Chapter 3

Solution 3.1

What is the difference between an Income Statement for a service provider compared to a product provider?

The income statement is normally prepared for a period of time showing the summary of revenues and expenses over that period. The presentation of the income statement will differ for businesses that offer a service (consultants, banks, tour operators) to those that sell a product (retailers and publicans).

Income statement for period ended 30 June

SERVICE PROVIDER

	€	€
Sales		**100,000**
Less expenses		
Rent	18,000	
Rates	5,000	
Wages and Salaries	40,000	
Repairs	3,500	
Advertising	5,000	
Accountants' fees	2,000	
Solicitors' fees	1,000	
Insurance	7,000	
Phone	1,500	83,000
Net Profit		**17,000**

Income statement for period ended 30 June

PRODUCT PROVIDER

	€	€
Sales		130,000
Less the cost of sales		40,000
Gross Profit		90,000
Less expenses		
Rent & rates	12,000	
Wages and Salaries	25,000	
Repairs	2,100	
Advertising	3,000	
Professional fees	4,000	
Office expenses	14,900	
Insurance	4,500	65,500
Net Profit		**24,500**

The difference between the two statements is that the provider of services does not purchase stock of goods for resale. The product provider purchases stock at one price (cost price) and sells it at another price (selling price). The difference between the two will amount to his gross profit and is shown in a trading account.

Solution 3.2

Distinguish between revenues and expenses using examples to illustrate your answer?

Revenue is the income generated by the business from the sale of its product or service. It is important to note that revenues include both cash and credit sales. Thus a sale is recorded even if the monies are not yet received. This is based on the realisation concept (see below) which states that a transaction is recorded when the purchaser incurs liability for the goods even though no cash may have changed hands. Revenues do not include any monies received by means of loans or cash received from selling fixed assets. These are transactions that affect the statement of financial position. Revenues are income earned (not necessarily received) from the sales of the products or services provided by the business.

Expenses are the costs incurred in running then business on a day to day basis and do not include the purchase of fixed assets or the repayment of any loans. Expenses are the cost of using the resources available to a business (people and fixed assets) to produce a product or service and sell it. Examples include purchases of inventory, wages for personnel, fuel to power assets (motor vehicles equipment), repairs to fixed assets, light and heat, insurance, advertising, rent , rates, telephone and internet costs, accounting fees and general expenses.

Solution 3.3

	Account to be debited	**Account to be credited**

1. Paid electricity by cheque	**Electricity a/c**	**Bank a/c**
2. Paid for stationary by cash	**Stationary a/c**	**Cash a/c**
3. Paid insurance by cheque	**Insurance a/c**	**Bank a/c**
4. Returned stationary for cash refund	**Cash a/c**	**Stationary a/c**
5. Paid wages by cheque	**Wages a/c**	**Bank a/c**
6. Received rent in cash from a tenant.	**Cash a/c**	**Rent Received a/c**
7. Paid motor expenses in cash.	**Motor Exps a/c**	**Cash a/c**

b)

DR — Bank Account — CR

		€			€
			1	Electricity	xxx
			3	Insurance	xxx
			5	Wages	xxx

DR — Cash Account — CR

		€			€
4	Stationary	xxx	2	Stationary	xxx
6	Rent Received	xxx	7	Motor Expenses	xxx

DR — Electricity Account — CR

		€			€
1	Bank	xxx			

DR — Stationary Account — CR

		€			€
2	Cash	xxx	4	Cash	xxx

DR — Insurance Account — CR

		€			€
6	Bank	xxx			

DR			Wages Account		CR
		€			€
5	Bank	xxx			

DR			Rent Receivable Account		CR
		€			€
			6	Bank	xxx

DR			Motor Expenses Account		CR
		€			€
7	Cash	xxx			

Solution 3.4

Identify the four accounts that record inventory transactions and explain why the asset of inventory is accounted for through these accounts

For businesses buying and selling products the selling price is normally set at a price above the cost price – otherwise the business would not make a profit. Inventory is bought at one price, the purchase price, and sold at another price (normally higher), the selling price. It makes no sense to have one account for inventory as goods are purchased and sold at different prices. Thus the actual inventory account is divided into four separate accounts as follows.

- Sales account - Detailing all inventory sold at selling price
- Sales returns account - detailing all inventory returned at selling price Inventory
- Purchases account - detailing all inventory purchased at cost price.
- Purchases returns account - detailing all inventory returned at cost price

These four accounts record all inventory going into the business (either through purchases or sales returns) and going out of the business (either through sales or purchases returns).

Solution 3.5

How a debit can represent both an asset and an expense

Assets are like expenses as, to acquire them, involves the outlay of some resource, usually money. Assets, expenses and losses are a cost to the organisation.

Also expenses have the effect of reducing profit and this has the effect of reducing capital. To reduce capital one must debit the account. Thus expenses and assets are represented by debits in double entry accounting.

Solution 3.6

(a)

	Account to be debited	**Account to be credited**
1. Stock purchased on credit	**Purchases a/c**	**Irish W/S Ltd a/c**
2. Stock purchased by cheque	**Purchases a/c**	**Bank a/c**
3. Cash sales	**Cash a/c**	**Sales a/c**
4. Credit sales	**D&D Ltd a/c**	**Sales a/c**
5. Purchases returns	**Irish W/S Ltd a/c**	**Purchases returns a/c**
6. Sales returns	**Sales returns a/c**	**D&D Ltd a/c**
7. Paid creditor	**Irish W/S Ltd a/c**	**Bank a/c**
8. Debtor paid	**Bank a/c**	**D&D Ltd a/c**

(b)

DR		Irish W/S Ltd Account			CR
		€			€
5	Purchases returns	500	1	Purchases	5,000
7	Bank	4,500			

DR		Purchases Account			CR
		€			€
1	Irish W/S a/c	5,000			
2	Bank a/c	3,500			

DR		Bank Account			CR
		€			€
8	DD Ltd	1,000	2	Purchases	3,500
			7	Irish W/S Ltd	4,500

DR		Sales Account			CR
		€			€
			3.	Cash A/C	2,800
			4	D.D. Ltd	1,750

DR		Cash Account			CR
		€			€
3.	Sales	2,800			

DR		DD Ltd Account			CR
		€			€
2	Sales A/C	1,750	3.	Sales returns	200
			8	Bank	1,000

DR		Purchases Returns Account			CR
		€			€
			5	Irish W/S Ltd A/C	500

DR		Sales Returns Account			CR
		€			€
6	DD Ltt	200			

Solution 3.7

	Account to be debited	Account to be credited
1. Credit purchases	**Purchases a/c**	**AA Ltd a/c**
2. Paid rent	**Rent a/c**	**Bank a/c**
3. Stationery bought	**Stationery a/c**	**Cash a/c**
4. Stock purchased	**Purchases a/c**	**Bank a/c**
5. Cash sales	**Cash a/c**	**Sales a/c**
6. Credit sales	**BB Ltd a/c**	**Sales a/c**
7. Purchases returns	**AA Ltd a/c**	**Purchases returns a/c**
8. Sales returns	**Sales returns a/c**	**BB Ltd a/c**
9. Paid rates	**Rates a/c**	**Bank a/c**
10. Paid wages	**Wages a/c**	**Bank a/c**
11. Paid cleaning	**Cleaning exps a/c**	**Cash a/c**
12. New Equipment	**Equipment a/c**	**Bank a/c**
13. Repairs to equipment	**Repairs a/c**	**Cash a/c**
14. Cash drawings	**Drawings a/c**	**Cash a/c**
15. Stock drawings	**Drawings a/c**	**Purchases a/c**

Solution 3.8

DR **Capital Account** **CR**

May		€	May		€
			1	Bank a/c	25,000

DR **Bank Account** **CR**

May		€	May		€
1	Capital a/c	25,000	2	Equipment a/c	5,000
10	Sales a/c	4,000	6	Purchases a/c	3,000

25	Rent receivable a/c	280	15	Rent a/c	1,000
			16	Stationery a/c	400
			16	Advertising a/c	250
			20	Drawings a/c	300
			22	Jackod a/c	1,500
			23	Wages a/c	800
			26	Travel expenses a/c	200
			30	AA Motors Ltd	8,000

DR			Drawings Account		CR
May		€	May		€
20	Bank a/c	300			
27	Purchases a/c	100			

DR			Equipment Account		CR
May		€	May		€
2	Bank a/c	5,000			

DR			Vehicles Account		CR
May		€	May		€
4	AA Motors Ltd	8,000			

DR			Purchases Account		CR
May		€	May		€
5	Jackod Ltd a/c	2,000	27	Drawings	100
6	Bank a/c	3,000			

DR			Purchases Returns Account		CR
May		€	May		€
			18	Jackod Ltd a/c	500

DR			Sales Account		CR
May		€	May		€
			10	Bank a/c	4,000
			29	G. Dunne a/c	350

DR			Rent Payable Account		CR
May		€	May		€
15	Bank a/c	1,000			

DR			Stationery Account		CR
May		€	May		€
16	Bank a/c	400			

DR		Advertising Account			CR
May		€	May		€
16	Bank a/c	250			

DR		Wages Account			CR
May		€	May		€
23	Bank a/c	800			

DR		Travel Expenses Account			CR
May		€	May		€
26	Bank a/c	200			

DR		Rent Receivable Account			CR
May		€	May		€
			25	Bank a/c	280

DR		Creditor - AA Motors Account			CR
May		€	May		€
30	Bank a/c	8,000	4	Vehicles a/c	8,000

DR		Creditor – Jackod Ltd Account			CR
May		€	May		€
18	Purchases returns a/c	500	5	Purchases a/c	2,000
22	Bank a/c	1,500			

DR		Debtor – G. Dunne Account			CR
May		€	May		€
29	Sales a/c	350			

Solution 3.9

Explain in your own words the relationship between 'net profit' and 'capital'.

If a business makes a profit then this profit belongs to the owner and, should the owner decide to keep the profit in the business, then profit increases capital (the amount the owner puts into the business). On the other hand, losses decrease capital. In general most business will retain a lot of profits in the business, as this is an important form of finance to enable the business to expand.

What do you understand by the term 'drawings'.

The term 'drawings' represents money or any other asset taken out of a business by the owner for his own use. For example, if the owner of the business withdrew cash or stock for his own use. Drawings is the opposite to capital and, in the balance sheet, drawings is deducted from capital to show the net capital invested by the owner.

Solution 3.10

By comparing the differences in the statements of financial position from one date to the next you are required to state as fully as possible what transaction took place.

1. Purchased equipment for €10,000 paying by cheque.
2. Purchased inventory for €10,000 paying by cheque.
3. Four transaction have occurred between 12 and 15 January
    - Owner invested a further €50,000 in the business.
    - The business acquired additional loans of €50,000
    - The business acquired additional premises for €100,000
    - The business paid amount owing to accounts payable amounting to €3,000- the amount paid by cash.
4. The business sold inventory originally costing €10,000 for €20,000 with the monies received immediately
5. The business sold inventory on originally costing €5,000 for €10,000. The sale was on credit