.1.6 calculate credit note amounts:</div> <ul style="list-style-type: none"> - item price - net - VAT - total - trade - bulk - PPD. </div> </div>	

2.2	Enter customer invoices and credit notes into books of prime entry	
	<p>Learners need to know:</p> <p>2.2.1 the books of prime entry:</p> <ul style="list-style-type: none"> - sales daybook - sales returns daybook - discounts allowed daybook <p>2.2.2 the columns within books of prime entry:</p> <ul style="list-style-type: none"> - customer name - customer account code - total - VAT - net - analysis (including product codes). 	<p>Learners need to be able to:</p> <p>2.2.3 calculate amounts from</p> <ul style="list-style-type: none"> - net figures - total figures <p>2.2.4 make entries in books of prime entry</p> <p>2.2.5 total columns in books of prime entry.</p>
2.3	Process receipts from customers	
	<p>Learners need to know:</p> <p>2.3.1 the records and documents to use:</p> <ul style="list-style-type: none"> - customer account - sales invoice - sales credit note - remittance advice - discount policy. 	<p>Learners need to be able to:</p> <p>2.3.2 identify discrepancies:</p> <ul style="list-style-type: none"> - underpayments - overpayments - incorrect discount taken - incorrect amounts - incorrect details - timing differences - missing transactions - duplicated transactions <p>2.3.3 calculate amounts due from customers including PPD</p> <p>2.3.4 allocate amounts correctly:</p> <ul style="list-style-type: none"> - in full payment - in part payment - against opening balances - against invoices - against credit notes.

3. Process supplier transactions		
3.1	Check the accuracy of supplier invoices and credit notes	
	<p>Learners need to understand:</p> <p>3.1.1 the documents to use:</p> <ul style="list-style-type: none"> - quotations including discounts - purchase orders - goods received notes - delivery notes - goods returned notes <p>3.1.2 the difference between discounts offered:</p> <ul style="list-style-type: none"> - prompt payment - trade and bulk <p>3.1.3 how discounts are shown on invoices:</p> <ul style="list-style-type: none"> - prompt payment - trade and bulk <p>3.1.4 how to use credit notes to adjust for PPD and how PPD is recorded once taken:</p> <ul style="list-style-type: none"> - discounts received daybook - supplier account - payables ledger control account - discounts received account - value added tax (VAT) account. 	<p>Learners need to be able to:</p> <p>3.1.5 identify discrepancies that may be found:</p> <ul style="list-style-type: none"> - non-delivery of goods - incorrect type or quantity of goods - incorrect calculations - incorrect discounts (trade, bulk and prompt payment) - date and terms of payment.
3.2	Enter supplier purchase invoices and credit notes into books of prime entry	
	<p>Learners need to know:</p> <p>3.2.1 the books of prime entry:</p> <ul style="list-style-type: none"> - purchase daybook - purchase returns daybook - discounts received daybook 	<p>Learners need to be able to:</p> <p>3.2.3 calculate amounts from net and total figures</p> <p>3.2.4 make entries in books of prime entry</p> <p>3.2.5 total columns in books of prime entry.</p>

	<p>3.2.2 the columns within books of prime entry:</p> <ul style="list-style-type: none"> - supplier name - supplier account code - total - VAT - net - analysis (including product code). 	
3.3	Process payments to suppliers	
	<p>Learners need to know:</p> <p>3.3.1 the records and documents to use:</p> <ul style="list-style-type: none"> - supplier account - invoices and credit notes (including discounts and VAT) - statement of account <p>3.3.2 the information to take into account:</p> <ul style="list-style-type: none"> - agreed payment terms. 	<p>Learners need to be able to:</p> <p>3.3.3 identify discrepancies between the supplier's statement of account and the supplier account in the payables ledger:</p> <ul style="list-style-type: none"> - underpayments - overpayments - incorrect discount taken - incorrect amounts - incorrect details - timing differences - missing transactions - duplicated transactions. <p>3.3.4 calculate payments due to suppliers, including PPD</p> <p>3.3.5 allocate amounts correctly</p> <ul style="list-style-type: none"> - in full payment - in part payment - against opening balances - against invoices - against credit notes.

4. Process receipts and payments		
4.1	Enter receipts and payments into an analysed cash book	
	<p>Learners need to know:</p> <p>4.1.1 the format of the cash book:</p> <ul style="list-style-type: none"> - date - details - cash - bank - analysis columns (including VAT) <p>4.1.2 the documents to use:</p> <ul style="list-style-type: none"> - direct debit/standing order schedule - remittance advice (including BACS) - paying in slip - cheque stub - cash receipt - receipts and payments listing. 	<p>Learners need to be able to:</p> <p>4.1.3 calculate amounts from net and total figures</p> <p>4.1.4 make entries in the cash book.</p>
4.2	Enter receipts and payments into an analysed petty cash book	
	<p>Learners need to know:</p> <p>4.2.1 the format of the petty cash book:</p> <ul style="list-style-type: none"> - date - details - cash - analysis columns (including VAT) <p>4.2.2 the documents to use:</p> <ul style="list-style-type: none"> - cash receipt - petty cash voucher. 	<p>Learners need to be able to:</p> <p>4.2.3 calculate amounts from net and total figures</p> <p>4.2.4 make entries in the petty cash book, including reimbursement, using the imprest and non-imprest systems.</p>
4.3	Total and balance the cash book and petty cash book	
	<p>Learners need to be able to:</p> <p>4.3.1 total and balance the:</p> <ul style="list-style-type: none"> - cash book - petty cash book. 	

4.4	Process recurring receipts and payments	
	Learners need to understand: 4.4.1 the information required to set up a recurring entry. 4.4.2 the effect of recurring entries in the digital bookkeeping system.	Learners need to be able to: 4.4.3 set up a recurring entry. 4.4.4 process a recurring entry.
5. Process transactions into the ledger accounts		
5.1	Transfer data from the books of prime entry to the ledgers	
	Learners need to know: 5.1.1 the ledgers: <ul style="list-style-type: none"> - receivables - payables - general 5.1.2 that the receivables and payables ledger control accounts are part of the double-entry system.	Learners need to be able to: 5.1.3 transfer data from books of prime entry to the relevant accounts in the ledgers.
5.2	Total and balance ledger accounts	
	Learners need to be able to: 5.2.1 total and balance ledger accounts <ul style="list-style-type: none"> - balance carried down - balance brought down - debit balance - credit balance. 	

First Intuition

1

Introduction to business

Introduction

This is an important background chapter which will give you a broad base of knowledge to help your understanding of many areas of this unit. As you progress through later parts of this syllabus it is worth periodically looking back at this chapter as you will increasingly see how elements of your knowledge start fitting together.

Topics covered:

- ▶ Types of business
- ▶ Financial documentation
- ▶ The sales cycle
- ▶ Sales documents
- ▶ The purchases cycle

Types of business



There are three main types of business. The way the business is set up depends on many factors including the size and the nature of the business, and who owns and has responsibility for the business.

Sole trader

This sort of business is typical of very small commercial enterprises like a sandwich shop. A sole trader is where the business is owned by a single individual and that individual takes on the risks of any debts owed by the business. In legal terms the business is not considered to be separate from the owner so if the business was to become bankrupt owing money the sole trader is personally responsible for those debts.

Partnership

Partnerships are similar to sole trader businesses but will consist of **several individuals** owning the business together, perhaps each contributing different skills and knowledge, as well as investing capital to finance the business. The partners will not necessarily own equal shares in the business as this will depend on the amount of money that they each invested in it. The share of the business owned by each partner will tend to dictate the way that any profits are shared. The partners will all take on the risks of any debts owed by the business.

Limited company

Limited companies are different from either sole traders or partnerships in that a separate legal entity is created. This is a process known as '**incorporation**'. The limited company will be owned by shareholders. These shareholders have '**limited liability**' for the debts of the business. If the company becomes bankrupt the shareholders will only lose the value of the shares that they have bought and will not be responsible for any other debts owed by the company.

Financial documentation



Any business will have various documents it produces and receives.

It is necessary for a business to keep financial records in order to measure its performance (has it made a profit?) and year end position (what does the business own and owe?).

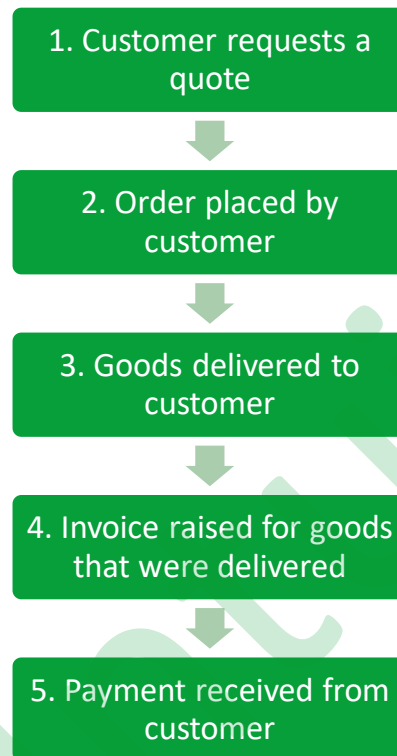
To ensure financial records are accurate all business transactions need to have some form of financial documentation.

We will need to consider the various documents typically encountered by a business as it passes through its normal activities, firstly looking at the 'sales cycle'.

The sales cycle

A business will provide physical goods (e.g. a cup of coffee in Costa) or a service (e.g. a haircut at a hairdressing salon) to a customer in exchange for payment. These are referred to as the 'sales' of the business. We also sometimes use the terms 'income', 'revenue' or 'turnover' to refer to the value of the sales made to customers.

We can see a typical sales cycle below:



At each stage of this process, documentation will be prepared and a record will be kept. This documentation forms the starting point of what is known as 'the flow of information'. The documents provide details of the various transactions that a business has entered into during a year and will help ensure that every single transaction is accurately reflected in the accounts produced at the end of the year.

The sales cycle shown above is quite comprehensive and for some sales you may not necessarily go through every single step. For example, a sandwich shop selling a ham roll is unlikely to receive a request for a formal quotation. This would be more likely if you were selling a car or something else of more significant value.

Before we look any further at the stages of the sales cycle, we need to understand two major categories of sales that a business might make:

- ▶ Cash sales
- ▶ Credit sales

Cash sales

A cash sale is **settled immediately** by the customer. It is important to understand that this does not necessarily mean that it is paid in the form of actual notes and coins. If the customer writes a cheque to pay for something, they are settling it immediately and hence this would be treated as a 'cash' transaction. Similarly, customers using debit or credit cards would be a 'cash' transaction. Sales made by businesses to individuals are often on a cash basis.

Credit sales

A credit sale is where the customer is given a period of time (referred to as a credit period) before they have to pay for what they have bought, so the transaction is **settled at a later date**. Many businesses give their customers 30 or 60 days credit as a way of attracting their custom. This carries a higher risk as the customer may take a long time to pay or may not pay at all. Sales made by businesses to other businesses are often made on credit.

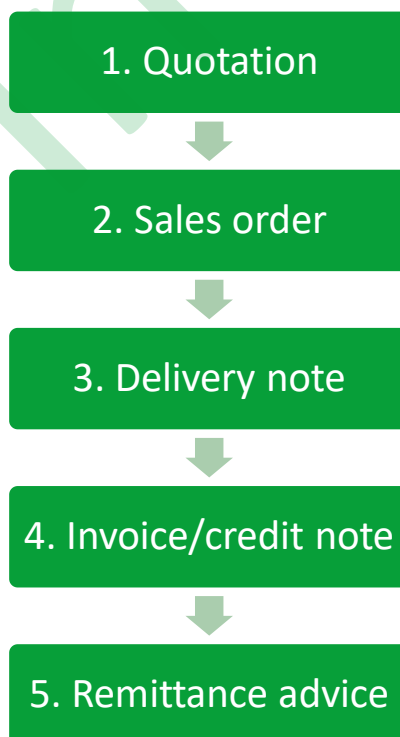
Sales documents



Looking back at the sales cycle above, each step may have an associated **document**. This will be a piece of paper (or perhaps an e-mail) that will pass between the business and the customer as a way of recording what has happened.

It is important that a business retains copies of these documents (which can be done by filing the physical pieces of paper, or increasingly by scanning the documents to store electronically) as they may be needed in the future by auditors or the tax authorities.

The documents listed here are numbered in the same order as the steps of the sales cycle that they relate to.



Step 1 Quotation

When a customer is deciding which business to purchase from, they may request a Quotation from each possible supplier so that they can compare details such as price and credit terms.

Information which should be included on a Quotation would be:

- ▶ Title and description of goods/service to be supplied
- ▶ Price including any potential discounts for bulk orders or prompt payment (early settlement)
- ▶ Terms and conditions which will relate to the sale

An example of a Quotation:

QUOTATION

The business providing the quote (us!) → **ANABELLE PRINTERS LTD**
 64 Brandon Way
 Cambridgeshire
 CB14 2JU

Anabelle Printers Ltd's internal reference number → 16

Anabelle Printers Ltd's VAT number → 891 2362 88

The date that the quote was produced → 14 March

The customer who has requested the quote → **To:** Tinds Trades Ltd
 94 Chessel Crescent
 Bitterne
 Southampton
 SO19 4BN

Quote Number:

VAT Number:

Date:

Please find below price details as requested

Product code	Description	Unit price (net)	Discount
4561	4 page colour brochure (100 per box)	£87.99	5% for 10 units or more
8675	A6 colour flyer (250 per box)	£95.17	10% for 15 units or more

Orders are subject to our terms and conditions detailed overleaf

Payment terms are 30 days from invoice date

Quotations may only be valid for a certain amount of time, so that if the customer tried to insist that you sold them goods at a price you quoted several years ago you would not have to honour that price.

If the Quotation is acceptable to the customer they will (hopefully) place an order.



Step 2 Sales Order

If the quote is acceptable to Tinds Trades then their purchase department will raise an order and send it to Anabelle Printers. This will be a Sales Order for Anabelle Printers and will be the start of the process of supplying goods to their customer.

The Sales Order will communicate to them the quantity and type of goods required, the agreed unit price and total value, and may give additional information on specific design or delivery requirements that the customer has.

An example of a Sales Order:

ORDER

The customer who has sent the order

TINDS TRADES LTD
94 Chessel Crescent
Bitterne
Southampton
SO19 4BN

The business that they are ordering from (us again!)

To: Anabelle Printers Ltd
64 Brandon Way
Cambridgeshire
CB14 2JU

The reference number of the original quotation

Order Number: AP67
Your Reference: 16

Date: 21 March
Date Required: 3 April

The date that the customer has placed the order

The date that the customer needs the product

Item	Description	Quantity	Unit price	Total
4561	4 page colour brochure (100 per box)	4	£87.99	£351.96
8675	A6 colour flyer (250 per box)	6	£95.17	£571.02
			Net total	£922.98

Additional information.....

Authorised by: Date



Step 3 Delivery Note

Once the Sales Order is received the goods can be produced for the customer and prepared for delivery.

To accompany the goods being delivered a Delivery Note will be prepared to detail the quantity and description of the goods being delivered.

This is an important document as it will be signed by the customer on delivery and will therefore be proof that the customer has received the goods. It will also be proof of acceptance of the quantity and quality of the goods and therefore shows the liability of the customer to pay for them.

Usually Delivery Notes come in multiple copies (sometimes in different colours) – one copy remains with the customer and one copy is returned to the supplier.

An example of a Delivery Note:

DELIVERY NOTE

The business making the delivery (us again!)

ANABELLE PRINTERS LTD
64 Brandon Way
Cambridgeshire
CB14 2JU

The customer that the delivery is being made to

To: Tinds Trades Ltd
94 Chessel Crescent
Bitterne
Southampton
SO19 4BN

The customer's order reference number

Order Number: AP67

The date of the delivery (did they meet the target date?)

Date: 2 April

Product code	Description	Quantity
4561	4 page colour brochure (100 per box)	4
8675	A6 colour flyer (250 per box)	6

Received by

Signature

Date

You may notice that no price details are included on the delivery note, just descriptions and quantities. This is because the warehouse staff receiving and checking the delivery are unlikely to know what the prices should be, they will just be counting units and checking it's the right product.



Step 4 Sales Invoice

Once the goods have been delivered to the customer a signed copy of the Delivery Note is returned to the accounts department of the business that supplied the goods which indicates that a Sales Invoice should now be raised.

An Invoice is a request for payment and the Sales Invoice is sent to the customer to tell them that they now need to pay for the delivery they received. Invoices will include details of the goods delivered, the unit prices and totals charged including any delivery charges and VAT. It will also show details of any payment terms agreed and how the payment should be made.

An example of a Sales Invoice:

INVOICE

The business requesting payment (us)

ANABELLE PRINTERS LTD
64 Brandon Way
Cambridgeshire
CB14 2JU

The customer that we are requesting payment from

To: Tinds Trades Ltd
94 Chessel Crescent
Bitterne
Southampton
SO19 4BN

Sequential invoice number

Invoice Number: 18736

Alphanumeric reference identifying the customer

Customer Reference: TT03

The date the invoice was raised

Invoice Date: 5 April

VAT Registration Number: 891 2362 88

Anabelle Printers Ltd's VAT number

Product code	Description	Quantity	Unit £	Tax Rate %	Total £
4561	4 page colour brochure (100 per box)	4	87.99	20	351.96
8675	A6 colour flyer (250 per box)	6	95.17	20	571.02
DC1	Delivery charge	1	10.00	20	10.00

Net total	£932.98
VAT 20%	£186.59
Gross	£1,119.57

Payment is due within 30 days of the Invoice date

(for this assessment VAT will be rounded down)

As well as a being used as a document to request payment from a customer, an invoice will also be required by a VAT-registered business in order to pay over or reclaim VAT from Her Majesty's Revenue and Customs (HMRC), which we will see in the next chapter. For most transactions a full **valid VAT invoice** must be used, and will include all of the following information:

- ▶ Unique sequential invoice number
- ▶ Seller's name and address
- ▶ Seller's VAT number
- ▶ Invoice date/ Time of supply (also known as tax point)
- ▶ Customer's name and address
- ▶ Description of goods and services
- ▶ Rate of any cash discount
- ▶ Total amount of VAT
- ▶ Total amount owing (including VAT)
- ▶ For each different type of item:
 - ▶ Unit price or rate (excluding VAT)
 - ▶ Quantity of goods or extent of services
 - ▶ Rate of VAT
 - ▶ Total amount payable (excluding VAT)

You may notice the mention of 'sequential' invoice numbering. This means that the business will number each invoice in turn (or in sequence) so invoice number 18736 will be followed by 18737 and then by 18738 etc. By numbering invoices (and other documents) in this way it makes it easy to spot any that are missing when they are being filed.

We will consider the impact that discounts have on an invoice in the next chapter.

Checks on Sales Invoices



There are a number of checks which should be made before the Sales Invoice is issued to the customer. Issuing an incorrect invoice to a customer can delay the payment of the invoice as well as being embarrassing.

The checks that should be performed would include:

- ▶ That the correct name and address of the customer are shown
- ▶ That the description of the goods supplied and the quantity have been checked to the Sales Order and the Delivery Note
- ▶ That the Delivery Note was signed by the customer (to show they were happy with everything when it was delivered)
- ▶ The invoice number and date are shown
- ▶ Unit prices are as agreed on the Quotation and Sales Order
- ▶ All calculations are correct (including VAT)
- ▶ Correct payment terms are displayed

LECTURE EXAMPLE 1 - PREPARING A SALES INVOICE

On 10 June, Fruits Ltd made a delivery to Pentop Ltd (customer account PL327) of 200 Applers (product code PAR937).

Complete the Sales Invoice below based on a unit price of £40.00 each plus VAT of £8.00.

INVOICE						
FRUITS LTD						
14 High Street Darton DF11 4GX						
To:		Pentop Ltd 92-96 Farm Trading Estate Kingstown PE7 5CV		Invoice Number:	10456	
		Customer Code:		Account		
		Date:				
		VAT Number:	Registration	298 3827 04		

Product description	Quantity	Unit Price £	Product code	Net total £	VAT @ 20% £	Gross total £

Which TWO of the following checks would be made before the invoice is sent to the customer?

	✓
Check that the customer is a limited company	
Check that the calculations on the invoice are correct	
Check that the delivery note was signed by the customer	
Check that the customer's outstanding account balance is zero	

Sales Credit Notes



If incorrect items are sent to a customer, or they are faulty, then the customer may return them. The returned goods should be accompanied by a Goods Returns Note which will give details of the quantity of items returned, and the reason for their return.

If a Sales Invoice has already been issued to the customer for the goods that have now been returned a Credit Note will need to be issued. A Credit Note is like a 'negative invoice' and cancels out part of (or all of) an invoice. When the customer comes to settle the Sales Invoice they will deduct any related Credit Note and pay the difference.

An example of a Credit Note:

The business issuing the credit note (us)

CREDIT NOTE

ANABELLE PRINTERS LTD
64 Brandon Way
Cambridgeshire
CB14 2JU

The customer who has returned the goods

To: Tinds Trades Ltd
94 Chessel Crescent
Bitterne
Southampton
SO19 4BN

Sequential credit note number

Credit Note Number: 122

Alphanumeric reference identifying the customer

Customer Reference: TT03

The date that the credit note was issued

Date: 8 April

VAT Number: 891 2362 88
Anabelle Printers Ltd's VAT number

Registration

Product code	Description	Quantity	Unit £	Tax Rate %	Total £
4561	4 page colour brochure (100 per box)	1	87.99	20	87.99

Net total	£87.99
VAT 20%	£17.59
Gross	£105.58

In this situation it looks like Tinds Trades have returned one of the products that they ordered back on 21 March. When they come to settle Invoice 18736 they will deduct the value of this Credit Note and will only need to pay a total of £1,013.99 (£1,119.57 – £105.58)



Step 5 Remittance Advice

Payment for invoices should be made by credit customers before the invoices become overdue. A payment may be made for a number of invoices at the same time so to make it clear what is being paid the customer will usually send a Remittance Advice with the payment which will clearly detail the invoices that the payment relates to.

Example of a Remittance Advice:

REMITTANCE ADVICE NOTE

Remittance advice note number: 12143

The customer who is making a payment

TINDS TRADES LTD
 94 Chessel Crescent
 Bitterne
 Southampton
 SO19 4BN

The business receiving the payment

Supplier: Anabelle Printers Ltd
 64 Brandon Way
 Cambridgeshire
 CB14 2JU

Account Number: TT03

Please indicate the items you are paying with a '✓'

Date	Invoice number	Debits	Credits	Paid ✓
5 April	18736	1,119.57		
8 April	122		105.58	

Cheque enclosed £.....

You will see that this Remittance Advice includes the Sales Invoice that Anabelle Printers sent to Tinds Trades on 5 April and also the Credit Note issued on 8 April. If Tinds Trades are paying the full outstanding balance of £1,013.99 then they would return the Remittance Advice with both entries ticked to make it clear to the accounts department of Anabelle Printers Ltd what they are paying (and the fact that there is a credit note being deducted). This will make it easy for Anabelle Printers to match the payment to the transactions it relates to.

LECTURE EXAMPLE 2 – FINANCIAL DOCUMENTATION

Businesses use a variety of documents.

Complete the following sentences by inserting the name of the relevant business document in each instance:

- ▶ When Hays Ltd delivers items to a customer it will complete a copy of a
- ▶ Once Hays Ltd has delivered items to a customer it will request payment by issuing a
- ▶ When a customer pays Hays Ltd by BACS they should indicate which invoices they are paying by sending a
- ▶ If customers return any goods that they are not happy with they should be issued with a

LECTURE EXAMPLE 3 – CHECKING DOCUMENTS



Anabelle Printers received an order from Mega Industries which has been delivered and now needs to be invoiced. Examine the following Sales Order, Delivery Note and Sales Invoice and identify any **discrepancies** that should be investigated before the Sales Invoice is sent to Mega Industries.

ORDER

MEGA INDUSTRIES
 12 Phoebe Street
 Ely
 CB25 4FY

To: Anabelle Printers Ltd
 64 Brandon Way
 Cambridgeshire
 CB14 2JU

Order Number: 3845
Your Reference: 17
Date: 22 March
Date Required: 6 April

Item	Description	Quantity	Unit price	Total
4565	6 page colour brochure (100 per box)	3	92.99	278.97
8685	A5 colour flyer (250 per box)	4	99.49	397.96
			Net total	£676.93

Additional information.....

Authorised by:..... Megan Lily..... Date..... 22 March.....

DELIVERY NOTE**ANABELLE PRINTERS LTD**

64 Brandon Way
Cambridgeshire
CB14 2JU

To: Mega Industries
12 Phoebere Street
Ely
CB25 4FY

Order Number: 3845

Date: 4 April

Product code	Description	Quantity
4565	6 page colour brochure (100 per box)	4
8675	A6 colour flyer (250 per box)	4

Received byRobert Smith.....

Signature*Bob Smith*.....

Date4 April.....

INVOICE**ANABELLE PRINTERS LTD**

64 Brandon Way
Cambridgeshire
CB14 2JU

To: Mega Industries
12 Phoebere Street
Ely
CB25 4FY

Invoice Number: 18741

Customer Reference: M102

Invoice Date: 5 April

VAT Registration Number: 891 2362 88

Product code	Description	Quantity	Unit £	Tax Rate %	Total £
4565	6 page colour brochure (100 per box)	6	95.99	20	575.94
8675	A6 colour flyer (250 per box)	4	95.17	20	280.68

Net total £856.62

VAT 20% £85.66

Gross £942.28

Payment is due within 30 days of the Invoice date

Discrepancies:

LECTURE EXAMPLE 4 – COMPLETING A REMITTANCE ADVICE NOTE



Mansons Ltd receives Remittance Advice Note from its customer Als Ltd (account reference AL012). Payment terms are for invoices to be paid on the last day of the month following the month of invoicing. (So, an invoice dated 12 April will be due to be paid on 31 May.)

Als Ltd banks with MACC Bank plc and Mansons Ltd banks with LBank plc.

Below are an incomplete Remittance Advice and an extract from Mansons Ltd's customer account for Als Ltd.

The current date is 30th June.

BACS REMITTANCE ADVICE

To: Date:

From:

A BACS payment has been made to your account in the sum of £

Invoice number	Credit note number	Amount £
Total amount paid		

Als Ltd Customer account

Date	Details	Amount £	Date	Details	Amount £
16 May	Sales invoice 1487	315	17 May	Sales credit note 876	15
29 May	Sales invoice 1512	200	24 May	Sales credit note 912	108
4 June	Sales invoice 1598	1,135	29 June	Sales credit note 934	68

To whom will the remittance advice be addressed? (Circle one)

MACC Bank plc Mansons Ltd LBank plc Als Ltd

Who will the remittance advice be from? (Select one)

MACC Bank plc Mansons Ltd LBank plc Als Ltd

What will be the date shown on the BACS remittance advice? (Select one)

31 May

30 June

31 July

4 June

Which will be the two items NOT shown on the remittance advice?

✓(2)	
Invoice number 1487	
Invoice number 1512	
Invoice number 1598	
Credit note number 876	
Credit note number 912	
Credit note number 934	

What will be the total amount paid?

£

Complete the Remittance Advice Note above.

The purchases cycle



As with the sales cycle, the purchase of goods on credit by the business either for resale (e.g. the purchase of bread and ham by a sandwich shop) or for consumption in their business activities (e.g. paper, envelopes etc.) will generate financial documents:

- ▶ The Purchase Order to be sent to the supplier
- ▶ A Delivery Note from the supplier (when the goods are delivered, detailing quantities and description)
- ▶ A Purchase Invoice received from the supplier requesting payment
- ▶ A Remittance Advice to send to the supplier with payment

Each of these documents will need to be checked and authorised.

We will see these documents in more detail later in the syllabus.

Petty Cash Voucher

Most businesses will hold a small amount of actual cash (notes and coins) at their premises which will be used to pay for small incidental expenses such as paying the milkman, taxi fares, and other small items.

This will be discussed in more detail later in the syllabus but payments made out of petty cash generate a document called a Petty Cash Voucher.

Example of a Petty Cash Voucher:

PETTY CASH VOUCHER		
Voucher number	244	
Date:	16 March	
Date	Details	Amount
13 March	Coffee	3.22
15 March	Envelopes	6.25
Total		9.47
<div style="display: flex; justify-content: space-between;"> Paid to..... Authorised by..... </div>		

First Intuition

Here are some Practice Examples for you to try...

PRACTICE EXAMPLE 1 - TYPES OF BUSINESS ORGANISATIONS

Write down the key characteristics of each of the three main types of business organisations:

Sole traders

Partnerships

Limited companies

PRACTICE EXAMPLE 2 - TYPES OF BUSINESS ORGANISATION

For each of the examples in the table below identify whether it appears to be a sole trader, a partnership or a limited company.

Business	Sole trader/partnership/limited company
Samuel sets up a business in which he owns all of the issued shares	
David sets up a business and makes all purchases in his own name	
Eliza and Lily open a flower shop and split all profits equally	

PRACTICE EXAMPLE 3 - SALES DOCUMENTS

Match the stages in the sales cycle shown in the boxes on the left to the document that would be expected to accompany them in the boxes on the right.

Step 1 - Customer requests a quote

Sales invoice

Step 2 - Order placed by customer

Quotation

Step 3 - Goods delivered to customer

Remittance advice note

Step 4 - Payment requested from customer

Sales order

Step 5 - Payment received from customer

Delivery note

PRACTICE EXAMPLE 4 - FINANCIAL DOCUMENTATION

Businesses use a variety of documents.

Complete the following sentences by inserting the name of the relevant business document in each instance:

- ▶ When a business delivers items to a customer it will retain a copy of a
- ▶ Once a business has made a delivery of items to a customer it will request payment for those goods by sending the customer a
- ▶ If a customer returns goods then they should be issued with a
- ▶ When a customer sends payment to a business they should indicate which invoices they are paying by sending a

PRACTICE EXAMPLE 5 - PREPARING A SALES INVOICE

On 1 July, Heart Ltd made a delivery to Strangers Ltd (customer account STR03) of 100 Bad Animals (product code BA2907). The sales invoice will be number 7298.

(a) Complete the Sales Invoice below based on a unit price of £10.00 each plus VAT of £2.00.

INVOICE					
HEART LTD					
To:	<input type="text"/>				
Customer account no:	<input type="text"/>				
Invoice no:	<input type="text"/>				
Date:	<input type="text"/>				
Product description	Product code	Quantity	Net total £	VAT £	Gross total £

(b) Which TWO of the following checks would be made before the invoice is sent to the customer?

	✓(2)
Check that the calculations on the invoice are correct	
Check that the delivery note was signed by the customer	
Check that the customer's outstanding account balance is zero	
Check that the customer is a sole trader	

PRACTICE EXAMPLE 6 - SALES INVOICES

List the information that you would expect to be included on a sales invoice.

PRACTICE EXAMPLE 7 - CHECKING SALES INVOICES

List some of the checks you would make before sending a sales invoice to a customer.

PRACTICE EXAMPLE 8 - CHECKING DOCUMENTS

Capitol Ltd received an order from Ratings Ltd which has been delivered and now needs to be invoiced. Examine the following Sales Order, Delivery Note and Sales Invoice and identify any **discrepancies** that should be investigated before the Sales Invoice is sent to Ratings Ltd.

Item	Description	Quantity	Unit price £	Total £
29389	Orange monkey	5	15.50	77.50
34728	Fluffy spider	10	24.30	243.00
			Net total	£320.50

Additional information.....

Authorised by:.....Managing Director..... Date..... 1 May.....

DELIVERY NOTE

CAPITOL LTD

To: Ratings Ltd

Order Number: 1001

Date: 18 May

Product code	Description	Quantity
29389	Orange monkey	5
34728	Fluffy spider	15

Received byStock boy.....

Signature*stock boy*.....

Date18 May.....

INVOICE**CAPITOL LTD****To:** Ratings Ltd**Invoice Number:** 28493**Customer Reference:** RAT04**Invoice Date:** 19 May

Product code	Description	Quantity	Unit £	VAT rate %	Total £
29837	Red monkey	8	16.50	20	132.00
34728	Fluffy spider	15	26.30	20	394.50

Net total

£562.50

VAT

£11.20

Gross

£573.70

Payment is due within 30 days of the Invoice date

Discrepancies:



PRACTICE EXAMPLE 9 - COMPLETING A REMITTANCE ADVICE NOTE

Aurora Ltd receives a Remittance Advice Note from its customer Glow Ltd (account reference GLO03).

Payment terms are for invoices to be paid on the last day of the month following the month of invoicing. (So, an invoice dated 17 February will be due to be paid on 31 March).

Below is an incomplete Remittance Advice from Glow Ltd and an extract from Aurora Ltd's customer account for Glow Ltd.

The current date is 31 May.

Complete the remittance advice note below.

REMITTANCE ADVICE NOTE		
To:	<input type="text"/>	Date: <input type="text"/>
From:	<input type="text"/>	
Enclosed is a cheque for £	<input type="text"/>	
Invoice number	Credit note number	Amount £
<input type="text"/>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>	<input type="text"/>
Total amount paid		<input type="text"/>

Glow Ltd customer account

Date	Details	Amount £	Date	Details	Amount £
9 Apr	Sales invoice 65	200	14 Apr	Sales credit note 12	30
15 Apr	Sales invoice 72	450	22 Apr	Sales credit note 21	60
4 May	Sales invoice 89	700	12 May	Sales credit note 35	75

Solutions to Lecture Examples

Lecture example 1 - Preparing a sales invoice

INVOICE						
				FRUITS LTD 14 High Street Darton DF11 4GX		
To: Pentop Ltd 92-96 Farm Trading Estate Kingstown PE7 5CV				Invoice Number: 10456 Customer Account Code: PL327 Date: 10 June VAT Registration No: 298 3827 04		
Product description	Quantity	Unit Price £	Product code	Net total £	VAT @ 20% £	Gross total £
Applers	200	40.00	PAR937	8000.00 (200 x 40)	1,600.00 (200 x 8)	9,600.00 (8,000 + 1,600)

Which TWO of the following checks would be made before the invoice is sent to the customer?

	✓
Check that the customer is a limited company	
Check the calculations on the invoice are correct	✓
Check the delivery note signed by the customer	✓
Check that the customer's outstanding account balance is zero	

Comments:

Businesses will happily sell products to sole traders and partnerships as well as to limited companies. It would make sense to perform a credit check on any new customer that places an order that will involve credit.

It would be quite common for customers to place further orders whilst still owing money to a business. This is not a problem as long as the customer is not falling behind in paying overdue invoices.

Lecture example 2 - Financial documentation

- ▶ When Hays Ltd delivers items to a customer it will complete a copy of a **Delivery Note**
- ▶ Once Hays Ltd has delivered items to a customer it will request payment by issuing a **Sales Invoice**
- ▶ When a customer pays Hays Ltd by BACS they should indicate which invoices they are paying by sending a **Remittance Advice Note**
- ▶ If customers return any goods that they are not happy with they should be issued with a **Credit Note**

Lecture example 3 - Checking documents

Discrepancies:

- ▶ Four units of product code 4565 were delivered when only three were originally ordered.
- ▶ The invoice is for six units of product code 4565 when only four units were delivered (and three units ordered).
- ▶ The price of product code 4565 on the invoice is £95.99 rather than the £92.99 quoted on the order.
- ▶ Units of product code 8675 were delivered when product code 8685 was ordered.
- ▶ The price on the invoice for product code 8675 is £95.17 when the order shows a price of £99.49 (although since we have just seen that they have recorded the wrong product code this error with the price is not surprising).
- ▶ Four times £95.17 equals £380.68, not £280.68.
- ▶ The VAT is not correct as 20% of the net total (it looks like they have calculated it as 10%). This means that the full gross value will not be correct.

So it looks like Anabelle Printers need to amend and reissue the Sales Invoice before they send it to the customer.

Lecture example 4 - Completing a remittance advice note

BACS REMITTANCE ADVICE

To: **Mansons Ltd**Date: **30 June**From: **Als Ltd**A BACS payment has been made to your account in the sum of £ **392.00**

Invoice number	Credit note number	Amount £
1487 (dated May so due for payment at 30 June)		315 (owed by the customer)
1512 (dated May so due for payment at 30 June)		200 (owed by the customer)
	876 (dated May)	-15 (credit note reduces what is owed)
	912 (dated May)	-108 (credit note reduces what is owed)
Total amount paid		392

Note that the items dated during June itself will not be due for payment until the end of July so are not included in this Remittance Advice at 30 June.

To whom will the remittance advice be addressed? **Mansons Ltd**

Who will the remittance advice be from? **Als Ltd**

What will be the date shown on the BACS remittance advice? **30 June**

Which will be the two items NOT shown on the remittance advice?

	✓
Invoice number 1487	
Invoice number 1512	
Invoice number 1598 (dated June so not due yet)	✓
Credit note number 876	
Credit note number 912	
Credit note number 934 (dated June)	✓

What will be the total amount paid?

£ **392.00**

First Intuition

Solutions to Practice Examples

PRACTICE EXAMPLE 1 - TYPES OF BUSINESS ORGANISATIONS

Sole traders

- ▶ The business is owned by a single individual
- ▶ The business is not a separate legal entity from the sole trader
- ▶ The sole trader has unlimited liability for the debts of the business

Partnerships

- ▶ The business is owned by several individuals (the partners)
- ▶ The business is not a separate legal entity from the partners
- ▶ The partners have unlimited liability for the debts of the business

Limited companies

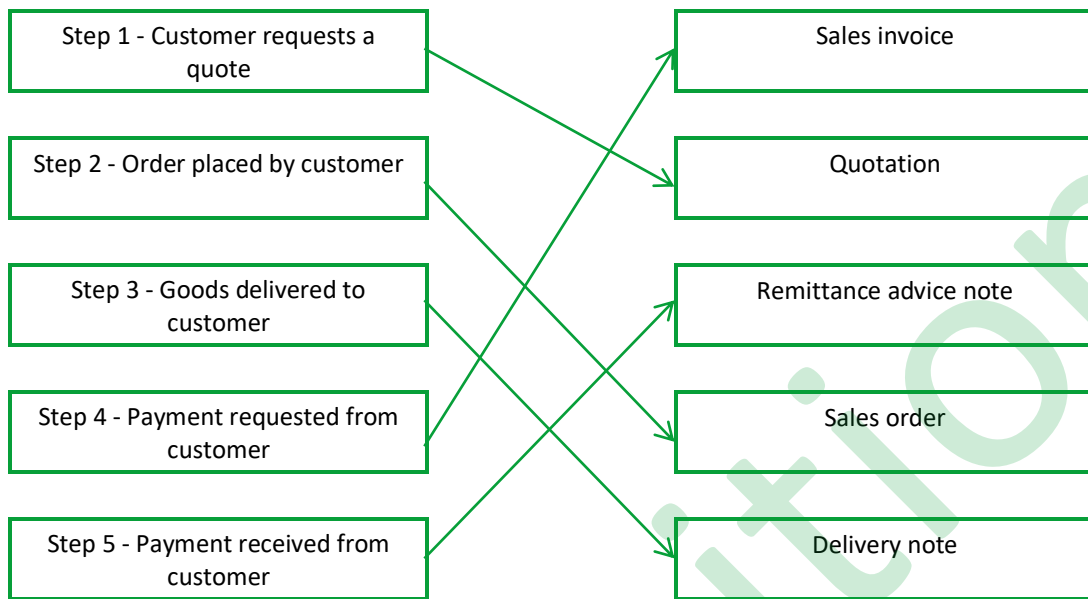
- ▶ The business can be owned by one or many individuals (the shareholders)
- ▶ The business is incorporated as a separate legal entity from the shareholders
- ▶ The shareholders have limited liability for the debts of the business up to the amount that they paid for their shares

PRACTICE EXAMPLE 2 - TYPES OF BUSINESS ORGANISATION

For each of the examples in the table below identify whether it appears to be a sole trader, a partnership or a limited company.

Business	Sole trader/partnership/limited company
Samuel sets up a business in which he owns all of the issued shares	Limited company
David sets up a business and makes all purchases in his own name	Sole trader
Eliza and Lily open a flower shop and split all profits equally	Partnership

PRACTICE EXAMPLE 3 - SALES DOCUMENTS



PRACTICE EXAMPLE 4 - FINANCIAL DOCUMENTATION

- ▶ When a business delivers items to a customer it will retain a copy of a **delivery note**
- ▶ Once a business has made a delivery of items to a customer it will request payment for those goods by sending the customer a **sales invoice**
- ▶ If a customer returns goods then they should be issued with a **credit note**
- ▶ When a customer sends payment to a business they should indicate which invoices they are paying by sending a **remittance advice note**

PRACTICE EXAMPLE 5 - PREPARING A SALES INVOICE

(a) Sales Invoice

INVOICE					
HEART LTD					
To:	Strangers Ltd				
Customer account no:	STR03				
Invoice no:	7298				
Date:	1 July				
Product description	Product code	Quantity	Net total £	VAT (20%) £	Gross total £
Bad Animal	BA2907	100	1,000 (100 X £10)	200 (100 X £2)	1,200

(b) Checks which would be made before the invoice is sent to the customer

	✓(2)
Check that the calculations on the invoice are correct	✓
Check that the delivery note was signed by the customer	✓
Check that the customer's outstanding account balance is zero We will sell to a customer even if they already owe us money, as long as they are within their credit limit	
Check that the customer is a sole trader We will happily sell to partnerships and limited companies	

PRACTICE EXAMPLE 6 - SALES INVOICES

Information expected on a sales invoice:

- ▶ The name and address of the business sending the invoice
- ▶ The VAT registration number of the business sending the invoice (if they are VAT registered)
- ▶ The name and address (and perhaps the account code) of the customer that the invoice is being sent to
- ▶ The invoice number (normally part of a sequential numbering system)
- ▶ The date that the invoice was issued
- ▶ Details of the goods that were delivered (including product code). More than one type of product can be included on a single invoice
- ▶ The number of units of each product type that were delivered
- ▶ The list price of each product
- ▶ Details of any trade discounts given to the customer
- ▶ The total net value of the invoice after trade discounts have been deducted
- ▶ The total amount of VAT being added onto the net value of the invoice. This should show the VAT rates being applied.
- ▶ The total gross value of the invoice
- ▶ Payment terms such as the credit period offered and any available settlement discounts

PRACTICE EXAMPLE 7 - CHECKING SALES INVOICES

The checks that should be performed would include:

- ▶ That the correct name and address of the customer are shown
- ▶ That the description of the goods supplied and the quantity have been checked to the Sales Order and the Delivery Note
- ▶ That the Delivery Note was signed by the customer (to show they were happy with everything when it was delivered)
- ▶ That the invoice number and invoice date are shown
- ▶ Unit prices are as agreed on the Quotation and Sales Order
- ▶ All calculations are correct (including VAT)
- ▶ Correct payment terms are displayed

PRACTICE EXAMPLE 8 - CHECKING DOCUMENTS

Discrepancies:

- ▶ 10 fluffy spiders were ordered but 15 were delivered (and are now being invoiced for)
- ▶ The unit price of fluffy spiders on the order is £24.30 but £26.30 per unit is charged on the invoice
- ▶ 5 orange monkeys were ordered and delivered but 8 red monkeys (with a similar but different product code) are being invoiced for
- ▶ The unit price of orange monkeys on the order is shown as £15.50 whereas £16.50 is shown on the invoice (although the invoice indicates red monkeys)
- ▶ The net totals of £132.00 and £394.50 add up to £526.50, not £562.50
- ▶ The VAT is calculated incorrectly, it should be 20% of £562.50 ($£562.50 \times 20\% = £112.50$ although remember that the £562.50 is wrong anyway)
- ▶ This all means that the gross total of the invoice is very, very wrong.

This invoice should not be sent to the client. It needs to be corrected and reissued.

PRACTICE EXAMPLE 9 - COMPLETING A REMITTANCE ADVICE NOTE

Note that the remittance advice note at the end of May will deal with transactions (both invoices and credit notes) dated April. The transactions dated May will not be dealt with until the end of June.

REMITTANCE ADVICE NOTE

To: **Aurora Ltd**Date: **31 May**From: **Glow Ltd**Enclosed is a cheque for £ **560**

Invoice number	Credit note number	Amount £
65 As an April sales invoice this will be due for payment at the end of May		200
	12 As an April credit note this can be accounted for at the end of May	(30)
72 As an April sales invoice this will be due for payment at the end of May		450
	21 As an April credit note this can be accounted for at the end of May	(60)
Total amount paid		560

2

Value Added Tax and discounts

Introduction

Understanding how Value Added Tax impacts the prices charged by businesses and how discounts work is important for all parts of this assessment. In particular it is important that you understand how discounts should be shown on an invoice.

Topics covered:

- ▶ Payment of Value Added Tax
- ▶ VAT rates
- ▶ Discounts
- ▶ Prompt payment discounts and VAT

What is Value Added Tax?



You need to have a solid knowledge of how Value Added Tax (VAT) is treated within the accounting system of a business. You need to be able to understand the nature of input VAT and output VAT, and how to account for them. You need to be able to balance off the VAT control account in the general ledger and identify the position at the period end. This is an important part of this syllabus as many tasks will have elements of VAT included.

VAT is an indirect tax that is charged on goods and services supplied in the UK by businesses that are VAT registered.

When we refer to tax as being an 'indirect' tax, this means it is a tax on spending rather than a tax on income (which are called 'direct' taxes and includes Pay As You Earn (PAYE)).

Not all businesses are registered for VAT but those who are, must charge VAT on their sales. This extra amount that we are charging does not belong to the business but is being collected on behalf of the government and must be paid to HMRC. Before the business pays over this VAT they are allowed to deduct any VAT they have suffered on their purchases.

ASSESS SMART

VAT is currently charged at a rate of 20% (this is called the standard rate).

There are two types of VAT to be aware of:

- (a) **Output VAT** – this is the VAT that businesses add to the value of their sales (or 'outputs') when they charge customers. This amount cannot be kept by the business and is owed to HMRC.
- (b) **Input VAT** – this is the VAT that businesses suffer on their purchases (or 'inputs') which they can reclaim from HMRC. This reclaim is normally made by deducting the input VAT from the output VAT before it is paid over.

When we are dealing with VAT we need to consider three different values for transactions:

- ▶ The '**Net**' value – this is the transaction value before adding any VAT. For sales this is the amount that the business will keep.
- ▶ The '**VAT**' amount – the total amount of VAT being added to the net value (the net value multiplied by 20%). For sales this is the amount owed to HMRC.
- ▶ The '**Gross**' value – this is the transaction value including VAT (the net value plus the VAT). For sales this is the amount that customers will be charged.

Output VAT

If a business sells some goods for £100 excluding VAT this means:

Net sales value £100 (this is the sales revenue retained by the business)

VAT @ 20% ($£100 \times 0.2$) £20 (this is the VAT owed to HMRC)

Gross sales value ($£100 \times 1.2$) £120 (this is the total amount the customer has to pay)

Make sure you understand the difference between a net sales value and a gross sales value.

- ▶ The net sales value **excludes** VAT
- ▶ The gross sales value **includes** VAT
- ▶ VAT added to the value of sales is called **output VAT**.

Input VAT

If a business buys some goods for £50 excluding VAT this means:

Net purchase value £50 (this is the expense suffered by the business)

VAT @ 20% ($£50 \times 20\%$) £10 (this is the VAT that can be claimed back from HMRC)

Gross purchase value ($£50 \times 1.2$) £60 (this is the total amount paid to the supplier)

Make sure you understand the difference between a net purchase value and a gross purchase value.

KEY TERMS

Make sure you understand the difference between a net value and a gross value.

A net value **excludes** VAT. A gross value **includes** VAT.

VAT on sales is called **output VAT**. VAT on purchases is called **input VAT**.

We therefore take the *net* amount and multiply by 20% to get the VAT and then add this VAT figure to the *net* amount to give us the *gross* value. Alternatively, to go straight from net to gross:

Net $\times 120\%$ = Gross

Or

Net $\times 1.2$ = Gross

For your assessment you will need to be able to calculate the VAT figures.

You should also **round down** to the nearest 1p the VAT amount in your assessment.

LECTURE EXAMPLE 1 – CALCULATING GROSS VALUES FROM NET VALUES



Complete the table below to show the VAT and gross values.

Net £	VAT £ at 20%	Gross £
100.00		
120.00		
58.00		
42.50		

We have now calculated the VAT when given the Net value and used it to establish the Gross value.

If you are given the Gross value in the assessment this figure will include VAT. You may need to work out the VAT included in this Gross figure and work back to find the Net figure.

ILLUSTRATION

Sheddle Ltd received an invoice from their supplier for wood they have purchased for £48.00 including VAT. As this includes VAT it is the gross value. We need to find the net value so that we can establish how much the wood has actually cost us and the input VAT that will be reclaimed by the business.

	%	£
GROSS	120.0%	48.00
VAT	20.0%	8.00
NET	100.0%	40.00

To get the net value:
 $\text{£}48.00 / 120 \times 100$
 Or $\text{£}48.00 / 1.2$

To get the VAT:
 $\text{£}48.00 / 120 \times 20$
 Or net of $\text{£}40.00 \times 0.2$

Most students find working out the Net value from the Gross value harder than doing it the other way round. The easiest approach tends to be dividing the Gross value by 1.2 to give the Net value, and then work out the VAT by multiplying this Net value by 0.2.

A good idea is to double-check your answer by working it 'the other way'...so in the Sheddle Ltd example, if we now take the Net value of £40.00 and multiply by 1.2 we get back to the £48.00 gross value that we started with. This proves that our £40.00 Net value is the correct answer.

LECTURE EXAMPLE 2 — CALCULATING NET VALUES FROM GROSS VALUES

Complete the table below to show the net and VAT values.

Net £	VAT £ at 20%	Gross £
		96.00
		240.00
		60.00
		1,197.60

Payment of Value Added Tax



At the end of each VAT period (which is usually a three-month period. Most businesses pay VAT to HMRC on a quarterly basis) the business must complete a VAT return where they total all of their output tax and then deduct all of their input tax and pay the balance to HMRC.

ILLUSTRATION

Payment to HMRC

Output VAT collected on sales	£25.00 owed to HMRC
Input VAT suffered on purchases	(£15.00) to be reclaimed from HMRC
Amount payable to HMRC	<u>£10.00</u>

If output VAT collected exceeds input VAT suffered = Net amount payable to HMRC

If input VAT suffered exceeds output VAT collected = Net amount reclaimed from HMRC

VAT rates

For your assessment you will be using a VAT rate of 20% as this is the standard rate that applies to the majority of goods and services but it is worth being aware that there are other VAT rates that apply to some specific items. The various VAT rates are:

- ▶ Standard rate (20%) – Relevant to most goods and services.
- ▶ Reduced rate (5%) – Domestic fuel, child car seats.
- ▶ Zero rate (0%) – Non luxury food, books, children's clothes.
- ▶ Exempt (non-taxable i.e. no VAT added) – Postal services, insurance.

These are covered in more detail in later levels of your AAT studies.

LECTURE EXAMPLE 3 – OUTPUT AND INPUT VAT

In the quarter just ended Ellies Ltd's sales amounted to £32,985.00 (**including** VAT).

What was the NET amount of their sales excluding VAT?

In the same quarter, Ellies Ltd's purchases amounted to £12,000.00 (**excluding** VAT).

What was the VAT on their purchases?

How much VAT must Ellies Ltd pay to HMRC in respect of the quarter just ended?

Discounts



There are three types of discounts you may see:

- (a) Trade discounts
- (b) Bulk discounts
- (c) Prompt payment (early settlement) discounts

Trade discounts

A trade discount is generally a percentage of the normal (or 'list') price that is deducted for certain customers. It may be offered to regular customers to encourage loyalty or to customers that are other businesses (i.e. in the 'trade') rather than individuals.

Bulk discounts

A bulk discount is similar to a trade discount in that a business may offer a discount on its list price if customers are buying a large number of units from it.

Both the above discounts reduce the purchase price of goods at the point that the customer buys them so the business knows for sure that the invoice will be at the discounted price.

Since it is known at the point of invoicing that the customer is going to get the discount the business will never charge the customer the full list price. The invoice is raised for the discounted price, and if VAT is applicable it will be calculated on the discounted price.

ILLUSTRATION – TRADE DISCOUNT

Without VAT:

Mr. Grass purchases goods from Arable Limited who is not VAT registered. As Mr. Grass is a regular customer Arable Ltd offer him a 10% trade discount on all purchases. Mr. Grass purchases goods with a list price of £500.00.

List price of goods	£500.00
Trade discount 10%	<u>(£50.00)</u> – calculated as £500.00 × 0.1
Invoiced value	<u>£450.00</u>

With VAT:

Mr. Grass also purchases goods from Graze Limited who is VAT registered. As Mr. Grass is a regular customer Graze Ltd offer him a 10% trade discount on all purchases. Mr. Grass purchases goods with a list price of £500.00 (excluding VAT).

List price of goods	£500.00
Trade discount 10%	<u>(£50.00)</u> – calculated as £500.00 × 0.1
Net invoice value	£450.00
VAT @ 20%	<u>£90.00</u> – calculated as £450.00 × 0.2
Gross invoice value	<u>£540.00</u>



Prompt payment discounts

These are conditional discounts. This means that the customer has to meet a particular condition to qualify for the discount. A prompt payment (early settlement) discount will be given on the invoice value if payment is made by a set date. For example, it could be that normal terms of trade are to give 30 days' credit, but if payment is made within 10 days a discount will be given.

Since the business doesn't know whether the customer is going to take up the settlement discount until they pay the invoice the discount cannot be deducted at the point of invoicing.

ILLUSTRATION CONTINUED

Without VAT:

Arable Ltd normally offer 30 days' credit but if Mr. Grass settles his account within 14 days Arable Ltd will allow him a further 5% discount. In order to receive this discount Mr. Grass has to meet the condition of paying early. It is unknown at the time of raising the invoice whether Mr. Grass will take the discount or not so **the invoice value will still be the £450.00** from the previous illustration. However, if Mr. Grass does settle within 14 days he will not need to pay this full invoice value:

Total invoiced value	£450.00 – notice that this is still after the trade discount
Early settlement discount 5%	(£22.50) – calculate as £450.00 × 0.05
Payment if made within 14 days	<u>£427.50</u>

Prompt payment discounts and VAT

On issuing a VAT invoice that offers a prompt payment discount, a supplier should enter the invoice into their accounts and record the VAT **ignoring** the prompt payment discount.

If the full amount is received without the prompt payment discount being taken, no adjustment is necessary.

If the discounted price is paid in accordance with the prompt payment terms the supplier must then adjust their records to reflect the amount actually received.

HMRC allow two methods to adjust the records if the prompt payment discount is subsequently taken up by the customer:

- ▶ A credit note can be issued for the reduction in consideration.
- ▶ Alternatively, if the supplier does not wish to issue a credit note, the original invoice must include the following information:
 - ▶ Terms of the prompt payment discount (including time and discounted price).
 - ▶ A statement that the customer can only recover as input tax the VAT actually paid to the supplier.

ASSESS SMART

The AAT have stated that only the credit note method is examinable in this unit.

ILLUSTRATION — PROMPT PAYMENT DISCOUNT AND CREDIT NOTE

Graze Ltd normally offer 30 days' credit but if Mr. Grass settles his account within 14 days Graze Ltd will allow him a further 5% discount. In order to receive this discount Mr. Grass has to meet the condition of paying early.

The invoice is shown below:

INVOICE					
GRAZE LTD 53 Cannon Way Worthing BN14 2JU					
To: Mr Grass 72 Green Way Southampton SO19 3BD		Invoice Number: 303 Customer Reference: GG01 Invoice Date: 5 June VAT Registration Number: 891 2362 88			
Product code	Description	Quantity	Unit £	Tax Rate %	Total £
2234	Gardening tools	1	500.00	20	500.00
Net total					£500.00
Trade discount 10%					£50.00
Net Total					£450.00
VAT @ 20%					£90.00
Gross Total					£540.00
Payment is due within 30 days of the invoice date. A discount of 5% applies if payment is made within 14 days of the invoice date.					

Mr. Grass did pay in time to receive the discount.

Complete the credit note below to show the discount he will receive.

The net amount of the discount is $\text{£}450.00 \times 5\% = \text{£}22.50$.

The VAT amount is $\text{£}22.50 \times 20\% = \text{£}4.50$.

Therefore the gross amount is $\text{£}27.00$.

CREDIT NOTE					
GRAZE LTD 53 Cannon Way Worthing BN14 2JU					
To: Mr Grass 72 Green Way Southampton SO19 3BD		Credit Note Number: CR204 Customer Reference: GG01 Date: 11 June VAT Registration Number: 891 2362 88			
Product code	Description	Quantity	Unit £	Tax Rate %	Total £
2234	Gardening tools – prompt payment discount	1	22.50	20	22.50
Net Total ($\text{£}450.00 \times 5\%$)					£22.50
VAT @ 20%					£4.50
Gross Total					£27.00

LECTURE EXAMPLE 4 – CALCULATING VAT WITH DISCOUNTS



Tubbies Limited sells a TV to Mr Po for £500.

A trade discount of 20% is given and an early settlement discount of 2% is offered for payment within 14 days.

Assuming that Mr Po DOESN'T make payment within 14 days, how much VAT should be charged?

List price	<input type="text"/>
Trade discount	<input type="text"/>
Net invoice value	<input type="text"/>
VAT	<input type="text"/>
Gross invoice value	<input type="text"/>

LECTURE EXAMPLE 5 – COMPLETING A SALES INVOICE WITH VAT AND DISCOUNTS

On 1 May Sarah Timple buys 100 red roses from her regular florist Tumbles Ltd at a price of £2.50 each. Tumbles gives Sarah a 10% trade discount on all her orders, in addition to this she is offered a 5% discount if she settles her bill within 10 days.

Her customer account reference number is ST01 and the next invoice is numbered at 1078.

(a) Complete the following invoice for Tumbles Ltd.

INVOICE				
TUMBLES LTD				
10 Fall Down Way Hillside HL12 2BN				
To:	Sarah Timple 89 Ambleside Drive Grasmere AB21 1TU	Invoice number:	<input type="text"/>	
		Customer reference:	<input type="text"/>	
		Invoice date:	<input type="text"/>	
		VAT registration no:	891 2362 98	
Product code	Description	Quantity	Unit £	Total £
RROSE	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
				Total
				Trade discount
				Net total
				VAT 20%
				Gross total
Payment terms: 30 days A discount of 5% applies if payment is made within 10 days of the invoice date.				

(b) If the prompt payment discount is taken, calculate the amount of the credit note:

Net VAT Gross

LECTURE EXAMPLE 6 – DIFFERENT TYPES OF DISCOUNT



Abbeys Ltd offers three kinds of discount to its credit customers: trade discounts; bulk discounts (or quantity discounts); and prompt payment discounts.

Indicate with a tick the most appropriate description of each type of discount.

Trade discount ✓	
A discount to credit customers for early settlement of the bill	
A discount to customers who regularly do business with Abbeys Ltd	
A discount in respect of a particularly large order	
A discount for payment in cash	

Bulk/quantity discount ✓	
A discount to credit customers for early settlement of the bill	
A discount to customers who regularly do business with Abbeys Ltd	
A discount in respect of a particularly large order	
A discount for payment in cash	

Prompt payment discount ✓	
A discount to credit customers for early settlement of the bill	
A discount to customers who regularly do business with Abbeys Ltd	
A discount in respect of a particularly large order	
A discount for payment in cash	

LECTURE EXAMPLE 7 – CHECKING A PURCHASE INVOICE

A supply of cardboard boxes has been delivered to Rocky Ltd by Missy & Co. The Purchase Order sent from Rocky Ltd, and the Purchase Invoice received from Missy & Co, are shown below.

PURCHASE ORDER	
ROCKY LIMITED	
4 High Street Cambridge CB1 4AB	
To: Missy & Co	Date: 7 May
Please supply 200 cardboard boxes product code 125689	
Purchase price: £60 per 100, plus VAT	
Discount: less 10% trade discount, as agreed.	

INVOICE	
MISSY & CO	
34 High Street Cambridge CB1 5RP	
To: Rocky Ltd 4 High Street Cambridge CB1 4AB	Invoice number: 4356
	VAT Registration No: 234 5675 00
	Date: 9 May

Quantity	Description	Unit amount £	Total £
200	Cardboard boxes product code 125689	£0.60	£120.00

VAT @ 20%	£24.00
Total	£144.00

Payment terms: 30 days net

Check the invoice against the purchase order and answer the following questions.

Has the correct number of units been delivered?	Yes	No
Has the correct product been delivered?	Yes	No
Has the correct purchase price of the cardboard boxes been charged?	Yes	No
Has the correct discount been applied?	Yes	No
What would be the VAT amount charged if the invoice was correct?	£_____	
What would be the total amount charged if the invoice was correct?	£_____	

LECTURE EXAMPLE 8 – COMPLETING A SALES INVOICE



On 1 May Rocky Ltd delivered the following goods to a credit customer, Topaz Stores.

DELIVERY NOTE					
ROCKY LTD 14 High Street Cambridgeshire CB1 4AB					
To: Topaz Stores 7 Hills St Yalding Kent ME11 5BS	Delivery note no: 2364 Date: 1 May Customer account code: T0987				
<table border="1" style="width: 100%;"> <thead> <tr> <th style="width: 50%;">Product code</th> <th style="width: 50%;">Quantity</th> </tr> </thead> <tbody> <tr> <td>K300</td> <td>100</td> </tr> </tbody> </table>		Product code	Quantity	K300	100
Product code	Quantity				
K300	100				

The list price of the goods was £8 per case plus VAT. Topaz Stores are to be given a 10% trade discount and a further 5% discount if the invoice is settled within 14 days.

(a) Complete the invoice below.

INVOICE		
ROCKY LTD 14 High Street Cambridgeshire CB1 4AB		
To: Topaz Stores 7 Hills St Yalding Kent ME11 5BS	Invoice Number: 543 Delivery Note Number: 2364 Date: 5 May VAT Registration No: 345 6546 223	
Quantity of cases	Product code	Total list price £
Net amount after trade discount		
VAT		
Gross		
A discount of 5% applies if payment is made within 14 days of the invoice date.		

(b) If the prompt payment discount is taken, calculate the amount of the credit note that will be issued:

Net VAT Gross

Rocky Ltd offers each customer a discount of 5% if any order amounts to £5,000 or over.

(c) What is the name of this type of discount?

Select your account name from the following list: Bulk discount, Cash discount, Prompt payment discount, Trade discount

LECTURE EXAMPLE 9 – PAYMENTS WITH DISCOUNTS

Rocky Ltd is preparing an invoice to be sent to L Red Ltd for £2,160.00 plus VAT.

A prompt payment discount of 2% will be offered for payment within 10 days.

(a) What is the amount Rocky Ltd should receive if payment is made within 10 days?

£

(b) What is the amount Rocky Ltd should receive if payment is NOT made within 10 days?

£

Here are some Practice Examples for you to try...

PRACTICE EXAMPLE 1 - VAT TERMINOLOGY

Link each of the terms in the boxes on the left with the appropriate descriptions in the boxes on the right.

Net value

The VAT suffered on purchases that can be reclaimed from HMRC by a VAT registered business

Gross value

The value of a transaction excluding VAT

Input VAT

The VAT collected on sales that must be paid over to HMRC

Output VAT

The value of a transaction including VAT

PRACTICE EXAMPLE 2 - VAT TERMINOLOGY

Define each of the following terms:

Output VAT

Input VAT

PRACTICE EXAMPLE 3 - CALCULATING GROSS VALUES FROM NET VALUES

Complete the table below to show the VAT and gross values.

Net £	VAT at 20% £	Gross £
10.00		
15.00		
65.00		
12.40		

PRACTICE EXAMPLE 4 - CALCULATING GROSS VALUES FROM NET VALUES

Complete the table below to show the VAT and gross values.

Net £	VAT at 20% £	Gross £
950.00		
1,030.00		
3,940.60		
19,345.15		

PRACTICE EXAMPLE 5 - CALCULATING NET VALUES FROM GROSS VALUES

Complete the table below to show the net and VAT values.

Net £	VAT at 20% £	Gross £
		60.00
		180.00
		96.00
		102.72

PRACTICE EXAMPLE 6 - CALCULATING NET VALUES FROM GROSS VALUES

Complete the table below to show the net and VAT values.

Net £	VAT at 20% £	Gross £
		1,980.00
		3,048.00
		5,472.84
		15,455.58

PRACTICE EXAMPLE 7 - OUTPUT VAT AND INPUT VAT

In the quarter just ended Cranberry Ltd's sales amounted to £18,500.00 (excluding VAT).

What was the gross value of their sales?

In the same quarter, Cranberry Ltd's purchases amounted to £16,800.00 (including VAT).

What was the value of input VAT on their purchases?

How much VAT must Cranberry Ltd pay to HMRC in respect of the quarter just ended?

PRACTICE EXAMPLE 8 - OUTPUT VAT AND INPUT VAT

In the quarter just ended Pineapple Ltd's sales amounted to £57,000.00 including VAT.

What was the value of output VAT on their sales?

In the same quarter, Pineapple Ltd's purchases amounted to £60,000.00 plus VAT.

What was the gross value of their purchases?

What is Pineapple Ltd's VAT position in respect of the quarter just ended?

PRACTICE EXAMPLE 9 - TRADE/ BULK DISCOUNTS WITH NO VAT

The list price of goods sold to a customer by a non VAT registered trader is £1,000 with 30 days' credit. The customer gets a 10% trade discount on all orders. **What is the net value of the invoice?**

PRACTICE EXAMPLE 10 - TRADE/ BULK DISCOUNTS WITH VAT

The list price of goods sold to a customer by a VAT registered trader is £1,000 with 30 days' credit. The customer gets a 10% trade discount on all orders. VAT is at the standard rate of 20%. **What is the gross value of the invoice?**

PRACTICE EXAMPLE 11 – PROMPT PAYMENT DISCOUNTS WITH NO VAT

The list price of goods sold to a customer by a non VAT registered trader is £1,000 with 30 days' credit. The customer gets a 10% trade discount on all orders and is offered a 5% prompt payment discount for paying within 7 days. **What is the value of the invoice?**

PRACTICE EXAMPLE 12 – PROMPT PAYMENT DISCOUNTS WITH VAT

The list price of goods sold to a customer by a VAT registered trader is £1,000 with 30 days' credit. VAT is at the standard rate of 20%. The customer gets a 10% trade discount on all orders and is offered a 5% prompt payment discount for paying within 7 days. **What is the value of the invoice?**

PRACTICE EXAMPLE 13 – PROMPT PAYMENT DISCOUNTS WITH VAT

The list price of goods sold to a customer by a VAT registered trader is £1,000 with 30 days' credit. VAT is at the standard rate of 20%. The customer gets a 10% trade discount on all orders and is offered a 5% prompt payment discount for paying within 7 days. **How much will the trader receive if the customer pays within 7 days?**

PRACTICE EXAMPLE 14 - COMPLETING A SALES INVOICE WITH VAT AND DISCOUNTS

On 1 March Tim Simple buys 200 pink carnations (product code PCARN) from his regular florist Tumbles Ltd at a price of £3.50 each. Tumbles gives Tim a 5% trade discount on all his orders, in addition to this he is offered a 4% discount if he settles his bill within 10 days.

His customer account reference number is TS02 and the next invoice is numbered at 1079.

(a) Complete the following invoice for Tumbles Ltd.

To:

Invoice Number:

Customer Reference:

Invoice Date:

1 March 20XX

VAT Registration No:

891 2362 88

TUMBLES LTD

24 Fernlight Road
Brighton
BN43SU

Product code	Description	Quantity	Unit £	Tax Rate %	Total £

Net total

Trade discount 5%

Net Total

VAT @ 20%

Gross Total

Payment is due within 30 days of the invoice date.

A discount of 4% applies if payment is made within 10 days of the invoice date.

(b) Complete the following credit note for Tumbles Ltd.

PRACTICE EXAMPLE 15 - DIFFERENT TYPES OF DISCOUNT

Dove Ltd offers three kinds of discount to its credit customers: prompt payment discounts, trade discounts; and bulk discounts (or quantity discounts).

Indicate with a tick the most appropriate description of each type of discount.

Prompt payment discount ✓	
A discount to credit customers for early settlement	<input type="checkbox"/>
A discount to customers who regularly do business with Dove Ltd	<input type="checkbox"/>
A discount in respect of a particularly large order	<input type="checkbox"/>
A discount for payment in cash	<input type="checkbox"/>

Trade discount ✓	
A discount to credit customers for early settlement	<input type="checkbox"/>
A discount to customers who regularly do business with Dove Ltd	<input type="checkbox"/>
A discount in respect of a particularly large order	<input type="checkbox"/>
A discount for payment in cash	<input type="checkbox"/>

Bulk/quantity discount ✓	
A discount to credit customers for early settlement	<input type="checkbox"/>
A discount to customers who regularly do business with Dove Ltd	<input type="checkbox"/>
A discount in respect of a particularly large order	<input type="checkbox"/>
A discount for payment in cash	<input type="checkbox"/>

PRACTICE EXAMPLE 16 - PAYMENTS WITH DISCOUNTS

Dove Ltd is preparing an invoice to be sent to Peace Ltd for £1,000.00 plus VAT. A settlement (prompt payment) discount of 4% will be offered for payment within 7 days.

(a) What is the amount Dove Ltd should receive if payment is made within 7 days?

£

(b) What is the amount Dove Ltd should receive if payment is NOT made within 7 days?

£

PRACTICE EXAMPLE 17 - PAYMENTS WITH DISCOUNTS

Dove Ltd is preparing an invoice to be sent to Calm Ltd for £30,000.00 plus VAT. A settlement discount of 3% will be offered for payment within 7 days.

- (a) What is the amount Dove Ltd should receive if payment is made within 7 days?

£

- (b) What is the amount Dove Ltd should receive if payment is NOT made within 7 days?

£

PRACTICE EXAMPLE 18 - PAYMENTS WITH DISCOUNTS

Dove Ltd is preparing an invoice to be sent to Silence Ltd for £19,400.00 plus VAT. A settlement discount of 5% will be offered for payment within 7 days.

- (a) What is the amount Dove Ltd should receive if payment is made within 7 days?

£

- (b) What is the amount Dove Ltd should receive if payment is NOT made within 7 days?

£

First Intuition

Solutions to Lecture Examples

Lecture example 1 - Calculating gross values from net values

Net £	VAT £ at 20%	Gross £
100.00	$100.00 \times 0.2 = \mathbf{20.00}$	$100.00 \times 1.2 = \mathbf{120.00}$
120.00	$120.00 \times 0.2 = \mathbf{24.00}$	$120.00 \times 1.2 = \mathbf{144.00}$
58.00	$58.00 \times 0.2 = \mathbf{11.60}$	$58.00 \times 1.2 = \mathbf{69.60}$
42.50	$42.50 \times 0.2 = \mathbf{8.50}$	$42.50 \times 1.2 = \mathbf{51.00}$

Lecture example 2 - Calculating net values from gross values

Net £	VAT £ at 20%	Gross £
80.00*	16.00**	96.00
200.00	40.00	240.00
50.00	10.00	60.00
998.00	199.60	1,197.60

* $96.00/120 \times 100 = 80.00$ or $96.00/1.2 = 80.00$

** $80.00 \times 0.2 = 16.00$ or $96.00 - 80.00 = 16.00$

Lecture example 3 - Output and input VAT

In the quarter just ended Ellies Ltd's sales amounted to £32,985.00 (including VAT).

What was the Net value of their sales excluding VAT?

£32,985.00 / 1.2 = £27,487.50

(This means that their Output VAT was £32,985.00 – £27,487.50 = £5,497.50)

In the same quarter, Ellies Ltd's purchases amounted to £12,000.00 (excluding VAT).

What was the VAT on purchases for the quarter?

£12,000.00 × 0.2 = £2,400.00 of Input VAT

(This means that the Gross value of purchases was £12,000.00 + £2,400.00 = £14,400.00)

How much VAT must Ellies Ltd pay to HM Revenue & Customs in respect of the quarter just ended?

Output VAT	£5,497.50
Input VAT	(£2,400.00)
VAT due to HMRC	£3,097.50

Lecture example 4 - Calculating VAT with discounts

List price	£500.00
Trade discount ($£500.00 \times 20\%$)	£100.00
Net invoice value	£400.00
VAT ($£400.00 \times 20\%$)	£80.00
Gross invoice value ($£400.00 + £80.00$)	£480.00

Lecture example 5 - Completing a sales invoice with VAT and discounts

(a) Complete the following invoice for Tumbles Ltd.

INVOICE				
TUMBLES LTD				
10 Fall Down Way Hillside HL12 2BN				
To:	Sarah Timple 89 Ambleside Drive Grasmere AB21 1TU	Invoice number:	1078	
		Customer reference:	ST01	
		Invoice date:	1 May	
		VAT registration no:	891 2362 98	
Product code	Description	Quantity	Unit £	Total £
RROSE	Red Roses	100	2.50	250.00
Total				250.00
Trade discount				(25.00)
Net total				225.00
VAT 20%				45.00
Gross total				270.00
Payment terms: 30 days A discount of 5% applies if payment is made within 10 days of the invoice date.				

(b) If the prompt payment discount is taken, calculate the amount of the credit note:

Net	11.25	VAT	2.25	Gross	13.50
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Lecture example 6 - Different types of discount

Trade discount ✓	
A discount to credit customers for early settlement of the bill	
A discount to customers who regularly do business with Abbeys Ltd	✓
A discount in respect of a particularly large order	
A discount for payment in cash	

Bulk/quantity discount ✓	
A discount to credit customers for early settlement of the bill	
A discount to customers who regularly do business with Abbeys Ltd	
A discount in respect of a particularly large order	✓
A discount for payment in cash	

Prompt payment discount ✓	
A discount to credit customers for early settlement of the bill	✓
A discount to customers who regularly do business with Abbeys Ltd	
A discount in respect of a particularly large order	
A discount for payment in cash	

Lecture example 7 - Checking a purchase invoice

Has the correct number of units been delivered? 200 units	Yes
Has the correct product been delivered? Product code 125689	Yes
Has the correct purchase price of the cardboard boxes been charged? (£60 per 100 means £0.60 per individual unit.)	Yes
Has the correct discount been applied? (a trade discount of 10% should have meant a price of £0.54 per unit)	No
What would be the VAT amount charged if the invoice was correct? (£120 × 0.1 = £12 trade discount. £120 – £12 = £108. £108 × 0.2 = £21.60)	£21.60
What would be the total amount charged if the invoice was correct? (£108 + £21.60 = £129.60)	£129.60

Lecture example 8 - Completing a sales invoice

(a) Complete the invoice below.

INVOICE		
ROCKY LTD 14 High Street Cambridgeshire CB1 4AB		
To: Topaz Stores 7 Hills St Yalding Kent ME11 5BS	Invoice Number: 543 Delivery Note Number: 2364 Date: 5 May VAT Registration No: 345 6546 223	
Quantity of cases	Product code	Total list price £
100	K300	800.00
Net amount after trade discount (800.00 x 90%)		720.00
VAT		144.00
Gross		864.00
A discount of 5% applies if payment is made within 14 days of the invoice date.		

(b) If the prompt payment discount is taken, calculate the amount of the credit note that will be issued:

Net VAT Gross
 (720.00 x 5%)

Rocky Ltd offers each customer a discount of 5% if any order amounts to £5,000 or over.

(c) What is the name of this type of discount?

Lecture example 9 - Payments with discounts

(a) What is the amount Rocky Ltd should receive if payment is made within 10 days?

£ **£ 2,540.16** ($£2,160 \times 0.02 = £43.20$ discount.
 $£2,160 - £43.20 = £2,116.80 + \text{VAT } (£2,116.80 \times 0.20) =$
 $£2,540.16$)

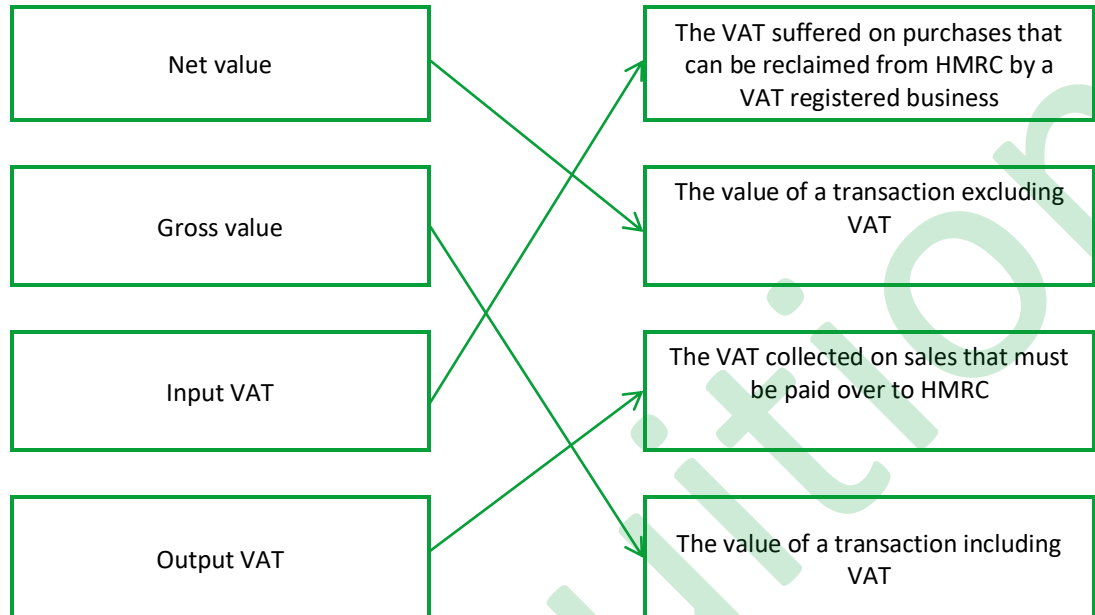
(b) What is the amount Rocky Ltd should receive if payment is NOT made within 10 days?

£ **£ 2,592.00** ($£2,160 + \text{VAT } (£2,160.00 \times 0.20)$)

First Intuition

Solutions to Practice Examples

PRACTICE EXAMPLE 1 - VAT TERMINOLOGY



PRACTICE EXAMPLE 2 - VAT TERMINOLOGY

Output VAT – this is the VAT that a VAT registered business adds onto the value of its sales (outputs). The business cannot keep this VAT and they must pay it over to HMRC meaning that they only keep the net value of the sales made. The output VAT would be a liability of the business (a payable balance).

Input VAT – this is the VAT that a business suffers on purchases and other expenses (inputs). A VAT registered business can reclaim input VAT from HMRC meaning that they only suffer the net cost of the expenses. The input VAT would be an asset of the business (a form of receivable balance).

PRACTICE EXAMPLE 3 - CALCULATING GROSS VALUES FROM NET VALUES

Net £	VAT at 20% £	Gross £
10.00	10.00×0.2 (or 20%) = 2.00	10.00×1.2 = 12.00 (or $10.00 + 2.00$)
15.00	15.00×0.2 = 3.00	15.00×1.2 = 18.00
65.00	65.00×0.2 = 13.00	65.00×1.2 = 78.00
12.40	12.40×0.2 = 2.48	12.40×1.2 = 14.88

PRACTICE EXAMPLE 4 - CALCULATING GROSS VALUES FROM NET VALUES

Net £	VAT at 20% £	Gross £
950.00	950.00×0.2 = 190.00	950.00×1.2 = 1,140.00
1,030.00	$1,030.00 \times 0.2$ = 206.00	$1,030.00 \times 1.2$ = 1,236.00
3,940.60	$3,940.60 \times 0.2$ = 788.12	$3,940.60 \times 1.2$ = 4,728.72
19,345.15	$19,345.15 \times 0.2$ = 3,869.03	$19,345.15 \times 1.2$ = 23,214.18

PRACTICE EXAMPLE 5 - CALCULATING NET VALUES FROM GROSS VALUES

Net £	VAT at 20% £	Gross £
$60.00/1.2$ = 50.00	50.00×0.2 = 10.00 (or $60.00 - 50.00$)	60.00
$180.00/1.2$ = 150.00	150.00×0.2 = 30.00	180.00
$96.00/1.2$ = 80.00	80.00×0.2 = 16.00	96.00
$102.72/1.2$ = 85.60	85.60×0.2 = 17.12	102.72

PRACTICE EXAMPLE 6 - CALCULATING NET VALUES FROM GROSS VALUES

Net £	VAT at 20% £	Gross £
$1,980.00/1.2 = \mathbf{1,650.00}$	$1,650.00 \times 0.2 = \mathbf{330.00}$	1,980.00
$3,048.00/1.2 = \mathbf{2,540.00}$	$2,540.00 \times 0.2 = \mathbf{508.00}$	3,048.00
$5,472.84/1.2 = \mathbf{4,560.70}$	$4,560.70 \times 0.2 = \mathbf{912.14}$	5,472.84
$15,455.58/1.2 = \mathbf{12,879.65}$	$12,879.65 \times 0.2 = \mathbf{2,575.93}$	15,455.58

PRACTICE EXAMPLE 7 - OUTPUT VAT AND INPUT VAT

What was the gross value of their sales?

$\pounds 18,500.00 \times 1.2 = \mathbf{\pounds 22,200.00}$ gross value including $\pounds 3,700.00$ output VAT.

What was the value of input VAT on their purchases?

$\pounds 16,800.00/1.2 = \pounds 14,000.00$ net value and $\pounds 14,000.00 \times 0.2 = \mathbf{\pounds 2,800.00}$ input VAT.

How much VAT must Cranberry Ltd pay to HMRC in respect of the quarter just ended?

Output VAT – input VAT = $\pounds 3,700.00 - \pounds 2,800.00 = \mathbf{\pounds 900.00}$ due to HMRC.

PRACTICE EXAMPLE 8 - OUTPUT VAT AND INPUT VAT

What was the value of output VAT on their sales?

$\pounds 57,000.00/1.2 = \pounds 47,500.00$ net value and $\pounds 47,500.00 \times 0.2 = \mathbf{\pounds 9,500}$ output VAT.

What was the gross value of their purchases?

$\pounds 60,000.00 \times 1.2 = \mathbf{\pounds 72,000.00}$ gross value including $\pounds 12,000.00$ input VAT.

What is Pineapple Ltd's VAT position in respect of the quarter just ended?

Output VAT – input VAT = $\pounds 9,500 - \pounds 12,000 = \mathbf{\pounds 2,500}$ to be reclaimed from HMRC. Note that in this example the input VAT exceeds the output VAT.

PRACTICE EXAMPLE 9 – TRADE/ BULK DISCOUNTS WITH NO VAT

The net value of the invoice will be after deducting the trade discount as we would know at the time of invoicing that the customer will definitely get this discount.

$\pounds 1,000 \times 10\% = \pounds 100$ trade discount. $\pounds 1,000 - \pounds 100 = \mathbf{\pounds 900}$ net value.

PRACTICE EXAMPLE 10 - TRADE/ BULK DISCOUNTS WITH VAT

The net value of the invoice is £900 from Practice Example 9.

The VAT will be 20% of the net value giving $£900 \times 0.2 = £180$. The gross value will be $£900 + £180 = \textbf{£1,080}$.

PRACTICE EXAMPLE 11 – PROMPT PAYMENT DISCOUNTS WITH NO VAT

The value of the invoice is £900, which is the same as Practice Example 9.

$£1,000 \times 10\% = £100$ trade discount. $£1,000 - £100 = \textbf{£900 net value}$.

At the point of invoicing the trader will not know if the prompt payment discount will be taken up by the customer and so the prompt payment discount is not reflected in the invoice amount.

PRACTICE EXAMPLE 12 – PROMPT PAYMENT DISCOUNTS WITH VAT

The value of the invoice is £1,080, which is the same as Practice Example 10.

The net value of the invoice is £900 from Practice Example 9.

The VAT will be 20% of the net value giving $£900 \times 0.2 = £180$. The gross value will be $£900 + £180 = \textbf{£1,080}$.

As in Practice Example 11, at the point of invoicing the trader will not know if the prompt payment discount will be taken up by the customer and so it is not reflected in the invoice amount.

PRACTICE EXAMPLE 13 - PROMPT PAYMENT DISCOUNTS WITH VAT

The VAT will now need to be calculated using the value after deducting both the trade discount and the prompt payment discount:

List price	£1,000
Trade discount (10%)	(£100)
	£900
Prompt payment discount ($£900 \times 5\%$)	(£45)
Net invoice value	£855
VAT @ 20%	£171
Payment from customer	£1,026

PRACTICE EXAMPLE 14 - COMPLETING A SALES INVOICE WITH VAT AND DISCOUNTS

(a) Complete the following invoice for Tumbles Ltd.

INVOICE					
TUMBLES LTD					
24 Fernlight Road Brighton BN43SU					
To:	Tim Simple		Invoice Number:	1079	
			Customer Reference:	TS02	
			Invoice Date:	1 March 20XX	
			VAT Registration No:	891 2362 88	

Product code	Description	Quantity	Unit £	Tax Rate %	Total £
PCARN	Pink carnations	200	3.50	20	700.00

Net total	700.00
Trade discount 5%	35.00
Net Total	665.00
VAT @ 20%	133.00
Gross Total	798.00

Payment is due within 30 days of the invoice date.

A discount of 4% applies if payment is made within 10 days of the invoice date.

Tim does pay in time to qualify for the prompt payment discount.

(b) Complete the following credit note for Tumbles Ltd.

CREDIT NOTE					
TUMBLES LTD					
24 Fernlight Road Brighton BN4 3SU					
To: Tim Simple		Credit Note Number: CR258			
		Customer Reference: TS02			
		Date: 11 March 20XX			
		VAT Registration No: 891 2362 88			
Product code	Description	Quantity	Unit £	Tax Rate %	Total £
PCARN	Pink carnations – prompt payment discount	1	26.60	20	26.60
Net Total (665.00 x 4%)					26.60
VAT @ 20%					5.32
Gross Total					31.92

PRACTICE EXAMPLE 15 - DIFFERENT TYPES OF DISCOUNT

Prompt payment discount ✓	
A discount to credit customers for early settlement	✓
A discount to customers who regularly do business with Dove Ltd	
A discount in respect of a particularly large order	
A discount for payment in cash	

Trade discount ✓	
A discount to credit customers for early settlement	
A discount to customers who regularly do business with Dove Ltd	✓
A discount in respect of a particularly large order	
A discount for payment in cash	

Bulk/quantity discount ✓	
A discount to credit customers for early settlement	
A discount to customers who regularly do business with Dove Ltd	
A discount in respect of a particularly large order	✓
A discount for payment in cash	

PRACTICE EXAMPLE 16 - PAYMENTS WITH DISCOUNTS

The gross value of the invoice is $£1,000.00 + £200.00 = £1,200.00$.

The available settlement discount is $£1,000.00 \times 4\% = £40.00 + \text{vat} = £48.00$, if paid within 7 days.

(a) What is the amount Dove Ltd should receive if payment is made within 7 days?

£ $1,000 - 40.00 = 960 \text{ plus } (960 \times 20\%) = \mathbf{1,152.00}$

(b) What is the amount Dove Ltd should receive if payment is NOT made within 7 days?

£ $\mathbf{1,200.00}$

PRACTICE EXAMPLE 17 - PAYMENTS WITH DISCOUNTS

The gross value of the invoice is £30,000 + £6,000 + £36,000.00

The available settlement discount is £30,000 x 3% = £900 + vat, if paid within 7 days

(a) What is the amount Dove Ltd should receive if payment is made within 7 days?

£ $30,000 - 900 = 29,100$ plus $(29,100 \times 20\%) = \mathbf{34,920.00}$

(b) What is the amount Dove Ltd should receive if payment is NOT made within 7 days?

£ $\mathbf{36,000.00}$

PRACTICE EXAMPLE 18 - PAYMENTS WITH DISCOUNTS

The gross value of the invoice is £19,400.00 + £3,880.00 = £23,280.00

The available settlement discount is £19,400.00 x 5% = £970.00 + vat, if paid within 7 days

(a) What is the amount Dove Ltd should receive if payment is made within 7 days?

£ $19,400 - 970 = 18,430$ plus $(18,430 \times 20\%) = \mathbf{22,116.00}$

(b) What is the amount Dove Ltd should receive if payment is NOT made within 7 days?

£ $\mathbf{23,280.00}$

3

Basic accounting

Introduction

This chapter introduces some of the important terminology used in accounting and looks at the basic format of the main elements of a set of accounts. Much of the content of this chapter will form the backbone of your accounting studies (and career!) so it is worth starting to become familiar with the ideas covered.

Topics covered:

- ▶ Introduction to users of accounts
- ▶ Definitions that will be useful throughout your studies
- ▶ The Financial Statements of a business
- ▶ The accounting system
- ▶ Digital bookkeeping systems

Introduction to users of accounts



There are different groups of people who will want to find out about how well a business is performing and to do this they may look at the financial statements (often called 'the accounts') of the business.

User Group	Reason for interest
Owners/Shareholders	To work out the level of return they are receiving on their investment so they can identify whether it should be kept or sold
Suppliers	To work out if they are likely to be paid if they offer credit to a company
Banks	To identify whether a company is a good credit risk for agreeing a loan request
Staff	To look at the security of their jobs and whether they are likely to receive a bonus based on the success of the company
Customers	To check that a company is likely to still be trading in a year or two when the customer wants to buy further supplies

A business will enter into many different transactions on a day to day basis. A large multinational company could be making thousands of sales every single day, making hundreds of purchases each week, paying tens of thousands of staff each month and paying rent on dozens of properties in several different countries.

To make sense of all of this information the business will need to have a system in place to record all of these transactions in a meaningful and logical way so that it can produce a set of accounts that will summarise everything that has happened and show the position the business is in when it gets to the end of its accounting period. This overall process is sometimes referred to as '**the accounting system**'.

Aims

The general **aims** of the accounting system of the business are:

- ▶ To identify **how well the business has performed** in the period. This means establishing what they have sold and the costs they have incurred and so the profit (or loss) that they have earned.
- ▶ To identify things the business **owns** (such as machinery or vehicles) and the things the business **owes** (such as bank loans and unpaid tax).
- ▶ To help understand what has happened to the **cash flow** of the business. Many profitable businesses go bankrupt because they do not generate enough cash flow to pay their bills when they are due.
- ▶ To **communicate** these things to the users of the accounts in as clear a manner as is possible.

Definitions that will be useful throughout your studies



Asset – this is something that is **owned** by the business. This would include property, vehicles, computers, stock of goods for resale, cash at the bank and amounts owed to the business by customers.

There are two categories of assets:

- ▶ **Fixed (or non-current) asset** – an asset which will be owned for more than one year, for example the business delivery van that may be owned for a number of years.
- ▶ **Current asset** – an asset which will be owned for less than one year, for example some books in the storeroom of a bookshop for selling to customers in the next few weeks.

Liability – this is something that is **owed** by the business to someone else. This would include bank loans, overdrafts, amounts owed to suppliers of goods and unpaid tax (such as VAT).

Income – sales made by the business to their customers. This can be for the sale of physical products (such as a car manufacturer selling a car) or for the provision of services (such as an airline taking a passenger to Spain). Sales are also referred to as 'revenue', 'income' or 'turnover'.

Expense – costs incurred by the business, such as purchases of goods, salaries or rent.

Trade receivables/ Debtors – someone who owes the business money, such as a credit customer.

Trade payables/ Creditors – someone the business owes money to, such as a credit supplier.

LECTURE EXAMPLE 1 – UNDERSTANDING BASIC DEFINITIONS

For each of the items below identify whether they would be classified as an asset, a liability, an expense, or as income.

	Asset ✓	Liability ✓	Expense ✓	Income ✓
Rent paid for the month				
Computer equipment for the office				
Customer outstanding balance owed to the shop				
Electricity bill for a three month period				
1,500 units of stock in the warehouse				
Loan from a bank				
£100 in the business bank account				
Purchase of 100 envelopes for the post room				



It is important to understand the difference between:

- ▶ capital expenditure and revenue expenditure
- ▶ capital income and revenue income.

Expenditure

Expenditure is money going out of the business (i.e. you are paying an amount to someone else). The two types of expenditure are:

- ▶ **Capital expenditure** – this is where you are spending money to acquire an asset that will be owned for several years e.g. buying a machine for the factory.
- ▶ **Revenue expenditure** – this is where you are spending money in a way that will only affect the business in the short-term i.e. paying salaries for a month.

Income

Income is money coming into the business (i.e. you are being paid money by someone else). The two types of income are:

- ▶ **Capital income** – this is where you are generating income by selling an item that was treated as capital expenditure when it was purchased i.e. when disposing of an old machine from the factory.
- ▶ **Revenue income** – this covers the majority of day-to-day sales of a business, whether sold on cash or credit terms i.e. a bookshop selling books.

LECTURE EXAMPLE 2 – CAPITAL VERSUS REVENUE ITEMS

Select one option in each instance below to show whether the item will be capital expenditure, revenue expenditure, capital income or revenue income.

Item	Capital expenditure ✓	Revenue expenditure ✓	Capital income ✓	Revenue income ✓
Receipts from credit customers				
Receipts from cash sales				
Receipts from owner				
Receipt from sale of a motor vehicle				
Purchase of a delivery van				
Purchase of goods for resale to customers				
Purchase of postage stamps using petty cash				

The Financial Statements of a business



The ultimate aim of the accounting system of a business is to produce a set of **Financial Statements** at the end of the year. This syllabus will take you through some of the fundamental processes that help accountants to achieve this.

Although a full set of accounts for a business are very long and can contain many different pieces of information, there are two main documents that they contain;

- ▶ The Statement of Financial Position
- ▶ The Statement of Profit or Loss

These statements will **not be tested** in the assessment for this paper, but knowledge of them will provide a useful background that may help your understanding.

Statement of Financial Position (SFP)

As the name suggests, the Statement of Financial Position (SFP) of a business shows the financial **position** of a business, by which we mean the assets that the business owns and the liabilities that the business owes. The SFP can be thought of as a snapshot of the business at a point in time as it is completed on a specific date (typically the last day of the accounting year).

You may hear the SFP referred to as the 'Balance Sheet' in the workplace. Either term is acceptable, but your assessment is likely to use 'Statement of Financial Position.'

If you had to prepare a Statement of Financial Position for yourself today, what might you include? You would need to consider what you **own** today (your assets) and what you **owe** other people today (your liabilities).

What you own

What you owe

It may look something like this:

Own (Assets)

House	£200,000
Car	£12,000
Computer	£3,000
Bank account	£10,000
Total assets	£225,000

Owe (Liabilities)

Mortgage	£180,000
Car loan	£10,000
Credit cards	£8,000
Total liabilities	£198,000

The Statement of Financial Position of a business also contains these two types of item:

- (a) **Assets** owned by the business such as property, vehicles and cash
- (b) **Liabilities** owed by the business such as bank loans or unpaid tax. This will also include the amount owed back to the owner of the business which is known as 'capital'.

This is what a typical SFP looks like:

Statement of Financial Position (or Balance Sheet) as at 31 December 20XX

	£	£
Non-current (Fixed) assets		50,000
Current assets		
Inventory (Stock)	12,000	
Trade receivables (Debtors)	19,000	
Cash	4,000	
	35,000	
Current liabilities		
Trade payables (Creditors)	(12,000)	
Net current assets		23,000
Non-current liabilities		
Bank loan		(10,000)
Net assets		63,000
Proprietor's interest		
Capital	50,000	
Profit	27,000	
Less: drawings	(14,000)	
		63,000

The SFP is made up of two 'halves'. The top half shows the total of all assets owned by the business and all liabilities owed to third parties. In this case the assets exceed the liabilities by a total of £63,000. The bottom half shows what is owed to the owner of the business (the 'proprietor'). As the owner owns the whole business the total of the bottom half should 'balance' with the total from the top half. This is why the SFP is sometimes called the 'Balance Sheet.'

If you think of it like a house that you own, if the house is worth £200,000 (the asset value) but the mortgage is still £140,000 (the liability) then your 'equity' in the house is £60,000. That's the value that you own as a net figure.



The accounting equation

The accounting equation is just a simple way of expressing how the above Statement of Financial Position works. It can also aid the understanding of double entry bookkeeping (which we will see later in the syllabus). From above you can see that:

$$\begin{array}{rcl} \text{Assets} & - & \text{Liabilities} \\ (50,000 + 35,000) & - & (12,000 + 10,000) \end{array} = \text{Capital (Proprietor's Interest)} = 63,000$$

The formula can be rearranged in different ways such as:

$$\begin{array}{rcl} \text{Assets} & = & \text{Capital (Proprietor's Interest)} + \text{Liabilities} \\ (50,000 + 35,000) & = & 63,000 + (10,000 + 12,000) \end{array}$$

Or:

$$\begin{array}{rcl} \text{Assets} & - & \text{Capital} \\ (50,000 + 35,000) & - & 63,000 \end{array} = \text{Liabilities} = (10,000 + 12,000)$$

However we choose to rearrange the equation it should always still 'balance'.

LECTURE EXAMPLE 3 – THE ACCOUNTING EQUATION

Financial accounting is based upon the accounting equation.

(a) Show whether the following statements are true or false.

	True ✓	False ✓
Assets plus liabilities are equal to capital		
Capital less assets are equal to liabilities		
Capital plus liabilities are equal to assets		

(b) Classify each of the following items as an asset or a liability.

	Asset ✓	Liability ✓
Machinery		
Bank overdraft		
Money owing to suppliers		

LECTURE EXAMPLE 4 – USING THE ACCOUNTING EQUATION

Balance Ltd had the following assets and liabilities on 6 October.

Assets and liabilities	£
Motor vehicles	53,230
Premises	98,300
Inventories	3,954
Trade payables	12,568
Cash at bank	2,944
Trade receivables	8,400
Bank loan	63,000

Show the accounting equation on 6 October by inserting the appropriate figures:

Assets

Liabilities

Capital

Remember that Assets – Liabilities = Capital.



The Statement of Profit or Loss

The Statement of Profit or Loss shows the financial **performance** of the business. This involves showing the income that the business has generated and all of the expenses that it has incurred. The difference is profit that the business has made (or loss if the expenses are greater than the income). The Statement of Profit or Loss will contain all transactions for the entire accounting period, typically an entire year.

The Statement of Profit or Loss is also called the 'Trading and profit and loss account' or the 'P & L account', all will be referred to throughout this chapter so you should become familiar with the different terminology.

The P & L account for a business contains two types of item:

- (a) **Income** such as sales to customers or bank interest received
- (b) **Expenses** such as purchases of stock, rent or salaries.

This is what a simple P & L account looks like:

Statement of Profit or Loss for the year ended 31 December 20XX

		£	£
Profit & loss account	Trading account	Sales	120,000
		Less cost of sales	
		Opening inventory	2,500
		Purchases	40,000
		Closing inventory	(4,500)
			(38,000)
		Gross profit	82,000
		Less expenses:	
		Rent	(30,000)
		Salaries	(12,000)
		Electricity	(4,000)
		Telephone expense	(800)
		Depreciation	(5,000)
		Bad debts	(3,000)
		Bank charges	(200)
			(55,000)
		Net profit for the year	27,000

This business has managed to make a profit as the total of all of the expenses is less than the sales income.

There is a link between the Statement of Profit or Loss and the Statement of Financial Position. Whatever net profit is earned in the year belongs to the owner of the business, so this figure is taken from the Statement of Profit or Loss and added to the Proprietor's Interest on the SFP. You can check that the £27,000 above is indeed added to the SFP a few pages ago.

The accounting system



We will now consider how the accounting system works to help us gather and record the information needed to produce the Financial Statements (the Statement of Financial Position and the Statement of Profit or Loss). The overall process is sometimes referred to as the '**flow of information**' as it involves taking information from each and every transaction undertaken during the year and ensuring that the details are properly reflected in the final accounts.

Financial transactions

There are a wide variety of different types of transactions that businesses may be involved in during an accounting period and you will see more and more of them as your studies and career progress.

Some of the more common transactions that you will encounter are:

- ▶ **Sales of goods and services**
- ▶ **Making purchases and paying expenses**
- ▶ **Payments into and out of the bank account**

Most financial transactions will be accompanied by a financial document of some sort. For example, if a business buys a new computer it will receive a Purchase Invoice. This is the **original, primary or 'source' document** (as it is the source of the information that will flow through our accounting system).

If you remember from earlier in the syllabus, we can often split transactions between cash transactions (those that are settled immediately) and credit transactions (those that are settled at a later date). These main types of transactions will generally have some form of source document that records them:

- ▶ **Cash transactions** (sales or purchases) will often be accompanied by a receipt, a till roll or even the chequebook stub
- ▶ **Credit transactions** will normally be accompanied by an invoice. An invoice is a demand for payment at some point in the future (remember that credit transactions are not settled immediately). Invoices will state the credit period given.

The first step in our 'flow of information' is to record these transactions in the **Books of Prime Entry (BoPE)**. The word 'prime' means 'first' (as in Prime Minister or Primary School), so the Books of Prime Entry (BoPE) are the **first place** we enter transactions into our accounting records.

In simple terms, all that the books of prime entry do is to list transactions of a similar type together. So all sales invoices issued by the business will be listed together, and all the cash receipts would be listed together.



The Books of Prime Entry

Depending on the type of transaction that we are recording we would use different Books of Prime Entry.



For each transaction undertaken by the business we have to first decide which of our Books of Prime Entry it needs to be recorded in.

- ▶ **Cash book receipts** – this will list all receipts into the bank account so would include cheque payments made by customers or proceeds of selling assets.
- ▶ **Discounts allowed day book** – this will list the prompt payment discounts that customers have taken advantage of.
- ▶ **Cash book payments** – this lists all payments out of the bank account so would include BACS payroll runs and cheques written to suppliers or to the landlord for rent.
- ▶ **Discounts received day book** – this will list all the prompt payment discounts that have been taken up from suppliers.
- ▶ **Sales day book** – all sales made on credit (sales invoices sent to credit customers).
- ▶ **Purchases day book** – all purchases made on credit (purchase invoices received from credit suppliers).
- ▶ **Sales returns day book** – to record returns of goods by customers (lists all sales credit notes issued).
- ▶ **Purchases returns day book** – to record returns of goods to suppliers (lists all purchase credit notes received).
- ▶ **Journal book** – this lists various transactions not initially recorded in any of the above (you will learn more about this book in more detail in later studies).
- ▶ **Petty cash book** – records small cash transactions paid for out of the petty cash tin e.g. the purchase of stamps.

The General Ledger

Entering the details of financial transaction into the Books of Prime Entry is just the first step in the 'flow of information'. Once the data has been collected in these books it then gets transferred to the General Ledger. The AAT sometimes refer to the General Ledger as the **Nominal** or **Main** Ledger in the assessment.

The General Ledger will contain a separate record of each type of transaction that the business has undertaken. It will have a record for sales, a record for purchases, a record for salary costs, a record for rent, a record for amounts owed to the bank, a record of the vehicles owned, and many others.

Each of these separate records is known as an 'account'. If someone talks about the 'rent account' they mean the individual record of how much rent expense the business has incurred in its accounting period.

To enter the summarised transactions into the Nominal Ledger we use a system of double entry bookkeeping. We will learn about this later in this syllabus.

The Trial Balance

At the end of the accounting period the Trial Balance lists the balances from each of the accounts from the General Ledger. The Trial Balance (or TB) is a check on whether it looks like all of the transactions have been correctly entered into the accounting system. The figures from the Trial Balance will be used to produce the Financial Statements.

The Financial Statements

Once the Trial Balance has been completed we would be in a position to draw up our year-end Financial Statements. The P & L account would include all income and expense accounts for the year so that we can work out how well the business has performed during the year by calculating the profit generated. The Balance Sheet would include all assets and liability accounts so that we can establish the position of the business at the end of the year.

Digital bookkeeping systems

Throughout this unit, we talk about the 'books' of prime entry but the reality is that very few businesses use handwritten books to keep their records anymore. Digital bookkeeping systems have become popular because they are able to automate a lot of the processes that bookkeepers traditionally did manually. Nevertheless, it is still important that you learn the principles of manual bookkeeping so that you understand what is going on 'behind the scenes' in the digital bookkeeping systems and you can identify and correct errors.

One of the benefits of digital systems is that they save time. Instead of manually entering hundreds of transactions, they can import these transactions in a matter of minutes. Data can be imported from:

- ▶ Bank records, by linking your bookkeeping system to your online banking
- ▶ Spreadsheets or csv files
- ▶ Third party software, if you use multiple systems

Benefits of digital systems

- ▶ Saves time, as discussed above, and therefore saves on finance staff costs too.
- ▶ Convenience, as many of the market-leading systems are app-based, the business owner can update their records 'on the go.'
- ▶ Automatically transfers data from books of prime entry to the ledgers and control accounts.
- ▶ Reduces errors or omissions. A direct import of transactions is likely to be more accurate than manually copying records across.
- ▶ Automatically carries out reconciliations such as:
 - Cash book to bank statement
 - Receivables and payables ledgers to their respective control accounts
- ▶ Can automatically produce a trial balance, meaning that the business owner can easily produce a snapshot of their finances in real time.
- ▶ Entries can be duplicated in order to save time. For example, a rent payment which is exactly the same each month can be processed as a recurring entry.

Drawbacks of digital systems

It is important to remember that systems will only be as accurate as the data that is input into them. Therefore, whether we are dealing with manual or digital systems, it is always important to be as accurate as possible when entering transactions.

There is also a risk that we become too trusting of digital systems. Just because the computer says it has automatically balanced the cash book or control accounts, doesn't necessarily mean the underlying transactions are automatically correct. Carrying out some manual checks on the records is recommended.

We may also find that digital systems create errors if they have not been set up correctly. Recurring entries which automatically post the same amount each week/month may be out of date if the amount or frequency changes, which then creates work to fix the errors.

First Intuition

Here are some Practice Examples for you to try...

PRACTICE EXAMPLE 1 - USERS OF ACCOUNTS

List some of the typical users of the financial statements of the business. For each user give an indication of why they are interested in looking at the accounts.

PRACTICE EXAMPLE 2 - BASIC ACCOUNTING TERMINOLOGY

Link the terms in the boxes on the left with the appropriate description in the boxes on the right:

Asset

Something that the business owes to someone else

Liability

The sales made by a business to customers

Income

Something that the business owns

Expense

Costs incurred by the business

PRACTICE EXAMPLE 3 - UNDERSTANDING BASIC DEFINITIONS

For each of the items below identify whether they would be classified as an asset, a liability, an expense or as income.

	Asset ✓	Liability ✓	Expense ✓	Income ✓
Wages paid for the month				
Machinery for the factory				
Loan from an investor				
Cash in the petty cash tin				
Sales of units to a customer				
Customer outstanding balance owed to the business				
Supplier outstanding balance owed by the business				
Premises where production takes place				
A bank overdraft				
Materials used in production				

PRACTICE EXAMPLE 4 - CAPITAL VERSUS REVENUE ITEMS

Write brief explanations of each of the following terms:

Capital expenditure –

Revenue expenditure –

Capital income –

Revenue income –

PRACTICE EXAMPLE 5 - CAPITAL VERSUS REVENUE ITEMS

Select one option in each instance below to show whether the item will be capital expenditure, revenue expenditure, capital income or revenue income.

Item	Capital expenditure ✓	Revenue expenditure ✓	Capital income ✓	Revenue income ✓
Receipts from cash sales				
Amounts paid into the business by the owner				
Receipts from credit customers				
Payment of monthly wages				
Purchase of a machine				
Receipt from sale of a machine				
Purchase of units for resale to customers				

PRACTICE EXAMPLE 6 - THE FINANCIAL STATEMENTS

Link the terms in the boxes on the left with the statement in which they would appear in the financial statements.

Liabilities

Expenses

Income

Assets

The statement of financial
position (balance sheet)The statement of profit or loss
(P & L)

PRACTICE EXAMPLE 7 - ASSETS AND LIABILITIES

Show whether the items below are assets or liabilities by drawing an arrow to connect each left hand box to the appropriate right hand box.

Premises

Loan from a bank

Cash in the bank

VAT owing to HMRC

Machinery

Assets

Liabilities

PRACTICE EXAMPLE 8 - ASSETS AND LIABILITIES

Show whether the items below are assets or liabilities by drawing an arrow to connect each left hand box to the appropriate right hand box.

Trade receivables

Bank overdraft

Trade payables

VAT owing from HMRC

Inventories

Assets

Liabilities

PRACTICE EXAMPLE 9 - THE ACCOUNTING EQUATION

Show which THREE of the following statements are correct definitions of the accounting equation.

	Tick (3)
Assets – liabilities = capital	<input type="checkbox"/>
Assets + liabilities = capital	<input type="checkbox"/>
Assets = liabilities + capital	<input type="checkbox"/>
Assets = liabilities – capital	<input type="checkbox"/>
Liabilities = assets + capital	<input type="checkbox"/>
Liabilities = assets – capital	<input type="checkbox"/>

PRACTICE EXAMPLE 10 - THE ACCOUNTING EQUATION

Financial accounting is based upon the accounting equation.

(a) Show whether the following statements are true or false.

	True ✓	False ✓
Assets less liabilities are equal to capital		
Assets less capital are equal to liabilities		
Capital less liabilities are equal to assets		

(b) Classify each of the following items as an asset or a liability.

	Asset ✓	Liability ✓
Computer equipment		
Money owed by customers		
Money owing to suppliers		

PRACTICE EXAMPLE 11 - THE ACCOUNTING EQUATION

Answer the following questions on the accounting equation.

Questions	£
If assets total £30,000 and liabilities total £25,000 what is the amount of capital?	
If liabilities total £40,000 and capital is £20,000 what is the amount of assets?	
If capital is £50,000 and assets total £90,000 what is the total of liabilities?	

PRACTICE EXAMPLE 12 - THE ACCOUNTING EQUATION

Answer the following questions on the accounting equation.

Questions	£
If assets total £23,489 and liabilities total £12,845 what is the amount of capital?	
If liabilities total £45,594 and capital is £67,492 what is the amount of assets?	
If capital is £22,321 and assets total £192,389 what is the total of liabilities?	

PRACTICE EXAMPLE 13 - THE ACCOUNTING EQUATION

Statements Ltd had the following assets and liabilities on 12 June.

Assets and liabilities	£
Machinery	24,390
Premises	35,400
Inventories	2,390
Trade payables	4,320
Cash at bank	1,230
Trade receivables	6,420
Bank loan	37,500

Show the accounting equation on 12 June by inserting the appropriate figures:

Assets £

Liabilities £

Capital £

PRACTICE EXAMPLE 14 - THE ACCOUNTING EQUATION

Statements Ltd had the following assets and liabilities on 4 July.

Assets and liabilities	£
Machinery	31,395
Premises	38,342
Inventories	2,834
Trade payables	5,219
Bank overdraft	835
Trade receivables	7,328
Bank loan	41,234

Show the accounting equation on 4 July by inserting the appropriate figures:

Assets £

Liabilities £

Capital £

PRACTICE EXAMPLE 15 - BOOKS OF PRIME ENTRY

Link the Books of Prime Entry in the boxes on the left with the appropriate descriptions of the transactions that they deal with.

Cash book receipts

A list of all credit sales made by the business

Cash book payments

A list of all receipts into the business bank account

Sales day book

A list of all credit purchases made by the business

Purchases day book

A list of all payments made out of the business bank account

PRACTICE EXAMPLE 16 – BOOKKEEPING SYSTEMS

Identify whether the following statements regarding bookkeeping systems are true or false.

	True ✓	False ✓
A digital bookkeeping system will always ensure your transactions are posted accurately.		
A digital bookkeeping system will always be better than a manual one.		
A digital bookkeeping system can import transactions from a spreadsheet.		
A digital bookkeeping system will always have high set up costs.		
A manual bookkeeping system will always be cheaper to run than a digital system.		

First Intuition

Solutions to Lecture Examples

Lecture example 1 - Understanding basic definitions

Rent paid for the month – this is an **expense** that will reduce the profit of the business.

Computer equipment for the office – this is an **asset** that is owned by the business.

Customer outstanding balance owed to the business – this is what we often refer to as a receivable or debtor which is an **asset**.

Electricity bill for a three month period – this an **expense** like the rent.

1,500 units of stock in the warehouse – this is an **asset** that is owned by the business (until they sell them!).

Loan from a bank – this is a **liability** that is owed by the business to the bank.

£100 in the business bank account – this cash is an **asset** owned by the business.

Purchase of 100 envelopes for the post room – this is an **expense**.

Lecture example 2 - Capital versus revenue items

Item	Capital expenditure	Revenue expenditure	Capital income	Revenue income
Receipts from credit customers				✓
Receipts from cash sales				✓
Receipts from owner			✓	
Receipt from sale of a motor vehicle			✓	
Purchase of a delivery van	✓			
Purchase of goods for resale to customers		✓		
Purchase of postage stamps using petty cash		✓		

Lecture example 3 - The accounting equation

Financial accounting is based upon the accounting equation.

(a) Show whether the following statements are true or false.

	True ✓	False ✓
Assets plus liabilities are equal to capital		✓
Capital less assets are equal to liabilities		✓
Capital plus liabilities are equal to assets	✓	

(b) Classify each of the following items as an asset or a liability.

Item	Asset or liability?
Machinery	Asset
Bank overdraft	Liability
Money owing to suppliers	Liability

Lecture example 4 - Using the accounting equation

Show the accounting equation on 6 October by inserting the appropriate figures:

Assets	166,828	$£53,230 + £98,300 + £3,954 + £2,944 + £8,400$
Liabilities	75,568	$£12,568 + £63,000$
Capital	91,260	$£166,828 - £75,568$

Solutions to Practice Examples

PRACTICE EXAMPLE 1 - USERS OF ACCOUNTS

Owners – to identify the return they are receiving on their investment in the business

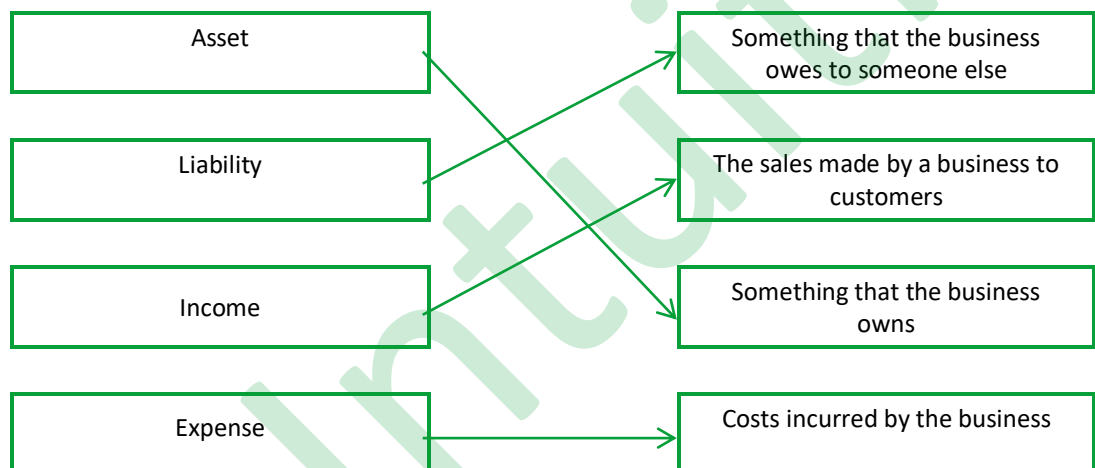
Managers – to see if they are meeting their targets and will receive a bonus

Banks – to identify whether they should lend to the business

Suppliers – to identify whether they should offer credit to the business

Staff – to see whether they will receive bonuses

PRACTICE EXAMPLE 2 - BASIC ACCOUNTING TERMINOLOGY



PRACTICE EXAMPLE 3 - UNDERSTANDING BASIC DEFINITIONS

	Asset ✓	Liability ✓	Expense ✓	Income ✓
Wages paid for the month			✓	
Machinery for the factory	✓			
Loan from an investor		✓		
Cash in the petty cash tin	✓			
Sales of units to a customer				✓
Customer outstanding balance owed to the business	✓ Trade receivables			
Supplier outstanding balance owed by the business		✓ Trade payables		
Premises where production takes place	✓			
A bank overdraft		✓ Owed to bank		
Materials used in production			✓	

PRACTICE EXAMPLE 4 - CAPITAL VERSUS REVENUE ITEMS

Capital expenditure - this is where you are spending money to acquire an asset that will be owned for several years e.g. buying a motor vehicle or premises.

Revenue expenditure - this is where you are spending money in a way that will only affect the business in the short-term i.e. paying the electricity bill for a quarter or purchasing materials that will be sold next week.

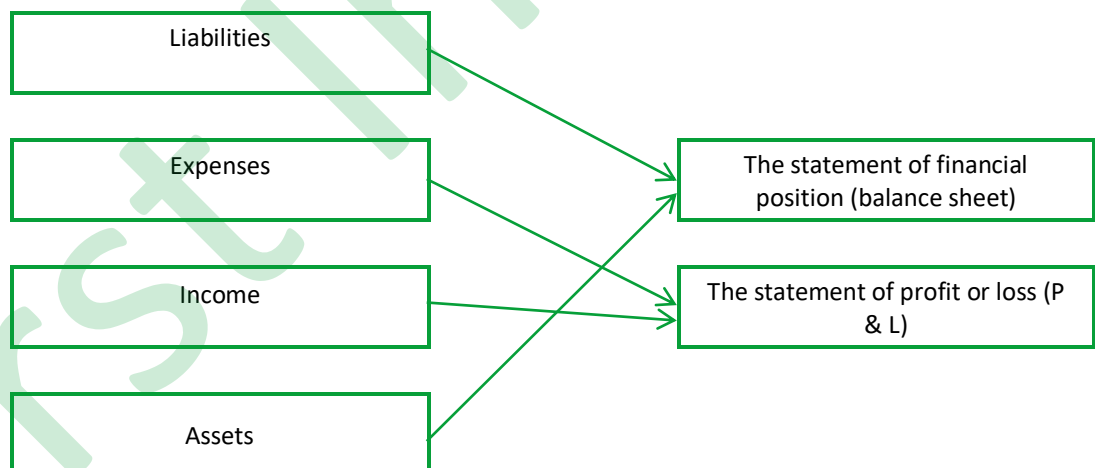
Capital income - this is where you are generating income by selling an item that was treated as capital expenditure when it was purchased i.e. when disposing of a motor vehicle. Capital income also includes amounts received from the owner as an investment in the business.

Revenue income - this covers the majority of day-to-day sales of a business, whether sold on cash or credit terms i.e. an electrical retailer selling a television.

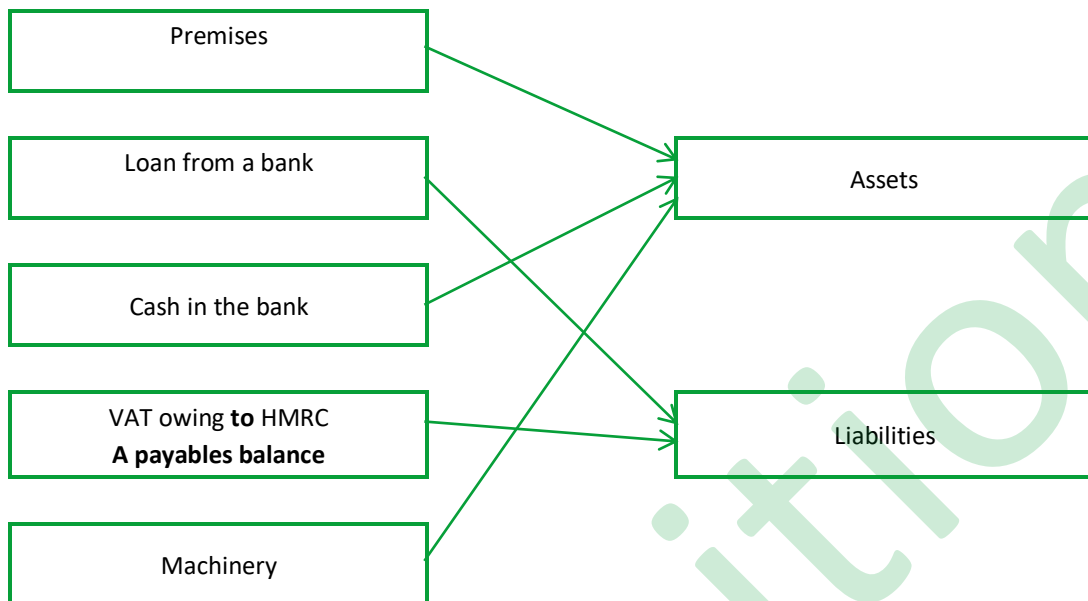
PRACTICE EXAMPLE 5 - CAPITAL VERSUS REVENUE ITEMS

Item	Capital expenditure ✓	Revenue expenditure ✓	Capital income ✓	Revenue income ✓
Receipts from cash sales				✓
Amounts paid into the business by the owner			✓	
Receipts from credit customers				✓
Payment of monthly wages		✓		
Purchase of a machine	✓			
Receipt from sale of a machine			✓	
Purchase of units for resale to customers		✓		

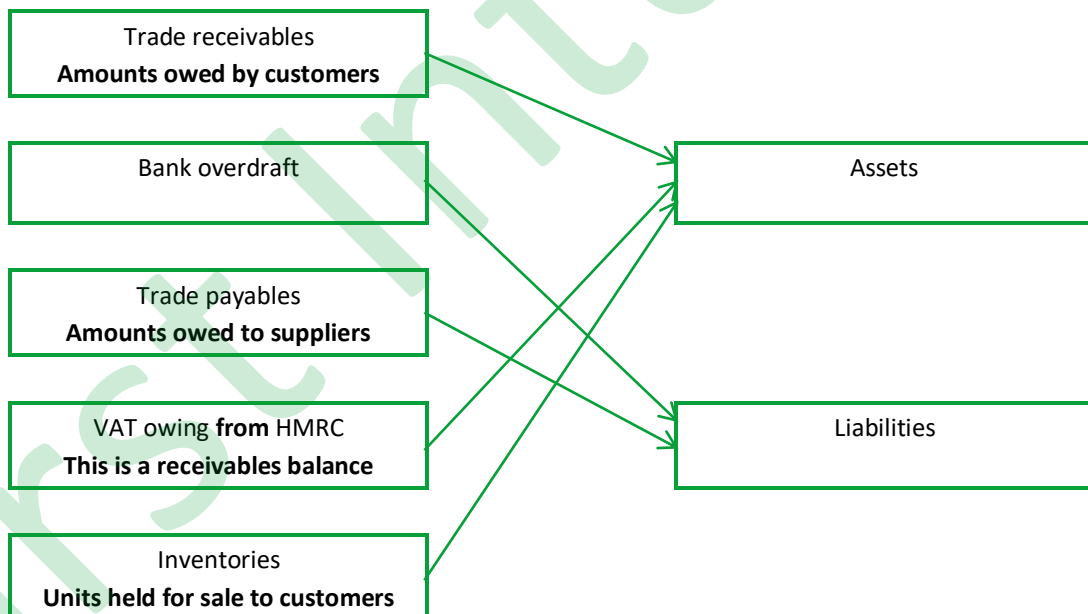
PRACTICE EXAMPLE 6 - THE FINANCIAL STATEMENTS



PRACTICE EXAMPLE 7 - ASSETS AND LIABILITIES



PRACTICE EXAMPLE 8 - ASSETS AND LIABILITIES



PRACTICE EXAMPLE 9 - THE ACCOUNTING EQUATION

The accounting equation is:

$$\text{assets} - \text{liabilities} = \text{capital}$$

This can be rearranged in various ways, such as:

$$\text{assets} = \text{liabilities} + \text{capital} \text{ or}$$

$$\text{liabilities} = \text{assets} - \text{capital}$$

	Tick
Assets – liabilities = capital	<input checked="" type="checkbox"/>
Assets + liabilities = capital	<input type="checkbox"/>
Assets = liabilities + capital	<input checked="" type="checkbox"/>
Assets = liabilities – capital	<input type="checkbox"/>
Liabilities = assets + capital	<input type="checkbox"/>
Liabilities = assets – capital	<input checked="" type="checkbox"/>

PRACTICE EXAMPLE 10 - THE ACCOUNTING EQUATION

- (a) It can help to use some simple figures here to work out if each statement is true or false. We know that $\text{Assets} - \text{Liabilities} = \text{Capital}$, so let's say that Assets are 5 and Liabilities are 2, this means that Capital must be $5 - 2 = 3$.

	True ✓	False ✓
Assets less liabilities are equal to capital; 5 - 2 does equal 3	✓	
Assets less capital are equal to liabilities; 5 - 3 does equal 2	✓	
Capital less liabilities are equal to assets; 3 - 2 = 1!! This is not the value of assets		✓ Assets = liabilities + capital

- (b)

	Asset ✓	Liability ✓
Computer equipment	✓	
Money owed by customers	✓ Trade receivables	
Money owing to suppliers		✓ Trade payables

PRACTICE EXAMPLE 11 - THE ACCOUNTING EQUATION

Questions	£
If assets total £30,000 and liabilities total £25,000 what is the amount of capital? Capital = assets - liability = £30,000 - £25,000 = £5,000	5,000
If liabilities total £40,000 and capital is £20,000 what is the amount of assets? Assets = liabilities + capital = £40,000 + £20,000 = £60,000	60,000
If capital is £50,000 and assets total £90,000 what is the total of liabilities? Liabilities = assets - capital = £90,000 - £50,000 = £40,000	40,000

PRACTICE EXAMPLE - 12 THE ACCOUNTING EQUATION

Questions	£
If assets total £23,489 and liabilities total £12,845 what is the amount of capital? Capital = assets – liabilities = £23,489 - £12,845 = 10,644	10,644
If liabilities total £45,594 and capital is £67,492 what is the amount of assets? Assets = liabilities + capital = £45,594 + £67,492 = £113,086	113,086
If capital is £22,321 and assets total £192,389 what is the total of liabilities? Liabilities = assets – capital = £192,389 - £22,321 = £170,068	170,068

PRACTICE EXAMPLE 13 - THE ACCOUNTING EQUATION

Assets = £24,390 + £35,400 + £2,390 + £1,230 + £6,420 = £ **69,830**

Liabilities = £4,320 + £37,500 = £ **41,820**

Capital = assets – liabilities = £69,830 - £41,820 = £**28,010**

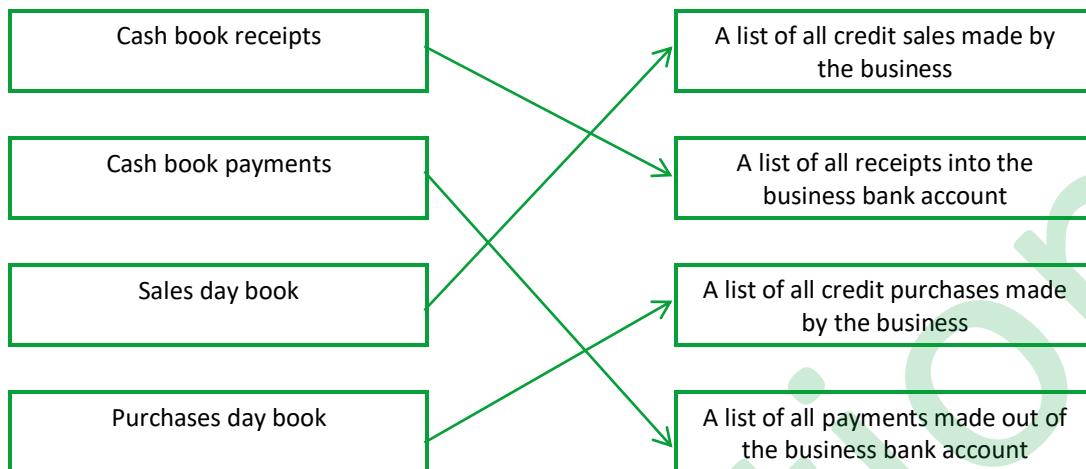
PRACTICE EXAMPLE 14 - THE ACCOUNTING EQUATION

Assets = £31,395 + £38,342 + £2,834 + £7,328 = £**79,899**

Liabilities = £5,219 + £835 + £41,234 = £**47,288** Notice that the bank balance is an overdraft in this task.

Capital = assets – liabilities = £79,899 - £47,288 = £**32,611**

PRACTICE EXAMPLE 15 - BOOKS OF PRIME ENTRY



PRACTICE EXAMPLE 16 – BOOKKEEPING SYSTEMS

Identify whether the following statements regarding bookkeeping systems are true or false.

	True ✓	False ✓
A digital bookkeeping system will always ensure your transactions are posted accurately.		✓ Errors can still occur
A digital bookkeeping system will always be better than a manual one.		✓ Not necessarily for some small organisations
A digital bookkeeping system can import transactions from a spreadsheet.	✓	
A digital bookkeeping system will always have high set up costs.		✓ Not necessarily, software can be paid for by monthly subscription
A manual bookkeeping system will always be cheaper to run than a digital system.		✓ Not necessarily when you factor in staff costs