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The Closing-off procedure, determining profit and preparing Financial Statements

Study Unit 7(A)

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Study Unit 7(A): The closing-off procedure

Introduction

Lecture 1

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The accounting cycle… so far

1. Capture transactions on source documents (Daily)
2. Analyse transactions and create journals (Daily)
3. Post to Ledgers (Daily / Monthly)
4. Balance accounts and prepare TB (Monthly)
5. Adjust accounts, create post-adjustment TB (Annually)

Lecture 1

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The accounting cycle... continues

Adjust accounts, create post-adjustment TB (Annually)

Closing of Nominal Accounts (Annually)

Prepare Financial Statements and report on results (Annually)

Lecture 1

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Study Unit 7(A): The closing-off procedure

Closing off procedure for a service entity

Lecture 2

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Why do we close off?

- Our recordings so far include the following:
  - Assets
  - Liabilities
  - Equity
  - Income
  - Expenses
- Our Basic Accounting Equation includes:
  - Assets
  - Liabilities
  - Equity

Lecture 2

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Income & Expenses

- What do we do with the Income and Expenses we've raised through the year?
  - We record these so that we can assess how much profit we've made
  - We have to pull these all together into one account so we can calculate our profit / loss
  - A profit will increase the owner's equity, a loss will decrease this (remember: Equity = Assets – Liabilities)

Lecture 2

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Profit or Loss Account

- At the end of every period, we close off the Nominal accounts to the Profit or Loss Account
- These all require entries, since we have balances on all of these Nominal Accounts
- We NEVER pass entries directly in the GL… so these will require GJ entries first

Lecture 2

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Example

- ACDC Services has the following balances at yearend:

– Capital	5 600
– Income	2 450
– Wages	875
– Cash in Bank	1 100
– General expenses	580
– Equipment	5 495

- Journalise the closing entries and prepare the accounts in the GL

Lecture 2

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Example: GJ

- General Journal

General Journal – February 2013 GJ1

Date	Details	Fol	Debit	Credit
28 Feb	Income	N1	2 450	
	Profit or Loss	N10		2 450
	Closing entry			

Lecture 2

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Example: Posting to GL

Dr Income N1 Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
28 Feb	Profit or Loss	GJ1	2 450		28 Feb	Balance	b/d	2 450

Dr Profit or Loss N10 Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
					28 Feb	Income	GJ1	2 450

Lecture 2

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Example: GJ

- General Journal

General Journal – February 2013 GJ1

Date	Details	Fol	Debit	Credit
28 Feb	Profit or Loss	N10	1 455	
	Wages	N4		875
	General Expenses	N5		580
	Closing entry			

Lecture 2

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Example: Posting to GL

Dr | Wages | N4 | Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
28 Feb	Balance	b/d	875		28 Feb	Profit or Loss	GJ1	875

Dr | General Expenses | N5 | Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
28 Feb	Balance	b/d	580		28 Feb	Profit or Loss	GJ1	580

Lecture 2

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Example: Posting to GL

Dr Profit or Loss N10 Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
28 Feb	Wages	GJ1	875		28 Feb	Income	GJ1	2 450
28 Feb	Wages	GJ1	580					

Lecture 2

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Example: GJ

- General Journal

General Journal – February 2013 GJ2

Date	Details	Fol	Debit	Credit
28 Feb	Profit or Loss	N10	995	
	Capital	B1		995
	Transfer of profit for the year to the capital account			

Lecture 2

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Example: Posting to GL

Dr **Profit or Loss** N10 **Cr**

Date	Details	Fol	Amount		Date	Details	Fol	Amount
28 Feb	Wages	GJ1	875		28 Feb	Income	GJ1	2 450
28 Feb	Wages	GJ1	580					
	Capital	GJ1	995					
			2 450					2 450

Lecture 2

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What effect does this have?

- At the end of the year, we need to ‘clear’ the income and expenses out, and move the profit to Equity, so that we can show the financial position of the business. The owners will want to know what effect the year has had on their investment in the company
- The Capital account will include the Capital contributions, the effect of the drawings, as well as the net profit

Lecture 2

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Study Unit 7(A): The Financial Statements

Statement of Changes in Equity

Lecture 3

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Statement of Changes in Equity for the year ended…

Capital:	
Balance as at (beginning of year)	5 600
Profit / Total Comprehensive income for the year	995
Drawings	-
Balance as at (end of year)	6 595

Lecture 3

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Study Unit 7: The Financial Statements

Statement of Financial Position

Lecture 4

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Statement of Financial Position as at (yearend)

ASSETS	
Non-Current Assets	5 995
Property, Plant & Equipment	5 995
Current Assets	1 100
Cash and Cash Equivalents	1 100
	7 095
EQUITY AND LIABILITIES	
Total Equity	6 595
Capital	6 595
Total Liabilities	
Non-Current Liabilities	-
Current Liabilities	
Trade and other Payables	500
	7 095

Lecture 4

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Study Unit 7: The closing-off procedure

Closing off procedure for a trading entity

Lecture 5

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What is the difference from a service entity?

- Gross Profit
  - Sales less Cost of Sales
  - Since the business makes it's money off buying stuff and selling it for a higher price, we need to be very clear about how much 'extra' we're selling it for (the mark-up on cost)
  - From there, we need to make sure that the Gross Profit will cover all the other expenses, and still make a net profit

Lecture 5

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How do we calculate the markup?

- Example:
  - You buy stock for R400 and sell it for R700. Selling expenses amount to R150
  - You have made a Gross Profit of R700 – R400 = R300
  - Your Profit is your Gross Profit less your other expenses R300 – R150 = R150
  - Mark-up % on cost: (300 / 400) X (100 / 1) = 75%
  - Mark-up % on selling price: (300 / 700) X (100 / 1) = 42.8%

Lecture 5

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So how do we deal with this?

- We calculate the Gross Profit in a Trading Account
  - This is the same concept as the Profit and Loss account, but only for the Sales and Cost of Sales
  - From there we transfer it to the Proift and Loss account
  - We then treat it the same as the service entity

Lecture 5

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Study Unit 7: The closing-off procedure

Cost of Sales for a Trading Entity

Lecture 6

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Isn’t Cost of Sales just Purchases?

- We want to calculate how much profit we’ve made on the items that we’ve sold through the year
- Our purchases represent ALL the stock we’ve purchased through the year, BUT… some of it will still be on hand at the end of the year
- Since we haven’t sold it yet, it would distort our Gross Profit figures

Lecture 6

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So what do we do?

- In one year, we'd have costs with no income, and in the next year, income with no costs!
- We remove the costs related to stock still on hand at yearend
  - This is the same concept as the Consumables on Hand
- We recognise that stock as an asset, since we will benefit from that in the future

Lecture 6

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How do we know how much stock we have?

- There are two types of stock systems we can use:
  - Perpetual Inventory System
  - Periodic Inventory System
- The way we recognise purchases, calculate Cost of Sales and treat the Trading Account will differ depending on these, BUT the overall profit won't be different! It's merely two different ways you could do the same thing!

Lecture 6

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Study Unit 7: The closing-off procedure

Periodic Inventory System

Lecture 7

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What is the periodic system?

- One way of knowing how much stock you have on hand at yearend is by performing a stock count at yearend
- Once you know how many items you have, you can reverse the cost of these out, and take them to the Trading Account
- This will mean that the Trading Account will include Sales, Cost of Sales, and the Inventory on Hand

Lecture 7

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What about Gross Profit?

- When we calculate Gross Profit, we calculate how much profit we've made from the sale of goods (Sales – Cost of Sales), but we should only take into account the goods we've ACTUALLY sold!
- With a Periodic System we would have sold the goods we had on hand at the beginning of the year, and we won't have sold the goods that we have on hand at the end of the year

Lecture 7

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What about Gross Profit?

- Thus, our Cost of Sales will look as follows:
  - Opening Inventory (at the beginning of the year, from the prior year)
  - Plus: Purchases for the year
  - Less: Closing Inventory (that we have left on hand at the end of the year)
- We calculate this in the GL by closing all of these off to the Trading Account

Lecture 7

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Example

- Brinkley Traders has the following balances at yearend and uses the periodic inventory system. Yearend 31 December 2013:
  - Inventory (1 January 2013) 2 300
  - Purchases 32 200
  - Sales 45 800
  - They performed an inventory account, and identified inventory to the value of R3 100 on hand
- Journalise the closing entries and prepare the accounts in the GL

Lecture 7

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Inventory	B2	3 100	
	Trading Account	B9		3 100
	Cost price of closing inventory on hand, brought into account			

Lecture 7

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Trading Account	B9	2 300	
	Inventory	B2		2 300
	Closing entry			

Lecture 7

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Example: Posting to GL

Dr **Inventory** B2 Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
1 Jan	Balance	b/d	2 300	31 Dec	Trading Account	GJ1	2 300
31 Dec	Trading Account	GJ1	3 100	31 Dec	Balance	GJ1	3 100

Dr **Trading Account** B9 Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
31 Dec	Inventory	GJ1	2 300	31 Dec	Inventory	GJ1	3 100

Lecture 7

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What effect does this have?

- At the beginning of the year, you have inventory on hand, (from the prior year)
  – but this will have sold during the year. You just haven't made any entries regarding this yet!
- At the end of the year, you have inventory on hand
  – If you leave BOTH in the Inventory account, it will double-count your inventory
- So you take BOTH to the Trading Account

Lecture 7

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Trading Account	B9	32 200	
	Purchases	N2		32 200
	Closing entry			

Lecture 7

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Sales	N1	45 800	
	Trading Account	B9		45 800
	Closing entry			

Lecture 7

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Example: Posting to GL

Dr | Purchases | N2 | Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
31 Dec	Balance	b/d	32 200		31 Dec	Trading Account	GJ1	32 200

Dr | Sales | N1 | Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
31 Dec	Trading Account	GJ1	45 800		31 Dec	Balance	b/d	45 800

Lecture 6

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Example: Posting to GL

Dr **Trading Account** B9 **Cr**

Date	Details	Fol	Amount	Date	Details	Fol	Amount
31 Dec	Inventory	GJ1	2 300	31 Dec	Inventory	GJ1	3 100
31 Dec	Purchases	GJ1	32 200	31 Dec	Sales	GJ1	45 800
	Profit and Loss	GJ2	14 400				
			48 900				48 900

Lecture 7

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What effect does this have?

- Take a look at the Trading Account:
  - Sales 45 800
  - Less: Cost of Sales: 31 400
    - Opening Inventory 2 300
    - Plus: Purchases 32 200
    - Less: Closing Inventory (3 100)
  - Gross Profit 14 400

Now our Trading Account reflects the Gross Profit. We now close this off to the Profit or Loss account

Lecture 7

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Trading Account	B9	14 400	
	Profit or Loss	B10		14 400
	Transfer of the Gross Profit to the Profit or Loss Account			

Lecture 7

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Example: Posting to GL

Dr **Profit or Loss** B10 **Cr**

Date	Details	Fol	Amount		Date	Details	Fol	Amount
					31 Dec	Trading Account (Gross Profit)	GJ1	14 400

Lecture 7

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Study Unit 7: The closing-off procedure

Perpetual Inventory System

Lecture 8

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What is the perpetual system?

- Instead of 'periodically' taking your stock figures into account, you may want to know how much inventory you have on hand at all times
- In this system, when you make purchases of stock, you record it as Inventory straight away, instead of purchases
  - This reflects that, when you purchase the goods, they represent assets, not expenses

Lecture 8

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What is the perpetual system?

- Once a sale is made, we then transfer the cost of the sold goods from Inventory to the Cost of Sales account
  - This allows you to see, at all times, what your Gross Profit is, without having to do Inventory counts! Your records will always reflect what should be on hand

Lecture 8

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How do we deal with this?

- When a sale occurs, we record it as we always have:

  Debit: Bank or Debtors

  Credit: Sales

- The Inventory transfer requires another entry:

  Debit: Cost of Sales

  Credit: Inventory

- We would thus need the information of how much each item costs that we sell

Lecture 8

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Mark-ups

NOTE

You can be given the Sales, or the Purchase price, with the mark-up percentage on either. You must be able to calculate the related Sale or Cost of Sale

PAY ATTENTION TO…

Which figures you're given, so you know what to calculate!

Lecture 8

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Example

- 5 December - Riley Traders made credit sales of R1 200 to S Smith on Invoice S001. They have a 30% mark-up on selling price

- Journalise the entries and prepare the accounts in the GL

Lecture 9

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Example: SJ

- Sales Journal

Sales Journal – December 2013 GJ1

Inv no.	Day	Details	Fol	Cost of Sales	Sales	Debtors Control
S001	5	S Smith		(1) 840	1 200	1 200

Calc (1):
1 200 X (100 - 30)/100
= 1 200 X 0,70
= 840

Lecture 9

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Example: Posting to GL

Dr Sales N1 Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
				31 Dec	Debtors	SJ1	1 200

Dr Debtors Control B3 Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
31 Dec	Sales	SJ1	1 200				

Lecture 9

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Example: Posting to GL

Dr Cost of Sales N2 Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
31 Dec	Inventory	SJ1	840				

Dr Inventory B4 Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
				31 Dec	Cost of Sales	SJ1	840

Lecture 9

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Example

- Let's assume that this was the only transactions for sales for the year, and see the closing entries on this

Lecture 9

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Trading Account	B8	840	
	Cost of Sales	N2		840
	Closing entry			

Lecture 9

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Sales	N1	1 200	
	Trading Account	B8		1 200
	Closing entry			

Lecture 9

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Example: Posting to GL

Dr | Cost of Sales | N2 | Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
31 Dec	Inventory	SJ1	840	31 Dec	Trading Account	GJ1	840

Dr | Sales | N1 | Cr

Date	Details	Fol	Amount	Date	Details	Fol	Amount
31 Dec	Trading Account	GJ 1	1 200	31 Dec	Debtors	SJ1	1 200

Lecture 9

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Example: Posting to GL

Dr **Trading Account** B8 **Cr**

Date	Details	Fol	Amount		Date	Details	Fol	Amount
31 Dec	Cost of Sales	GJ 1	840		31 Dec	Sales	GJ1	1 200
			1 200					1 200

Lecture 9

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Example: GJ

- General Journal

General Journal – December 2013 GJ1

Date	Details	Fol	Debit	Credit
31 Dec	Trading Account	B8	360	
	Profit or Loss	B8		360
	Transfer of the gross profit to the Profit or Loss account			

Lecture 9

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Example: Posting to GL

Dr Trading Account B8 Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
31 Dec	Cost of Sales	GJ 1	840		31 Dec	Sales	GJ1	1 200
	Profit or Loss		360					
			1 200					1 200

Dr Profit or Loss N1 Cr

Date	Details	Fol	Amount		Date	Details	Fol	Amount
					31 Dec	Trading Account	GJ1	360

Lecture 9

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Study Unit 7: The closing-off procedure

Additional costs of sale

Lecture 10

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What other costs are there?

- The costs of the goods are not limited to the purchase price alone. The costs include all costs incurred in bringing the inventory to the current location. This will include:
  - Transport costs incurred by the purchaser (Freight in)
  - Import duties
  - Assembly / installation costs

Lecture 10

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What do we do with these costs?

- Since these represent the cost of the sale, we need to take them into account when we calculate Gross Profit
  - Create separate accounts for these as expenses
  - Close these off to the Trading Account to include in the calculation of Gross Profit
  - Close Gross Profit off to Profit or Loss as normal

Lecture 10

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Study Unit 7: The closing-off procedure

Purchase returns, allowances and settlement discount received

Lecture 11

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Purchase Returns

- When goods are returned to a seller, there will be a debit note to indicate the transfer of goods.
  - This will affect both the purchases, the inventory account (if using a perpetual system) and the amount due to the creditor

Lecture 11

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Allowances

- If the seller agrees to decrease the price because the quality of goods are lower
  - This will be recorded in a separate Allowances account, and will not affect the Sales / purchases account, but will affect the amount owed to creditors

Lecture 11

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Settlement discount

- This is only recorded when we pay within the sellers credit terms, and is actually utilised
  - Create a Settlement Discount Received account, and will decrease Creditors Control

Lecture 11

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Trade discount

- This is deducted from the purchase price before we even see the documents, so when the purchase is first recorded, it will already be net of the trade discount
  - Thus, we don't record it separately

Lecture 11

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Study Unit 7: The closing-off procedure

The Gross Profit Percentage

Lecture 12

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Gross Profit Percentage

- Calculated as follows:
  - Net Sales (Sales – Sales Returns – Settlement Discount Granted)
  - Less Cost of Sales
- We calculate this to identify the performance of our core business, not all the supporting costs (admin, rental, salaries etc)

Lecture 12

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Gross Profit Percentage vs Mark-up

- Theoretically, these two should be the same, but in reality they are generally a little different, due to returns, discounts, theft, shrinkage, inventory count errors etc

Lecture 12

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Gross Profit Percentage

- As a percentage of Sales:
  - Gross Profit X 100 / Sales

- As a percentage of Cost of Sales:
  - Gross Profit X 100 / Cost of Sales

Lecture 12

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Study Unit 7: The closing-off procedure

Statement of Profit or Loss (Trading entity)

Lecture 13

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Statement of Profit or Loss and other Comprehensive Income for the year ended…

Revenue	(1)	xxx
Cost of Sales		(xxx)
Inventory (beginning of year)		xxx
Purchases	(2)	xxx
Freight in		xxx
		xxx
Inventory (end of year)		(xxx)
GROSS PROFIT		XXX
Distribution, administrative and other expenses		(xxx)
Rental Expense		xxx
Salaries		xxx
Communication expenses		xxx
Stationery		xxx
General expenses		xxx
Depreciation		xxx
Profit / Total comprehensive income for the year		xxx

(1) Sales - Sales Returns

(2) Purchases - Purchase Returns

Lecture 13