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DIPLOMA IN SUPPLY CHAIN MANAGEMENT

FINANCIAL ACCOUNTING (MODULE I)

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Course outline

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- Definition of terms used in accounting
- Users of accounting information
- Information needs
- Qualities of good accounting information
- Nature of accounting equation
- Effects of business transactions

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- Definition of a ledger and an account
- Importance of a ledger
- Relationship between a ledger and an account
- Classifications of ledgers
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- Definition of a trial balance
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- Importance of a trial balance

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1.0 INTRODUCTION TO ACCOUNTING

- a) Definition of terms used in accounting.
- b) Users of accounting information.
- c) Information needs
- d) Qualities of good accounting information
- e) Nature of accounting equation
- f) Effects of business transaction

1.0 INTRODUCTION TO ACCOUNTING

a) NATURE OF ACCOUNTING

Accounting is defined as the process of identifying, measuring and reporting economic information to the users of this information to permit informed judgment

Many businesses carry out transactions. Some of these transactions have a financial implication i.e. either cash is received or paid out. Examples of these transactions include selling goods, buying goods, paying employees and so many others.

Accounting is involved with identifying these transactions measuring (attaching a value) and reporting on these transactions. If a firm employs a new staff member then this may not be an accounting transaction. However when the firm pays the employee salary, then this is related to accounting as cash involved. This has an economic impact on the organization and will be recorded for accounting purposes. A process is put in place to collect and record this information; it is then classified and summarized so that it can be reported to the interested parties.

b) USERS OF ACCOUNTING INFORMATION

Accounting information is produced in form of financial statement. These financial statements provide information about an entity financial position, performance and changes in financial position. Financial position of a firm is what the resources the business has and how much belongs to the owners and others.

The financial performance reflects how the business has performed, whether it has made profits or losses. Changes in financial positions determine whether the resources have increased or reduced.

The users of accounting information have an interest in the existence of the firm. Therefore the information contained in the financial statements will affect the decision making process.

The following are the users of accounting information:

i. **Owners:**

They have invested in the business and examples of such owners include sole traders, partners (partnerships) and shareholders (company). They would like to have information on the financial performance, financial position and changes in financial position.

This information will enable them to assess how the managers of the business are performing whether the business is profitable or not and whether to make drawings or put in additional capital.

ii. **Customers**

Customers rely on the business for goods and services. They would like to know how the business is performing and its financial position.

This information would enable them to assess whether they can rely on the firm for future supplies.

Suppliers

They supply goods or services to the firm. The supplies are either for cash or credit. The suppliers would like to have information on the financial performance and position so as to assess whether the business would be able to pay up for the goods and services provided as and when the payments falls due.

iii. Managers

The managers are involved in the day-to-day activities of the business. They would like to have information on the financial position, performance and changes in financial position so as to determine whether the business is operating as per the plans.

In case the plan is not achieved then the managers come up with appropriate measures (controls) to ensure that the set plans are met.

iv. The Lenders

They have provided loans and others sources of capital to the business. Such lenders include banks and other financial institutions. They would like to have information on the financial performance and position of the business to assess whether the business is profitable enough to pay the interest on loans and whether it has enough resources to pay back the principal amount when it is due.

v. The Government and its agencies

The Government is interested in the financial performance of the business to be able to assess the tax to be collected in the case there are any profits made by the business.

The other government agencies are interested with the financial position and performance of the business to be able to come with National Statistics. This statistics measure the average performance of the economy.

vi. The Financial Analyst and Advisors

Financial analyst and advisors interpret the financial information. Examples include stockbrokers who advise investors on shares to buy in the stock market and other professional consultants like accountants. They are interested with the financial position and performance of the firm so that they can advise their clients on how much is the value their investment i.e. whether it is profitable or not and what is the value.

Others advisors would include the press who will then pass the information to other relevant users.

vii. The Employees

They work for the business/entity. They would like to have information on the financial position and performance so as to make decisions on their terms of employment. This information would be important as they can use it to negotiate for better terms including salaries, training and other benefits.

They can also use it to assess whether the firm is financially sound and therefore their jobs are secure.

viii. The Public

Institutions and other welfare associations and groups represent the public. They are interested with the financial performance of the firm. This information will be important for them to assess how socially responsible is the firm.

This responsibility is in form the employment opportunities the firm offers, charitable activities and the effect of firm's activities on the environment.

c) THE ACCOUNTING EQUATION

A business owns properties. These properties are called **assets**. The assets are the business resources that enable it to trade and carry out trading. They are financed or funded by the owners of the business who put in funds.

These funds, including assets that the owner may put is called **capital**. Other persons who are not owners of the firm may also finance assets. Funds from these sources are called liabilities.

The total assets must be equal to the total funding i.e. both from owners and non-owners. This is expressed in form of accounting equation which is stated as follows:

$$\text{ASSETS} = \text{LIABILITIES} + \text{CAPITAL}$$

Each item in this equation is briefly explained below.

Assets:

An asset is a resource controlled by a business entity/firm as a result of past events for which economic benefits are expected to flow to the firm.

An example is if a business sells goods on credit then it has an asset called a debtor. The past event is the sale on credit and the resource is a debtor. This debtor is expected to pay so that economic benefits will flow towards the firm i.e. in form of cash once the customers pay.

Assets are classified into two main types:

- i) Non- current assets (formerly called fixed assets).
- ii) Current assets.

Non- current assets are acquired by the business to assist in earning revenues and not for resale. They are normally expected to be in business for a period of more than one year.

Major examples include:

- Land and buildings
- Plant and machinery
- Fixtures, furniture, fittings and equipment
- Motor vehicles

Current assets are not expected to last for more than one year. They are in most cases directly related to the trading activities of the firm. Examples include:

- Stock of goods – for purpose of selling.
- Trade debtors/accounts receivables – owe the business amounts as a result of trading.
- Other debtors – owe the firm amounts other than for trading.
- Cash at bank.
- Cash in hand.

Liabilities:

These are obligations of a business as a result of past events settlement of which is expected to result to an economic outflow of amounts from the firm. An example is when a business buys goods on credit, then the firm has a liability called creditor. The past event is the credit purchase and the liability being the creditor the firm will pay cash to the creditor and therefore there is an out flow of cash from the business.

Liabilities are also classified into two main classes.

- i) Non-current liabilities (or long term liabilities)
- ii) Current liabilities.

Non-current liabilities are expected to last or be paid after one year. This includes long-term loans from banks or other financial institutions. Current liabilities last for a period of less than one year and therefore will be paid within one year. Major examples:

- Trade creditors/
or accounts payable – owed amounts as a result of
business buying goods on credit.
- Other creditors - owed amounts for services supplied to the firm
other than goods.
- Bank overdraft - amounts advanced by the bank for a short-term
period.

Capital:

This is the residual amount on the owner’s interest in the firm after deducting liabilities from the assets.

The Accounting equation can be expressed in a simple report called the **Balance Sheet**. The basic format is as follows:

		Name	
Balance sheet as at 31.12.			
	Sh	Sh	
Capital		xx	
<u>Non Current Liabilities</u>			<u>Non Current Assets</u>
Loan		xx	Land & Buildings
			Plant & Machinery
			Fixtures, furniture & fittings
			Motor vehicles
<u>Current liabilities</u>			
Overdraft	xx		<u>Current Assets</u>
Creditors	<u>xx</u>	xx	Stocks
			Debtor’s
Capital and Liabilities			Cash at bank
			Cash in hand
		<u>xx</u>	Total assets

The above format of the balance sheet is the horizontal format however currently the practice is to present the Balance Sheet using the vertical format which is shown below.

Name

Balance sheet as at 31.12.

Non Current Assets	<u>Sh</u>	<u>Sh</u>	<u>Sh</u>
Land & Buildings			xx
Plant & Machinery			xx
Fixtures, furniture & fittings			xx
Motors vehicles			<u>xx</u>
			xx
Current Assets			
Stocks/inventories		xx	
Debtors/ trade receivables		xx	
Cash at bank		xx	
Cash in hand		<u>xx</u>	
Current Liabilities			
Bank Overdraft	xx		
Creditors/trade payables	<u>xx</u>	<u>(xx)</u>	
Net Current Assets			<u>xx</u>
Net assets			<u>xx</u>
Capital			xx
Non Current Liabilities			
Loan (from bank or other sources)			<u>xx</u>
			<u>xx</u>

Please pay attention to the format. The Non Current assets are listed in order of permanence as shown i.e. from Land and Buildings to motor vehicles. The Current Assets are listed in order of liquidity i.e. which asset is far from being converted into cash. Example ,stock is not yet sold, (i.e. not yet realised yet) then when it is sold we either get cash or a debtor (if sold on credit). When the debtor pays then the debtor may pay by cheque (cash has to be banked) or cash.

The Current Liabilities are listed in order of payment i.e. which is due for payment first. Bank overdraft is payable on demand by the bank, then followed by creditors.

Note that in the vertical format, current liabilities are deducted from current assets to give net current assets. This is added to Non Current assets, which give us net assets.

Net assets should be the same as the total of Capital and Non Current Liabilities.

Example 1.1

B Kelly has a business that has been trading for some time. You are given the following information as at 31.12.2002

	£
Buildings	11,000
Furniture & Fittings	5,500
Motor Vehicles	5,800
Stocks	8,500
Debtor	5,600
Cash a bank	1,500
Cash in hand	400
Creditors	2,500
Capital	30,800
Loan	5,000

You are required to prepare a Balance Sheet as at 31 December 2001

B Kelly

Balance Sheet as at 31 December 2001

Non Current Assets	£	£	£
Buildings			11,000
Furniture & Fittings			5,500
Motor Vehicles			<u>5,800</u>
			22,300
Current Liabilities			
Stock		8,500	
Debtors		5,600	
Cash at bank		1,500	
Cash in hand		<u>400</u>	
		16,000	
Creditors		<u>(2,500)</u>	
Net Current Assets			<u>13,500</u>
Net Assets			<u>35,800</u>
Capital			30,800
Non-Current Liabilities			
Loan			<u>5,000</u>
			<u>35,800</u>

Example 1.2

L Stokes sets up a new business. Before he actually sells anything he has bought motor vehicles of £3,000, premises of £7,000, stock of goods £2,000. He still owes £800 in respect of them. He had borrowed £4,000 from D Evans. After the events just described and before trading starts, he had £300 cash in hand and £600 cash at bank.

You are required to calculate the amount of his capital.

Solution:

Assets:	£	£
Motor Vehicle		3,000
Premises		7,000
Stock		2,000
Cash at bank		600
Cash in hand		<u>300</u>
		12,900

Liabilities:

Creditors	800	
Loan - D Evans	4,000	<u>(4,800)</u>
		<u>8,100</u>

Capital 8,100

Remember the Accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Capital}.$$

To get capital we rearrange the equation as follows:

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

Total Assets = £12,900

Total Liabilities = £4,800

Capital = £12,900 - 4,800
= £8,100

Example 1.3

C Kings has the following items in his balance sheet as on 30 June 2002.

Capital £41,800, Creditors £3,200, Fixtures £7,000, Motor Vehicles £8,400, Stock of goods £9,900, Debtors £6,500, Cash at bank £12,900 and Cash in hand £240.

During the first week of July 2002:

- He bought extra stock of goods £1,540 on credit.
- One of the debtors paid him £560 in cash.
- He bought extra fixture by cheque £2,000.

You are to draw up a balance sheet as on 7 July 2002 after the above transactions have been completed.

First we need to look at the effect of the above transactions on the assets and liabilities of C Kings.
For

- Buying extra stock increases the level of stock by £1,540 and because this is bought on credit the creditors increase by £1,540 also.
- Amount received from the debtor means that the level of debtors reduces and cash increases by £560.
- Extra fixtures bought by cheque, will increase the fixtures and reduce the cash at bank by £2,000.

This can be summarized as follows:

	Opening Balances £	Increase/(Decrease)	Closing Balances £
Capital	41,800	-	41,800
Creditors	3,200	1,540	4,740
Fixtures	7,000	2,000	9,000
Motor Vehicles	8,400	-	8,400
Stock	9,900	1,540	11,440
Debtors	6,560	(560)	6,000
Cash at bank	12,900	(2000)	10,900
Cash in hand	240	560	800

Given these closing balances then the balance sheet can be drawn as follows:

C Kings

Balance sheet as at 7 July 2002.

Non Current Assets

Fixtures	£	£
Motor Vehicles		
		<u>9,000</u>
		<u>8,400</u>
		17,400

Current Assets

Stock	11,440
Debtors	6,000
Cash at bank	10,900
Cash at hand	<u>800</u>
	29,140

Current Liabilities

Creditors	(4,740)
Net Current Assets	<u>24,400</u>
Net Assets	<u>41,800</u>

Capital 41,800

From the illustration remember that any change in the items of the balance sheet will have a double effect on the accounting equation has a double effect and therefore the equation will always balance.

Example 1.4

D Moody has the following assets and liabilities as on 31 April 2002:

	£
Creditors	15,800
Equipment	46,000
Motor Vehicle	25,160
Stock	24,600
Debtors	23,080
Cash at bank	29,120
Cash in hand	160

During the first week of May 2002 Moody:

- a. Bought extra equipment on credit for £5,520.
- b. Bought extra stock by cheque £2,280.
- c. Paid creditors by cheque £3,160.
- d. Debtors paid £3,360 by cheque and £240 by cash.
- e. Moody put in extra £1,000 cash as capital.

Required:

- a. Determine the capital as at 1st May 2002.
- b. Draw up a balance sheet after the above transactions have been completed.

Solution:

(i) Using the accounting equation of $\text{Assets} = \text{Liabilities} + \text{Capital}$, then assets and liabilities can be listed as follows.

<u>Assets</u>	£	<u>Liabilities</u>	£
Equipment	46,000	Creditors	15,800
Motor Vehicle	25,160		
Stock	24,600		
Debtors	23,080		
Cash at bank	29,120		
Cash in hand	<u>160</u>		
	148,120		

$$\begin{aligned} \text{Capital} &= \text{Assets} - \text{Liabilities} \\ &= £148,120 - £15,800 = \underline{£132,320} \end{aligned}$$

- (ii) To draw up the balance sheet, we consider the effect of the above transactions on the relevant balances:
- a. Buying extra equipment means that the equipment balance will increase by £5,520 and the creditors will also increase by the same amount.
 - b. Buying extra stock by cheque means that the level of stock goes up by £2,280 and the balance at bank reduces by the same.
 - c. Paying creditors by cheque reduces the balance on the creditors account and also reduce the amount at the bank.
 - d. Debtor paying the firm reduces the debtors balance by £3,360 and increases the cash at bank and cash in hand by £3,360 and £240 respectively.
 - e. Additional cash of £1,000 increases the cash in hand balance by £1,000 and the capital balances.

This is also summarized as follows:

	Opening Balance	Adjustment Increase/Decrease	Closing <u>Balance</u>
Assets/Liabilities	£	£	£
Equipment	46,000	+5,520	51,520
Motor Vehicle	25,160		25,160
Stock	24,600	+2,280	26,880
Debtors	23,080	-3,600	19,480
Cash at bank	29,120	(-2,280 - 3,160 + 3,360)	27,040
Cash in hand	160	(+240 + 1000)	1,400
Creditors	15,800	(+5,520 - 3,160)	18,160
Capital	132,320	+1,000	133,320

The balance sheet will therefore be prepared as follows:

D Moody

Balance sheet as at 7 May 2002

Non Current Assets	£	£
Equipment		51,520
Motor vehicle		<u>25,160</u>
		76,680
Current Assets		
Stock	26,880	
Debtors	19,480	
Cash at bank	27,040	
Cash in hand	<u>1,400</u>	
	74,800	
Current Liabilities		
Creditors	(18,160)	
Net Current Assets		<u>56,640</u>
Net Assets		<u>133,320</u>
Capital		<u>133,320</u>

2.0 THE LEDGER AND THE TRIAL BALANCE.

Specific Objectives

By the end of the subject, the trainee should be able to:-

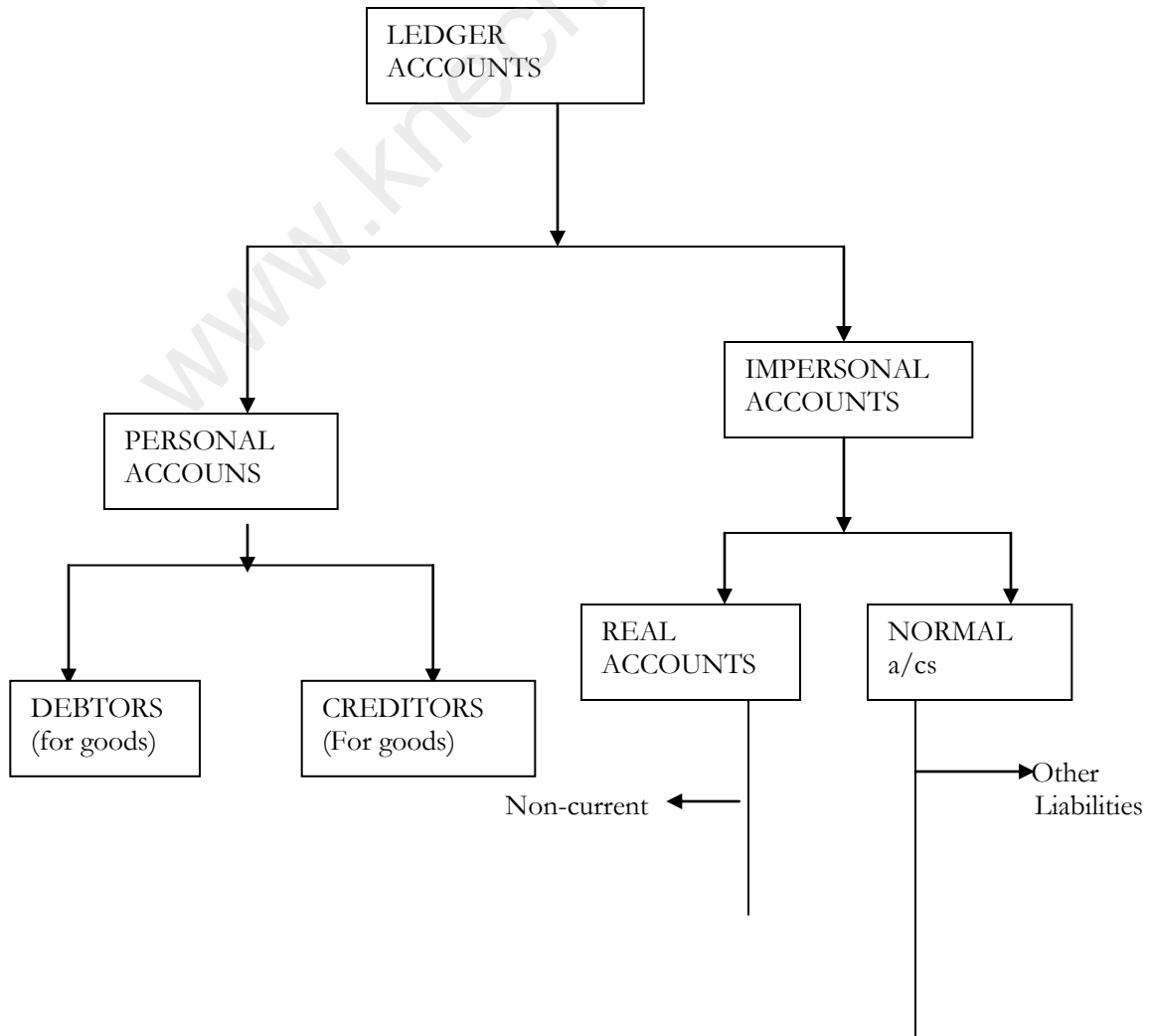
- a) Define a ledger and an account
- b) Explain the importance of a ledger
- c) Explain the relationship between the ledger and accounts
- d) Classify ledgers
- e) Classify accounts
- f) Explain the double entry systems
- g) Balance off ledger accounts
- h) Define a trial balance
- i) Explain the importance of the trial balance

2.1 THE LEDGER

The ledger is simply the accounts. The Ledger is classified into 3 main classes.

1. Sales Ledger, which has the accounts of all the debtors.
2. Purchases Ledger, which has the accounts of all the creditors.
3. The General Ledger. Has all the other accounts i.e. other assets, liability, incomes and expenses and capital.

The ledger accounts can also be classified as follows:



assets

Inventories/ Stocks ←

→ Other Assets

→ Income

→ Expenses

→ Capital

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The Accounting equation forms the basis of double entry and therefore it should always be maintained. Any change in assets, liabilities or capital will have a double effect such that assets will always be equal to liabilities plus capital. If the owners put in additional capital then this will increase the cash at bank and the capital amount therefore the equation is still maintained.

Debit				Name					Credit		
Date	Detail	Folio	Amount	Date		Detail	Folio	Amount			

In this account the date will show the opening period of the asset, liability or capital i.e. the balance brought forward. It will also show the date when a transaction took place (i.e. either an asset was bought or liability incurred).

The detail column (also called the particulars column) shows the nature of the transaction and reference to the corresponding account. The Folio Column for purposes of detailed recording shows the reference number of the corresponding account. The amount column shows the amount of the asset, liability or capital.

The left side of the account is called the debit side and the right side is called the credit side. All assets are shown or recorded on the debit side while all the liabilities and capital are recorded on the credit side. Each type of asset or liability must have its own account whereby all transactions affecting them are recorded in this account. Therefore there should be an account for Premises, Plant and Machinery, Stock, Debtors, Creditors etc.

Under the accounting equation if all assets are represented by liabilities and capital therefore all debits should be the same as credits.

For the double entry to be reflected in the accounts, every debit entry must have a corresponding credit entry. The transactions affecting these accounts are posted in the account as debit entry and credit entry to complete the double entry.

When we make a debit entry we are either:

- i. Increasing the value of an asset.
- ii. Reducing the value of a liability.
- iii. Reducing the value of capital.

When we make a credit entry we are either:

- i. Reducing the value of an asset.
- ii. Increasing the value of a liability.
- iii. Increasing the value of capital.

Example 1.5

H Jumps has the following assets and liabilities as on 30 November 2002:

Creditors £39,500; Equipment £115,000; Motor vehicle £62,900; Stock £61,500; Debtors £57,700; Cash at bank £72,800 and Cash in hand £400.

Compute the balance on the capital account as at 30 November 2002.

During the first week of December 2002, Jump:

- Bought extra equipment on credit for £13,800.
- Bought extra stock by cheque £5,700.
- Paid creditors by cheque £7,900.
- Received from debtors £8,400 by cheque and £600 by cash.
- Put in an extra £2,500 cash as capital.

You are to draw up a balance sheet as on 7 December 2002 after the above transactions have been completed.

Answer:

Capital = Assets – Liabilities

<u>Assets</u>	<u>£</u>	<u>Liabilities</u>	<u>£</u>
Equipment	115,000	Creditors	39,500
Motor vehicle	62,900		
Stock	61,500		
Debtors	57,700		
Cash at bank	72,800		
Cash in hand	<u>400</u>		
	371,300		

$$\text{Capital} = \text{£}371,300 - \text{£}39,500 = \text{£}330,800$$

<u>Creditors A/C</u>				<u>Motor Vehicles a/c</u>			
2002	£ B	2002	£	2002	£	2002	£
Bank	7900	1.12 Bal b/d	39,500	1.12 Bal b/d	62,900	1.12 Bal c/d	62,900
1.12 Bal c/d	31,600						
	<u>39,500</u>		<u>39,500</u>		<u>62,900</u>		<u>62,900</u>

<u>Equipment a/c</u>			
2002	£	2002	£
1.12 Bal b/d	115,000	7.12 Bal c/d	128,800
Creditors	<u>13,800</u>		<u>128,800</u>
	<u>128,800</u>		

		Stock a/c	
2002	£	2002	£
1.12 Bal b\d	61,500	7.12 Bal c\d	<u>67,200</u>
Bank	<u>5700</u>		<u>67,200</u>
	<u>67,200</u>		

		Debtors a/c	
2002	£	2002	£
1.12 Bal b\d	57,700	Bank	8,400
Bank	<u>570</u>	Cash	600
	<u>57,700</u>	7.12 Bal c\d	<u>48,700</u>
			<u>57,700</u>

		Cash at Bank a/c	
2002	£	2002	£
1.12 Bal b\d	72,800	Stock	5,700
Debtors	<u>8,400</u>	Creditors	7,900
	<u>81,200</u>	7.12 Bal c\d	<u>67,600</u>
			<u>81,200</u>

		Cash in hand a/c	
2002	£	2002	£
1.12 Bal b\d	400	7.12 Bal c\d	<u>3500</u>
Debtors	600		<u>3500</u>
Capital	<u>2500</u>		
	<u>3500</u>		

		Capital	
2002	£	2002	£
7.12 Bal b\d	<u>333300</u>	1.12 Bal b\d	330800
	<u>128,800</u>	Cash	<u>2500</u>
			<u>128,800</u>

		Creditors Of Equipment	
2002	£	2002	£
7.12 Bal b\d	<u>13800</u>	Equipment	<u>13800</u>
	<u>13,800</u>		<u>13,800</u>

H Jump

Balance sheet as at 7 December 2002

Non Current Assets £ £ £

Equipment		128,800
Motor vehicles		<u>62,900</u>
		191,700

Current Assets

Stock	61,200	
Debtors	48,700	
Cash at Bank	67,600	
Cash in Hand	<u>3,500</u>	
	187,000	

Current Liabilities

Creditors of equipment	13,800		
Creditors	<u>31,000</u>	<u>(45,400)</u>	
Net Current Assets			<u>141,000</u>
Net Assets			<u>333,300</u>

Capital

333,300

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Example 1.6

Write up the asset, capital and liability accounts in the books of M Crash to record the following transactions: 2002

- June 1 Started business with £50,000 in the bank.
- “ 2 Bought motor van paying by cheque £12,000.
- “ 5 Bought Fixtures £4,000 on credit from Office Masters Ltd.
- “ 8 Bought a van on credit from Motor Cars Ltd £8,000.
- “ 12 Took £1,000 out of the bank and put it into the cash till.
- “ 15 Bought Fixtures paying by cash £600.
- “ 19 Paid Motor Cars Ltd by cheque £8000.
- “ 21 A loan of £10,000 cash is received from J Marcus.
- “ 25 Paid £8,000 of the cash in hand into the bank account.
- “ 30 Bought more Fixtures paying by cheque £3,000.

Capital a/c			Cash at bank a/c		
2002		£	2002		£
30/6	Bal c/f	50,000	1/6	Bank	50,000
		<u>50,000</u>			<u>50,000</u>
			2002		£
			1/6	Capital	50,000
			12/6	Cash	8,000
			2/6	Van	12,000
			12/6	Cash	1,000
			19/6	Motor ltd	8,000
			30/6	Fixtures	3,000
			30/6	Bal c/f	34,000
					<u>58,000</u>
					<u>58,000</u>

Motor Van		
2002		£
2/6	Bank	12,000
8/6	Super M	8,000
		<u>20,000</u>
		<u>20,000</u>

Fixtures		
2002		£
5/6	young	4,000
15/6	Cash	600
30/6	Bank	3,000
		<u>7,600</u>
		<u>7,600</u>

Motor Car Ltd – Creditors		
2002		£
19/6	Bank	8,000
		<u>8,000</u>
		<u>8,000</u>

Office Masters Ltd - Creditor		
2002		£
30/6	B\ f	4,000
		<u>4,000</u>
		<u>4,000</u>

Cash in hand			
2002	£	2002	£
12/6 Cash	1,000	15/6 Cash	600
		25/6 Bank	800
21/6 J. Marcus	<u>10000</u>	30/6 Bal c/f	<u>2400</u>
	<u>11000</u>		<u>11000</u>

J. Marcus - Loaner			
2002	£	2002	£
30/6 c\f	<u>10000</u>	21/6 Cash	<u>10000</u>

Note that the difference between the debit side and the credit side is the balancing figure. Most assets will have a balance on the credit side and most liabilities and capital accounts will have a balance on the debit side. A simple balance sheet from these balances will be as follows:

M Crash

Balance Sheet as at 30th June 2002

	£	£
Non Current Assets		
Fixtures		7,600
Motor vehicles		<u>20,000</u>
		27,600
Current Assets		
Cash at bank	34,000	
Cash in hand	<u>2,400</u>	
	36,400	
Current Liabilities		
Creditors – others	<u>(4,000)</u>	
Net Current Assets		<u>32,400</u>
Net Assets		<u>60,000</u>
Capital		50,000
Non Current Liabilities		
Loan – J Jarvis		<u>10,000</u>
		<u>60,000</u>

Let us now consider other transactions that take place in a business and the accounting entries to be made.

Accounting for sales, purchases, incomes and expenses.

Sales:

This is the sell of goods that were bought by a firm (the goods must have been bought with the purpose of resale). Sales are divided into cash sales and credit sales. When a cash sale is made, the following entries are to be made.

- i. Debit cash either at bank or in hand.
- ii. Credit sales account.

For a credit sale:

- i. Debit debtors/ Accounts receivable account.

- ii. Credit sales account.

A new account for sales is opened and credited with cash or credit sales.

Purchases:

Buying of goods meant for resale. Purchases can also be for cash or on credit. For cash purchases:

- i. Debit purchases.
- ii. Credit cash at bank/cash in hand

For credit purchases, we:

- i. Debit purchases.
- ii. Credit creditors for goods.

A new account is also opened for purchases where both cash and credit purchases are posted. **NOTE: NO ENTRY IS MADE INTO THE STOCKS ACCOUNT.**

Incomes:

A firm may have other incomes apart from that generated from trading (sales). Such incomes include:

- Rent
- Bank interest
- Discounts received.

When the firm receives cash, from these incomes, the following entries are made:

- Debit cash in hand/at bank.
- Credit income account.

Each type of income should have its own account e.g. rent income, interest income.

Incomes increase the value of capital and that is the reason why they are posted on the credit side of their respective accounts.

Expenses:

These are amounts paid out for services rendered other than those paid for purchases. Examples include:

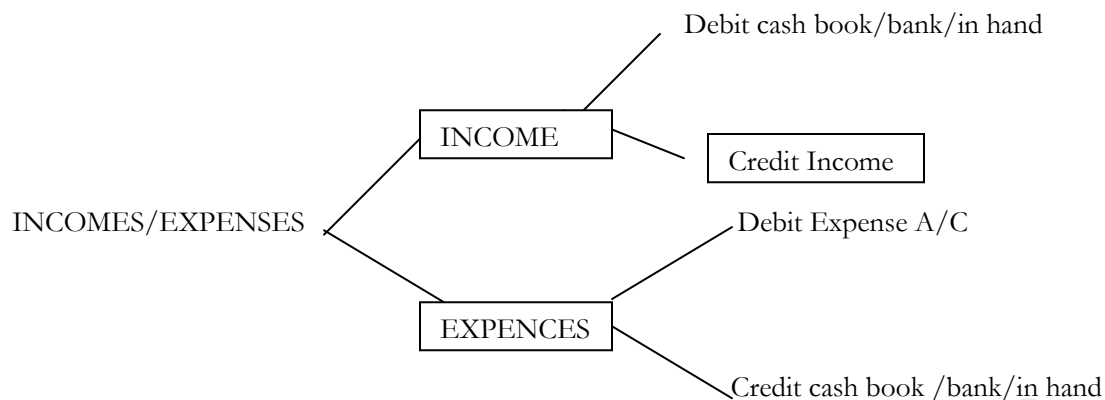
- Postage and stationery
- Salaries and wages
- Telephone bills
- Motor vehicle running expenses.
- Bank charges.

When a firm pays for an expense, we:

- i. Debit the expense account.
- ii. Credit cash at bank/in hand.

Each expense should also have its own account where the corresponding entry will be posted. Expenses decrease the value of capital and thus the posting is made on the debit side of their accounts.

The following diagram is a simple summary of the entries made for incomes and expenses.



Returns Inwards and Returns Outwards.

Returns Inwards: These are goods that have been returned by customers due to various reasons e.g.

- i. They may be defective/damaged,
- ii. Being of the wrong type .
- iii. Excess goods being delivered.

Goods returned may relate to cash sales or credit sales. For the goods returned in relation to cash sales and cash is refunded to the customer the following entries are made:

- i. Debit returns – inwards
- ii. Credit cashbook.

For goods returned that relate to credit sales; no cash has been given to customer, the following entry is to be made.

- i. Debit returns inwards.
- ii. Credit debtors.

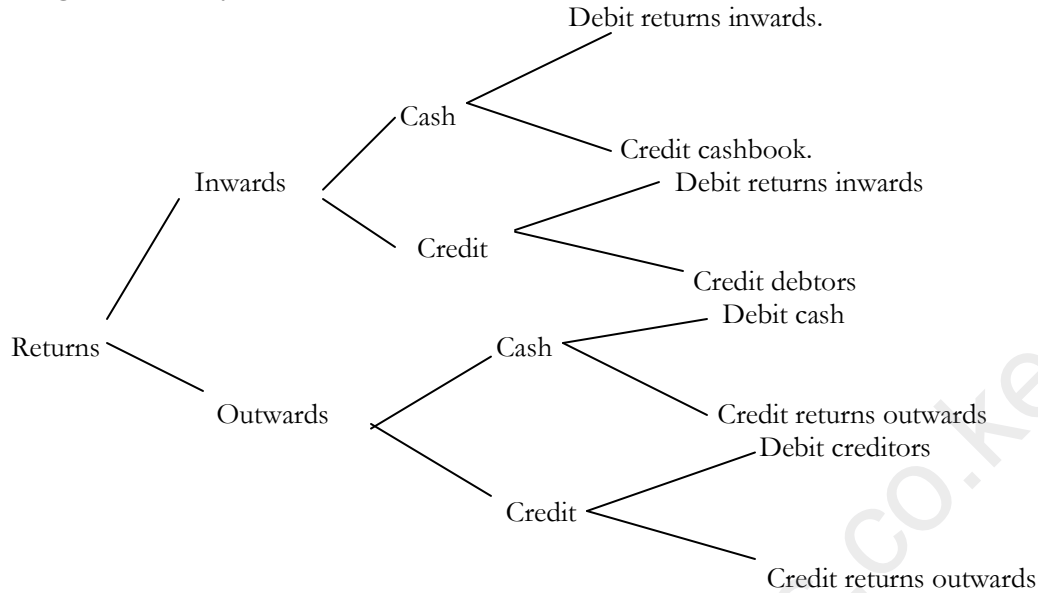
Returns Outwards: These are goods returned to suppliers/creditors. They may be for cash purchases or for credit purchases. For cash purchases a cash refund given to the firm by the supplier,

- i. Debit the cashbook (cash at bank/hand).
- ii. Credit returns outwards.

For credit purchases and no refund has been made:

- i. Debit creditors.
- ii. Credit returns outwards.

Diagrammatically shown as follows:



Now lets us take one example that includes most of the above transactions.

Example 1.8

You are to enter the following transactions, completing the double entry in the books for the month of May 2002.

- 2002
- May 1 Started business with £2,000 in the bank.
- “ 2 Purchased goods £175 on credit from M Rooks.
- “ 3 Bought furniture and fittings £150 paying by cheque.
- “ 5 Sold goods for cash £275.
- “ 6 Bought goods on credit £114 from P Scot.
- “ 10 Paid rent by cash £15.
- “ 12 Bought stationery £27, paying in cash.
- “ 18 Goods returned to M Rooks £23.
- “ 21 Let off part of the premises receiving rent by cheque £5.
- “ 23 Sold goods on credit to U Foot for £77.
- “ 24 Bought a motor van paying by cheque £300.
- “ 30 Paid the month’s wages by cash £117.
- “ 31 The proprietor took cash for himself £44.

Example

		Bank a/c	
2002		£	
1/5 Capital	2,000	2002	£
		3/5 Furn& fitting	150
		24/5 Motor vehicle	300
21/5 Rent	5	31/5 Bal c/f	<u>1,555</u>
	<u>2,005</u>		<u>2,005</u>
		Capital a/c	
31/5 Bal c/f	<u>2,000</u>	1/5 Bank	<u>2,000</u>

Purchases a/c			
2002	£	2002	£
2/5 M Rooks	175		
6/5 P Scot	114	31/5 Bal c/f	289
	<u>289</u>		<u>289</u>

Creditor – M Rooks a/c			
2002	£	2002	£
18/5 Returns in	23	2/5 Purchases	175
31/5 Bal c/f	152		
	<u>175</u>		<u>175</u>

Furniture & Fittings a/c			
2002	£	2002	£
3/5 Bank	150	31/5 Bal c/f	150
	<u>150</u>		<u>150</u>

Sales a/c			
2002	£	2002	£
31/5 Bal c/f	352	5/5 Cash	275
		23/5 U. Foot	77
	<u>352</u>		<u>352</u>

Cash in hand a/c			
2002	£	2002	£
5/5 Sales	275	10/5 Rent	15
		12/5 Stationery	27
		30/5 Wages	117
		31/5 Bal c/f	116
	<u>275</u>		<u>275</u>

P Scot a/c			
2002	£	2002	£
31/5 Bal c/f	114	6/5 Purchases	114
	<u>114</u>		<u>114</u>

Expenses – Rent a/c			
2002	£	2002	£
11/5 Bal c/f	15	10/5 Cash	15
	<u>15</u>		<u>15</u>

Expenses – Stationery a/c			
2002	£	2002	£
12/5 Cash	27	31/5 Bal c/f	27
	<u>27</u>		<u>27</u>

Returns – Out a/c			
2002	£	2002	£
31/5 Bal c/f	<u>23</u>	18/5 M Rooks	<u>23</u>

Income – Rent a/c			
2002	£	2002	£
21/5 Bal c/f	<u>5</u>	31/5 Bank	<u>5</u>

Debtors – U Foot a/c			
2002	£	2002	£
23/5 Sales	<u>77</u>	31/5 Bal c/f	<u>77</u>

Motor vehicle a/c			
2002	£	2002	£
24/5 Bank	<u>300</u>	31/5 Bal c/f	<u>300</u>

Expenses – Wages a/c			
2002	£	2002	£
30/5 Cash	<u>117</u>	31/5 Bal c/f	<u>117</u>

Drawings a/c			
2002	£	200	£
31/5 Cash	<u>44</u>	31/5 Bal c/f	<u>44</u>

Accounting for drawings, discounts allowed and discounts received.

Drawings

The owner makes drawings from the firm in various ways:

i) Cash or bank withdrawals

When the owner withdraws money from the business we debit drawings and credit cashbook (cash in hand or cash at bank).

ii) Taking goods for own use and

When the owner takes out some of the goods for his own use, we debit drawings and credit purchases.

iii) Personal expenses, paid by the business

Here we debit the drawings and credit expense account

Taking some of the other assets from the business e.g. motor vehicles or using part of the premises.

Sometimes the owner may take over some of the assets of the business e.g. vehicle or converting business premises into living quarters or not paying into the business cash collected personally from the customers. When this happens we debit drawings and credit the relevant asset e.g. motor vehicles, premises or some building or even debtors.

Discounts

Discounts received.

A discount received is an allowance by the creditors to the firm to encourage the firm to pay the amount dues within the agreed time. It is an amount deducted from the invoice price.

When a discount is given by the supplier then we debit creditor's account and credit discounts received e.g. A. Ltd sells some goods on credit to B Ltd. £1,000 under the terms of sale, B Ltd, will receive a discount of 5% if they pay the amount due within one month. B decides to take up the offer and pays the amount within the given time. B will record the transaction as follows.

Debit: Creditor – A Ltd

Credit: Discounts Received

Creditor A. Ltd a/c	
2002	£
Bank	950
Discount received	<u>50</u>
	<u>1000</u>

Purchases a/c	
2002	£
A Ltd	1,000

Discounts Received a/c	
200	£
Bal c/f	<u>50</u>

Bank a/c	
2002	£
A Ltd	950

Discounts Allowed

These are the allowances made by a firm on the amounts receivable from the customers to encourage prompt payment. The amounts deducted from the sales invoice. In the previous example when A Ltd issued the discount and was taken up by B the entries will be:

- i. Debit - discount allowed
- ii. Credit - debtors - B Ltd.

Debtors B Ltd a/c	
2002	£
Sales	1,000
	<u>1,000</u>

Sales a/c	
2002	£
Debtor	1,000

Discount allowed a/c	
2002	£
<u>50</u> Bal c/f	<u>50</u>

Bank a/c	
2002	£
950	

THE TRIAL BALANCE

The trial balance is a simple report that shows the list of account balances classified as per the debits and credits. The purpose of the trial balance is to show the *accuracy of the double entries* made and to *facilitate the preparation of final accounts* i.e. the trading, profit & loss account and a balance sheet.

The debits of the trial balance should be the same as the credits, if not then there is an error in one or more of the accounts.

The trial balance in example 1.8 would be extracted as follows:

Name		
Trial balance as at 31 May 2002		
	<u>Debit</u>	<u>Credit</u>
	£	£
Rent – income		5
Debtor – U Foot	7	
Motor vehicle	300	
Bank	1555	
Purchases	289	
Wages	117	
Capital		2000
Creditor – M Rooks		152
Furniture & Fittings	150	
Sales		352
Cash in hand	72	
Creditor – P Scot		114
Expenses – Rent	15	
Expenses – Stationery	27	
Returns Outwards		23
Drawings	<u>44</u>	<u>.</u>
	<u>2464</u>	<u>2464</u>

From the trial balance please note that assets and expenses are on the debit side. Capital, liabilities and incomes are normally listed on the credit side.

The next example is a detailed one that shows extracting of trial balance once all the postings have been made in the relevant accounts.

Example 1.9

Write up the following transactions in the books of S Pink:

2003

- | | | |
|-------|----|--|
| March | 1 | Started business with cash £1,000. |
| “ | 2 | Bought goods on credit from A Cliks £296. |
| “ | 3 | Paid rent by cash £28. |
| “ | 4 | Paid £1,000 of the cash of the firm into a bank account. |
| “ | 5 | Sold goods on credit to J Simpson £54. |
| “ | 7 | Bought stationery £15 paying by cheque. |
| “ | 11 | Cash sales £49. |
| “ | 14 | Goods returned by us to A Cliks £17. |
| “ | 17 | Sold goods on credit to P Lutz £29. |

“	20	Paid for repairs to the building by cash £18.
“	22	J Simpson returned goods to us £14.
“	27	Paid A Cliks by cheque £279.
“	28	Cash purchases £125.
“	29	Bought a motor vehicle paying by cheque £395.
“	30	Paid motor expenses in cash £15.
“	31	Bought fixtures £120 on credit from R west.

Solutions

Capital a/c		Cash in hand a/c	
2003	£	2003	£
31/3 Bal c/d	<u>1,500</u>	1/3 Cash	<u>1,500</u>
		2003	£
		1/3 Capital	1,500
		11/3 Sales	49
		3/3 Rent	28
		4/3 Bank	1,000
		20/3 Repairs	18
		28/3 Purchases	125
		30/3 Motor exp.	15
		31/3 Bal c/d	<u>363</u>
			<u>1,549</u>

Purchases a/c	
2003	£
2/3 A Hanson	296
28/3 Cash	125
	<u>421</u>
2003	£
31/3 Bal c/d	<u>421</u>

Creditors – A Cliks ac	
2003	£
14/3 Returns out	17
27/3 Bank	279
	<u>296</u>
2003	£
2/3 Purchases	296
	<u>296</u>

Rent –Expenses a/c	
2003	£
3/3 Cash	<u>28</u>
2003	£
31/3 Bal c/d	<u>28</u>

Bank a/c	
2003	£
4/3 Cash	1,000
5/3 Stationery	15
27/3 A. Hanson	279
29/3 Motor van	395
31/3 Bal c/d	<u>311</u>
	<u>1,000</u>

Debtor – J Simpson a/c	
2003	£
3/3 Sales	54
2003	£
22/3 Returns in	14
31/3 Bal c/d	<u>40</u>
	<u>54</u>

Sales a/c	
2003	£
31/3 Bal c/d	132
2002	£
5/3 JSimpson	54
11/3 Sales	49
17/3 P Lutz	29
	<u>132</u>

Stationery a/c			
2003	£	2003	£
7/3 Bank	<u>15</u>	31/3 Bal c/d	<u>15</u>

132

132

Returns outwards a/c			
2003	£	2003	£
31/3 Bal c/d	<u>17</u>	14/3 A Clinks	<u>17</u>

P Lutz – Debtor a			
2003	£	2003	£
17/3 Sales	<u>29</u>	21/3 Bal c/d	<u>29</u>

Building repairs - expenses			
2003	£	2003	£
20/3 Cash	<u>18</u>	31/3 Bal c/d	<u>18</u>

Returns - Inwards			
2003	£	2003	£
22/3 J Simpson	<u>14</u>	31/3 Bal c/d	<u>14</u>

Motor vehicle			
2003	£	2003	£
29/3 Bank	<u>395</u>	31/3 Bal c/d	<u>395</u>

R West – Creditor (others)			
2003	£	2003	£
31/3 Bal c/d	<u>120</u>	31/3 Fixtures	<u>120</u>

Motor expenses			
2003	£	2003	£
30/3 Cash	<u>15</u>	31/3 Bal c/d	<u>15</u>

Fixtures			
2003	£	2003	£
31/3 A. Webster	<u>120</u>	31/3 Bal c/d	<u>120</u>

S PINKS
TRIAL BALANCE AS AT 31 MARCH 2003

	<u>Debit (£)</u>	<u>Credit (£)</u>
Capital		1500
Purchases	421	
Cash in hand	363	
Bank	311	
Rent expense	28	
Sales		132
Fixtures	120	
Debtor – J Simpson	40	
Debtor – P Lutz	29	
Motor vehicle	395	
Creditors	-	-
Motor expenses	15	
Returns inwards	14	
Creditors others – R West		120
Stationery	15	
Returns outwards		17
Building repairs	<u>18</u>	<u>-</u>
	<u>1769</u>	<u>1769</u>

Example 1.10

The following transactions took place during the month of May:

- 2003
- May 1 Started firm with capital in cash of £250.
 - “ 2 Bought goods on credit from the following persons: R Kelly £54; Pcombs £87; J Role £25; D Mobile £76; I. Sims £64.
 - “ 4 Sold goods on credit to: C Blanes £43; B Long £62; F Skin £176.
 - “ 6 Paid rent by cash £12.
 - “ 9 C Blanes paid us his account by cheque £43.
 - “ 10 F Skin paid us £150 by cheque.
 - “ 12 We paid the following by cheque: J Role £25; R Kelley £54.
 - “ 15 Paid carriage by cash £23.
 - “ 18 Bought goods on credit from P Combs £43; Mobile £110.
 - “ 21 Sold goods on credit to B Long £67.
 - “ 31 Paid rent by cheque £18.

Answer

Capital

2003	£	2003	£
31/5 Bal c/d	250	1/5 Cash	250

Cash in Hand

2003	£	2003	£
1/5 Capital	250	6/5 Rent	12
		15/5 Carriage	23
		31/5 Bal c/d	<u>215</u>
	<u>250</u>		<u>250</u>

Creditor R Kelly

2003	£	2003	£
12/5 Bank	<u>54</u>	2/5 Purchases	<u>54</u>

Creditor P Combs

2003	£	2003	£
31/5 Bal c/d	130	2/5 Purchases	87
		18/5 Purchases	<u>43</u>
	<u>130</u>		<u>130</u>

Creditor – J Role

2003	£	2/5	£
12/5 Bank	<u>25</u>	Purchases	<u>25</u>

Creditor – D Mobile

2003	£	2003	£
31/5 Bal c/d	186	2/5 Purchases	76
		18/5 Purchases	<u>110</u>
	<u>186</u>		<u>186</u>

Creditor I Sims

2003	£	2003	£
31/5 Bal c/d	<u>64</u>	2/5 Purchases	<u>64</u>

Debtor C. Blares

2003	£	2003	£
4/5 Sales	<u>43</u>	4/5 Bank	<u>43</u>

Debtor B Long

2003	£	2003	£
4/5 Sales	62	31/5 Bal c/d	129
21/5 Sales	<u>67</u>		
	<u>129</u>		<u>129</u>

Debtor F Smith

2003	£	2003	£
4/5 Sales	176	10/5 Bank	150
		31/5 Bal c/d	<u>26</u>
	<u>176</u>		<u>176</u>

Purchases

2003	£	2003	£
2/5 R Kelly	54	31/5 Bal c/d	459
2/5 P Combs	87		
2/5 J Role	25		
2/5 D Mobile	76		
2/5 L Sims	64		
18/5 P Combs	43		
18/5 D. Mobile	<u>100</u>		
	<u>459</u>		<u>459</u>

Sales

2003	£	2003	£
31/5 Bal c/f	348	4/5 C Blanes	43
		4/5 F Long	62
		4/5 F Skin	176
		4/5 B Long	67
			<u>348</u>

Bank

2003	£	2003	£
9/5 C Blanes	43	12/5 J Role	25
10/5 H F Skin	150	12/5 R Kelly	54
		31/5 Rent	18

Carriage Expenses

2003	£	2003	£
15/5 Cash	<u>23</u>	31/5 Bal c/d	<u>23</u>

<u>193</u>	31/5	Bal c/d	<u>96</u>
<u>193</u>			<u>193</u>

Rent

19x6	£	19x6	£
6/5 Cash	12	31/5 Bal c/d	30
31/5 Bank	<u>18</u>		<u>30</u>
	<u>30</u>		<u>30</u>

Trial Balance as at 31/5/2003

	<u>Debit</u>	<u>Credit</u>
Capital	-	250
Cash	215	-
Creditor – R Kelly	-	-
Creditor – P Combs	-	130
Creditor – J Role	-	-
Creditor – D Mobile	-	186
Creditor – L. Simms	-	64
Debtor – C. Blanes	-	-
Purchases	459	-
Sales	-	348
Debtor- B. Long	129	-
Debtor- F Skin	26	-
Bank	96	-
Carriage	-	-
Rent	30	-
	<u>978</u>	<u>978</u>

Question One

Spark has been trading for a number of years as an electrical appliance retailer and repairer in premises which he rents at an annual rate of \$1,500 payable in arrears. Balances appearing in his books at 1 January 19X1 were as follows:

	\$	\$
Capital account		1,808
Motor van		1,200
Fixtures and fittings		806
Provision for depreciation on motor van (credit)		720
Provisions for depreciation on fixtures& fittings (credit)		250
Inventory at cost		366
Receivables for credit sales:		
Brown	160	
Blue	40	
Stripe	<u>20</u>	
		220
Cash at bank		672
Cash in hand		5
Payables for supplies:		
Live	143	
Negative	80	
Earth	<u>73</u>	
		296
Amount owing for electricity		45
Local taxes paid in advance		100

Although Sparks has three credit customers the majority of his sales and services are for cash, out of which he pays various expenses before banking the balance.

The following transactions took place during the first four months of 19X1

	January	February	March	April
	\$	\$	\$	\$
Suppliers' invoices:				
Live	468	570	390	602
Negative	-	87	103	64
Earth	692	-	187	-
Capital introduced		500		
Bankings of cash (from cash sales)	908	940	766	1,031
Expenditure out of cash sales before banking:				
Withdrawals on account	130	120	160	150
Stationery	12	14	26	21
Travelling	6	10	11	13
Petrol and van repairs	19	22	37	26
Sundry expenses	5	4	7	3
Postage	12	10	15	19
Cleaner's wages	60	60	65	75
Goods invoiced to credit customers:				
Brown	66	22	10	12

	120	140	130	180
Blue				
Stripe	44	38	20	48
Cheque payments (other than those to suppliers):				
Telephone	40	49	59	66
Electricity	62	47	20	106
Local taxes	-	-	220	-
Motor van (1 February 19X1)	-	800	-	-
Unbanked at the end of April	-	-	-	12

Spark pays for goods by cheque one month after receipt of invoice, and receives a settlement discount of 15% from each supplier.

Credit customers also pay by cheque one month after receipt of invoice, and are given a settlement discount of 10% of the invoice price.

Required:

Write up the ledger accounts of Spark for the four months to 30 April 19X1, and extract a list of account balances after balancing off the accounts.

Question Two

Mary

Balance Sheet as at 31 December 2000

Non Current Assets	£	£
Premises		25,000.00
Plant		<u>12,000.00</u>
		37,000.00
Current Assets:		
Stock	11,000.00	
Debtors	10,000.00	
Cash at bank	5,000.00	
Cash in hand	<u>3,000.00</u>	
	29,000.00	
Current liabilities:		
Creditors	<u>(12,000.00)</u>	<u>17,000.00</u>
		<u>54,000.00</u>
Capital		34,000.00
Non Current Liabilities:		
Loan from bank		<u>20,000.00</u>
		<u>54,000.00</u>

During the year to 31 December 2001 the following total transactions occurred:

- a) Mary withdrew a total of £10,000.00 in cash
- b) Stock in trade was bought, all on credit, for £34,000.00
- c) Sales were made totaling 60,000.00 of stock in trade which had cost £37,000.00. Of these sales £51,000.00 were on credit and £9,000.00 for cash.
- d) A total of £16,000.00 was drawn from the bank in cash to the cash till.
- e) Electricity for the year paid by cheque totaled £2,000.00
- f) Rates for the year paid by cheque totaled £1,000.00
- g) Wages for the year all paid cash totaled £10,000.00
- h) Sundry expenses all paid in cash totaled £2,000.00
- i) Creditors were paid a total of £36,000.00 all by cheque
- j) Debtors paid a total of £54,000.00 all in cheques.
- k) The bank charged interest on the loan deducting £3,000.00.

Required:

Prepare a revised balance sheet.

(20 marks)

Question Three

a) Explain the nature of accounting and the accounting equation (8 marks)

b) Calculate the profit for the year ended 31 December 2001 from the following information (12 marks)

Non Current Assets	01.01.2001	31.12.2001
	£	£
Property	20,000.00	20,000.00
Machinery	<u>6,000.00</u>	<u>2,000.00</u>
	<u>26,000.00</u>	<u>29,000.00</u>
Current Assets:		
Debtors		8,000.00
	4,000.00	
Cash	<u>1,000.00</u>	<u>1,500.00</u>
	<u>5,000.00</u>	<u>9,500.00</u>
Current Liabilities:		
Creditors	5,000.00	3,000.00
Overdraft	6,000.00	9,000.00
	<u>11,000.00</u>	<u>12,000.00</u>
Net Current Liabilities	<u>(6,000.00)</u>	<u>(2,500.00)</u>
Net Assets	<u>20,000.00</u>	<u>26,500.00</u>

Drawings during the year amounted to £4,500.00

Additional capital introduced by the owner £5,000.00

Question Four

Brian Barmouth is a sole trader. At 30 June 2000 the following balances have been extracted from his books:

Sales	£ 47,600.00
Purchases	22,850.00
Office expenses	1,900.00
Insurance	700.00
Wages	7,900.00
Rates	2,800.00
Heating and Lighting	1,200.00
Telephone	650.00
Discounts allowed	1,150.00
Opening stock	500.00
Returns inwards	200.00
Returns outwards	150.00
Premises	40,000.00
Plant and Machinery	5,000.00
Motor Vehicles	12,000.00
Debtors	12,500.00
Bank balance	7,800.00
Creditors	3,400.00
Loan-long term loan	10,000.00
Capital	60,000.00
Drawings for the year	4,000.00
Closing stock	550.00

Required:

Construct a trial balance, from the above list of balances.

3.0 TYPES OF ERRORS AND THEIR CORRECTION

Specific Objectives:

By the end of the topic, the trainee should be able to:

- a) State the type of errors that do not affect the agreement of a trial balance
- b) State types of errors that affect the agreement of a trial balance
- c) Explain functions of a suspense account
- d) Correct the errors

3.1 ERRORS ON ACCOUNTS

There are two types of errors in accounts:

- Errors that don't affect the trial balance
- Errors that affect the trial balance

Errors that don't affect the trial balance

The trial balance produced from the accounts appears to be okay/correct, i.e. the debits are the same as the credits. However, on taking a close check on the balances and transactions posted, errors may have been made and therefore the balances shown on the trial balance may be incorrect i.e. under/over stated.

There are 6 main types of errors that don't affect the trial balance and these are explained as follows:

a) Error of omission

Here, a transaction is completely omitted from the accounts and therefore the double entry is not made e.g. a sales invoice of £400 is not posted in the sales journal therefore no entry is made in the debtor's account and the sales account i.e. both debit of £400 in debtor's account and credit of £400 in the sales account.

The effect of the error is understates both the debtors and the sales.

To correct this error, the transaction is posted in the books by:

Debiting debtors	£400
Crediting sales	£400

b) Error of Commission

This error occurs when a transaction is posted to a wrong account but the account is of the same class. Example: a credit sale to T Thompson is posted to L Thompson's account for an amount of £200. Instead of a debit to T Thompson's account it is made to L Thompson's account and the corresponding credit in the sales account is correct.

Although the debit entry is made into the wrong account, the two accounts are of the same class i.e. debtors.

To correct this error a transfer is made from L Thompson's account to T Thompson by:

£

(i)	Debit T Thompson a/c	200
(ii)	Credit L Thompson a/c	200

c) Error of principle

In this type of error a transaction is posted not only to the wrong account but also of a different class e.g. Motor vehicle purchased for £400 is posted to the motor vehicle expenses a/c. (Instead of debiting motor vehicles, we debited motor vehicle expenses a/c and the credit entry in the cashbook is correct)

The motor vehicles account is a non-current asset, and motor vehicles expenses a/c is an expense account. Therefore a capital expenditure has been posted as revenue expenditure.

To correct this error a transfer is made from the motor expenses account to the motor vehicles a/c by:

		£
(i)	Debit Motor vehicles a/c	400
(ii)	Credit Motor expenses a/c	400

d) Complete reversal of entries

A transaction is posted to the correct accounts but to the wrong sides of the accounts i.e. a debit is posted as a credit and a credit is posted as a debit. Example: cash drawn from the bank of £150 for business use is posted as a debit in the bank account and credit in cash in hand.

To correct this error, two entries are made in the relevant accounts:

- (i) Correct the error
- (ii) Post the transaction correctly

The entries will therefore be as follows:

(i)	Debit Cash in hand by	£150
	Credit bank by	£150

To correct the error of £ 150 posted in the wrong sides of these account

(ii)	Debit cash by	£150
	Credit bank by	£150

To post the entries correctly

e) Error of Original entry

Here a transaction is posted to the correct accounts but the amount posted is not correct i.e. it is either under/over stated. In some cases, this is known as a transposition error e.g. cash received from a debtor of £980 is credited/posted to the customer's account as £890.

To correct this error, the amount understated or overstated is posted to these accounts to reflect the correct balance. In this case, we will:

	£
Debit cash book	90
Credit debtors	90

f) Compensating Errors

These are errors that tend to cancel out each other i.e. if the effect of one error is to understate the debits or credits then another error may take place to overstate the debits or credits by the same amount, hence canceling out each other. E.g. if the balance c/d of the purchases a/c is £3,980 but shown in the trial balance as £3,890 and another error carried to the trial balance of fixture amounting to £4,540 instead of £4,450:

Purchases	£	
		3,980
		<u>3,890</u>
		<u>(90)</u>
		←
Fixtures	£	
		4,450
		<u>(4,540)</u>
		<u>90</u>
		←

This type of error is corrected by use of a suspense account.

Example 5.5

Give the journal entries needed to record the corrections of the following. Narratives are required.

- Extra capital of £ 10,000 paid into the bank had been credited to Sales account.
- Goods taken for own use £ 700 had been debited to General Expenses.
- Private insurance £ 89 had been debited to Insurance account.
- A purchase of goods from C Kelly £ 857 had been entered in the books as £ 587.
- Cash banked £ 390 had been credited to the bank column and debited to the cash column in the cashbook.
- Cash drawings of £ 400 had been credited to the bank column of the cashbook.
- Returns inwards £ 168 from M McCarthy had been entered in error in J Charlton's account.
- A sale of a motor van £ 1,000 had been credited to Motor Expenses.

Solution

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	Debit	Credit
Sales	10,000	
Capital		10,000
Additional capital passed into sales a/c now transferred to capital a/c		
Drawings	700	
General expenses		700
Drawings debited in general expense now transferred to drawing a/c		
Drawings	89	
Insurance		89
Private insurance transferred from insurance a/c to drawings a/c		
Purchases	270	
C Kelly		270
Purchases and creditors amount to 857 initially entered as £587		
Bank	390	
Cash		390
Correct error in posting		
Bank	390	
Cash		390
To post the cash banked correctly		
Bank	400	
Cash		400
Cash drawings correctly started from bank to cash		
J Charlton	168	
M McCarthy		
Returns in from McCarthy entered in error in J Carlton now transferred to his a/c		168
Motor expenses	1000	
Motor disposal a/c		1000
To correct error in recording sales proceeds In expense account		

Example 5.6 (Exam type question – May 200 Question 2)

The balance sheet of N Patel, a sole trader, as at 31 March 2000 was as follows:

Capital 1 April 1999	Sh'000	Sh'000	Sh'000	Sh'000
		1,890	Land and buildings (at valuation)	1,650

Profit for the year ended 31 March 2000	450	Machinery (at cost)	1,200	
Deduct: drawings	<u>150</u>	300	Deduct: depreciation	<u>750</u> 450
Creditors		630	Stock at cost	570
Bank overdraft		<u>270</u>	Debtors	<u>420</u> <u>990</u>
		<u>3,090</u>		<u>3,090</u>

Further investigation reveals the following information:

1. The closing stock includes damaged goods which, although they had cost Sh. 10,000 have an estimated sale value of Sh.7, 500.
2. Debtors include Sh. 20,000 in respect of a customer who has gone bankrupt. A provision for doubtful debts of 2 ½% is also required on the balance of the debtors.
3. The machinery was acquired five years ago and is being depreciated to its scrap value on a straight-line basis over eight years. A more realistic estimate indicates that the life span will be 10 years.
4. Wages owing at 31 March 2000 amounted to Sh. 9,500 but this has not been reflected in the accounts.
5. Charges for the bank overdraft, amounting Sh 8,000 have not been reflected in the accounts.
6. In arriving at the profit for the period, a drawing of Sh 100,000 paid to Mr. Patel had been deducted as an expense.
7. Sh 20,000 rent owing to Mr. Patel for the letting of part of his business premises to external party had not been received and no entry had been made in the books in respect of this item.

Required:

- a) Journal entries to correct errors and omissions. (10 marks)
- b) A statement of revised profit for the year ended 31 March 2000. (8 marks)
- c) A revised balance sheet as at 31 March 2000. (7 marks)

(Total: 25 marks)

Solution

a) **THE JOURNAL**

	Debit	Credit
Trading account	2,500	
Stock		2,500
Being a reduction in stock for damaged goods		
Profit and loss(Bad debts)	20,000	
Debtors		20,000
Debtors gone bankrupt written off		
Profit and loss)	10,000	

Provision for doubtful debts Being a provision for doubtful debts created at 20%.		10,000
Provision for depreciation	150,000	
Profit and loss A change in estimated lifespan for machinery		150,000
Profit and loss(wages)	9,500	
Accrued expenses Wages owing omitted in the accounts		9,500
Profit and loss (Bank overdraft charges)	8,000	
Bank overdraft Changes for overdraft not reflected in the accounts.		8,000
Drawings	100,000	
Profit and loss Drawing to Mr. Patel deducted as an expense.		100,000
Accrued income	20,000	
Profit and loss (rent income) Rent receivable owing not reflected in the accounts.		20,000

b) **STATEMENT OF ADJUSTED NET PROFIT**

	Sh	Sh
Net profit as per the account		450,000
<u>Add:</u> Provision for depreciation	50,000	
Drawings	100,000	
Accrued income (rent)	<u>20,000</u>	<u>170,000</u>
		620,000
<u>Less:</u> Stock reduction	2,500	
Bad debts	20,000	
Provision for doubtful debts	10,000	
Accrued expenses	9,500	
Bank charges	<u>8,000</u>	<u>(50,000)</u>
Net profit (revised)		<u>570,000</u>

REVISED BALANCE SHEET AS AT 31 MARCH 2000

	Sh	Sh	Sh
Land and buildings	1,650,000	-	1,650,000
Machinery	<u>1,200,000</u>	<u>(700,000)</u>	<u>500,000</u>
	<u>2,850,000</u>	<u>700,000</u>	2,150,000
Add: Current Assets			
Stock		567,500	
Debtors	400,00		
Less: Provision for doubtful debts	<u>(10,000)</u>	390,000	
Accrued rent income		<u>20,000</u>	
		977,500	
Less Current liabilities			
Creditors	630,000		

Accrued wage expense	9,500		
Bank overdraft	<u>278,000</u>	<u>(917,500)</u>	<u>60,000</u>
			<u>2,210,000</u>
Capital			1,890,000
Add Net Profit			<u>570,000</u>
			2,460,000
Less drawings			<u>(250,000)</u>
			<u>2,210,000</u>

Errors That Affect The Trial Balance And The Suspense Account

These types of errors are reflected on the trial balance because the debits will not be same as the credits. The debits may be more than the credits and vice versa.

Examples include:

1. Transaction is posted on one side of the accounts i.e. only a debit entry or a credit entry. Example cash received from a debtor is debited to the cashbook and no other entry is made in the account, i.e. no credit entry on the debtor's a/c.
2. A transaction is posted on one side of both the accounts i.e. two debits or two credits. Example a payment to a creditor of £ 300 is credited in the cashbook and also credited in the creditor's accounts.
3. A transaction is posted correctly but different amounts i.e. debit is not the same as the credit. Example – cash received from a debtor of £ 450 is debited in the cashbook as £ 450 and credited as £ 540 in the debtor's a/c.
4. Error on balances of accounts – i.e. understatement or overstatement of an account balance due to mathematical errors.
5. Balance on an account is shown on the wrong side of the account when opening the ledger accounts or when taken up to the trial balance. Example Bal c/d in the cash book for cash at bank of £ 2000 is shown as a credit i.e. an overdraft, instead of a debit in the trial balance. The balance may also be brought down as an overdraft instead of a debit balance in the trial balance.
6. A balance is omitted from the trial balance on the accounts in total.

To correct the above errors, the appropriate or the adjusting entries are made through an account called a suspense account. The difference in the accounts is posted to this account and the entries to correct the accounts are posted here. The balance to be shown on the suspense accounts depends on which side the error is shown on the trial balance.

If the debits > credits, then an amount is included on the credit side of the trial balance so that the debits = credits. This is a credit balance and will be taken to the suspense account on the credit side.

Example:

	DR	CR
Total	240	200
Suspense	<u>-</u>	<u>40</u>
	<u>240</u>	<u>240</u>

Suspense a/c

£	Difference as per T/B	£
		40

If the credits are more than the debits this is a debit balance and therefore we require an amount to be added to the total of the debits for the two side to be same. This debit balance is posted to the debit side of the suspense a/c.

	DR	CR
Total	260	300
Suspense	<u>40</u>	<u>=</u>
	<u>300</u>	<u>300</u>

Suspense a/c

Difference as per T/B	£ 40	£
-----------------------	---------	---

Posting the correct entries should eliminate the balance on the suspense account.

In some cases, after checking for all errors that can affect the trial balance, the suspense a/c has a balance. This balance depends on whether it is a credit or debit and whether it is material or not for purposes of proper accounting treatment. The following is the recommended approach:

Balance	Material	Not Material
Debit	Show as an asset (eg) other debtors	Charge in P&L as an expense
Credit	Show as a liability (eg) other creditors	Report as income in P&L

Example 5.7

A bookkeeper extracted a trial balance on 31 December 2002 that failed to agree by £3,300, a shortage on the credit side of the trial balance. A suspense account was opened for the difference.

In January 2003 the following errors made in 2003 were found:

- (i) Sales daybook had been undercast by £1,000.
- (ii) Sales of £2,500 to J Church had been debited in error to J Chane account.
- (iii) Rent account had been undercast by £700.
- (iv) Discounts received account had been under cast by £3,000.
- (v) The sale of a motor vehicle at book value had been credited in error to Sales account £3,600.

You are required to:

- a) Show the journal entries necessary to correct the errors.
- b) Draw up the suspense account after the errors described have been corrected.
- c) If the net profit had previously been calculated at £79,000 for the year ended 31 December 2002, show the calculations of the corrected net profit

Solution

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	£	£
Suspense	1,000	
Sales		,1000
Sales under cast of £100 now corrected		
J Church	2,500	
J Chane		2,500
Sale to J Church posted to J Chane corrected		
Rent	700	
Suspense		700
Under cast in rent balance now corrected		
Suspense	3,000	
Discount received		3,000
Under cast in discount received balance now corrected		
Sales a/c	3,600	
Disposal		,3600
Sale of motor vehicle entered in sales a/c now corrected		

Suspense a/c

	£		£
Sales	1,000	Bal b/d	3,300
Discount received	3,000	Rent	700
	4,000		4,000

STATEMENT OF CORRECTED NET PROFIT

Net profit as per account	£	£
		79,000
Add:		
Sales	1,000	
Discount received	<u>3,000</u>	<u>4,000</u>
Less:		
Rent	700	
Sales	<u>3,600</u>	<u>(4,300)</u>
Corrected net profit		78,700

Example 5.8

Chi Knitwear Ltd is an old fashioned firm with a handwritten set of books. A trial balance is extracted at the end of each month, and a profit and loss account and balance sheet are computed. This month, however, the trial balance did not balance, the credits exceeding debits by £1,536.

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Your are asked to help and after inspection of the ledgers discover the following errors:

- (i) A balance of £87 on a debtor's account has been omitted from the schedule of debtors, the total of which was entered as debtors in the trial balance.
- (ii) A small piece of machinery purchased for £1,200 had been written off to repairs.
- (iii) The recipients' side of the cashbook had been under cast by £720.
- (iv) The total of one page of the sales daybook had been carried forward as £8,154, whereas the correct amount was £8,514.
- (v) A credit note for £179 received from a supplier had been posted to the wrong side of his account.
- (vi) An electricity bill in the sum of £152, not yet accrued for, is discovered in a filing tray.
- (vii) Mr. Smith, whose past debts to the company had been the subject of a provision, at last paid £731 to clear his account. His personal account has been credited but the cheque has not yet passed through the cashbook.

Solution

Suspense a/c	
	£
Opening balance	1,536.00
Sales - under record	360.00
	1,896.00
	£
Debtors	87.00
Cashbook under cast	720.00
Creditors error	179.00
Creditors (correct)	179.00
Cashbook: smiths debt paid	731.00
	1,896.00

- i. Increase total for debtors by 87.
- ii. Add 1,200 to fixed assets and reduce repair costs by 1,200 therefore an increase in profits.
- iii. Increase sales by 360.
- iv. Reduce the creditors by 358.
- v. accruals by 152 and reduce profits by the same.
- vi. Increase the cash balance by 731.

Example 5.9 (Exam type question – May 2002 question 1).

On 31 December 2001, an inexperienced bookkeeper working for Wanji, a sole trader extracted a trial balance. Due to errors committed by the bookkeeper, the trial balance failed to balance by Sh 369,400. He placed the difference in a suspense account as shown below:

Wanji trial balance as at 31 December 2001

	Sh	Sh
Fixed assets – cost	832,000	
Stocks:		
1 January 2001	148,000	
31 December 2001		98,800
Trade debtors		76,000
Prepayments		10,000
Trade creditors	34,600	
Bank overdraft		15,200
Accruals		16,000
Drawings	359,600	
Capital		1,054,000
Sales	1,043,200	
Provision for depreciation		166,400
Purchases		733,000
Operating expenses	126,000	
Provision for doubtful debts		3,800
Discounts received	5,000	
Discounts allowed		5,800
Suspense account		<u>369,400</u>
	<u>2,548,400</u>	<u>2,548,400</u>

Investigations carried out after preparing the above trial balance detected the following errors:

1. The total of the sales daybook for December 2001 was overcast by Sh 25,700.
2. On July 2001, the business purchased office equipment for Sh 40,000. These were debited to purchases account. Depreciation on the equipment is at the rate of 10% per annum on cost and based on the period (months) of usage in the year.
3. A payment to a creditor by cheque of Sh. 8,500 was erroneously credited to the creditor's account.
4. A payment of Sh. 4,500 for telephone expenses was debited to telephone account as Sh 5,400.
5. An amount of Sh 15,000 received from a debtor was not posted to the debtor's account from the cashbook.
6. Purchases daybook for October 2001 was under cast by Sh 28,000.

Assume the business had reported a net profit of Sh 85,800 before adjusting for the above errors.

Required:

- (a) The adjusted trial balance and the correct balance of the suspense account. (6 marks)
- (b) Journal entries to correct the errors (Narrations not required) (6 marks)
- (c) Suspense account starting with the balance determined in the adjusted trial balance in (a) above. (4 marks)
- (d) The adjusted net profit for the year. (4 marks)

Solution:

Adjusted Trial Balance

	Sh	Sh
Fixed assets – cost	832,000	
Stock - 1 January 2001	148,000	
Trade debtors	76,000	

Prepayments	10,000	
Trade creditors		34,600
Bank overdraft		15,200
Accruals		16,000
Drawings	359,600	
Capital		1,054,000
Sales		1,043,200
Provision for depreciation		166,400
Purchases	733,000	
Operating expenses	126,000	
Provision for doubtful debts		3,800
Discounts received		5,000
Discounts allowed	5,800	
Suspense account	<u>47,800</u>	
	<u>2,338,200</u>	<u>2,338,200</u>

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	Dr	Cr
Sales	25,700	
Suspense		25,700
Office equipment	40,000	
Purchases		40,000
Provision for depreciation	2,000	
Profit and loss		2,000
Creditors	8,500	
Suspense		8,500
Creditors	8,500	
Suspense		8,500
Suspense	900	
Telephone		900
Suspense	15,000	
Debtor		15,000
Suspense	2,500	
Discounts allowed		2,500
Suspense	2,500	
Discounts received		2,500
Purchases	28,000	
Suspense		28,000

SUSPENSE ACCOUNT

2001		Sh	2001		Sh
1 Jan	Bal b/d	47,800	1 Jan	Sales	25,700
	Telephone	900		Creditors	8,500
	Debtors	15,000		Creditors	8,500
	Discount allowed	2,500		Purchases	28,000
	Discount received	2,500			
	Bal c/d	<u>2,000</u>			
		<u>70,700</u>			<u>70,700</u>

STATEMENT OF ADJUSTED NET PROFIT

Net profit as per the accounts	Sh	Sh
Add		85,800
Purchases	40,000	
Telephone expenses	900	
Discount allowed + received	<u>5,000</u>	<u>45,900</u>
		131,700
Less		
Sales	25,700	
Depreciation	2,000	
Purchases	<u>28,000</u>	<u>(55,700)</u>
Corrected Net Profit		<u><u>76,000</u></u>

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SOURCE DOCUMENTS

Specific Objectives

By the end of subject, the trainee should be able to:

- a) Explain the meaning of source documents
- b) Identify types of source documents
- c) Explain the uses of source documents
- d) Explain the relationship between source documents and books of accounts.

SOURCE DOCUMENTS

This shows the evidence transactions. They are collected, filed and posted in the books of prime entry. Example, if a firm sells goods on credit, then an invoice is raised. The source documents as shown in the above include:

- Sales invoice
- Purchases invoice
- Credit note
- Debit note
- Receipts, cheques and petty cash vouchers
- Other correspondences.

(i) Sales Invoice

The sales invoice is raised by the firm and sent to the debtor/customer when the firm makes a credit sale.

The sales invoice contains the following:

- i. Name and address of the firm
- ii. Name and address of the buying firm
- iii. Date of making the sale – invoice date.
- iv. Invoice number
- v. Amount due (net of trade discount)
- vi. Description of goods sold
- vii. Terms of sale

(ii) Purchases Invoice

A purchase invoice is raised by the creditor and sent to the firm when the firm makes a credit purchase. It shows the following:

- i. Name and the address of the creditor/seller
- ii. Name and address of the firm
- iii. Date of the purchase (invoice date)
- iv. Invoice number
- v. Amount due
- vi. Description of goods sold
- vii. Terms of sale

(iii) Credit note

A credit note is raised by the firm and issued to the debtor when the debtor returns some goods back to the firm. It's contents include:

- i. Name and address of the firm
- ii. Name and address of the debtor

-
- iii. Amount of credit
 - iv. Credit note number
 - v. Reason for credit e.g. if goods sent but of the wrong type.

The purpose of the credit note is to inform the debtor or customer that the debtor's account with the firm has been credited i.e. the amount due to the firm has been reduced or cancelled.

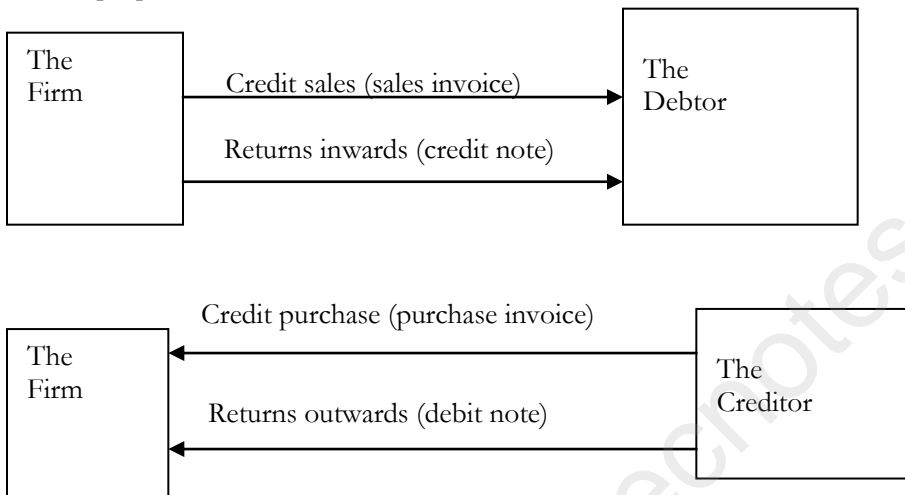
The credit note may also be issued when the firm gives an allowance of the amounts due from the debtors. From the context we can assume that all credit notes are issued when goods are returned.

(iv) Debit note

This is raised by the creditor and issued to the firm when the firm returns some goods to the creditor. It includes the following items:

- i. Name and address of the firm
- ii. Name and address of the creditor
- iii. Amount of debit
- iv. Debit Note number
- v. Reason for the debit

The purpose of the debit note is to inform the firm that the amount due to the creditor has been reduced or cancelled.



(vi) Receipts

A receipt is raised by the firm and issued to customers or debtors when they make payments in the form of cash or cheques. It shows:

- i. The name and address of the firm
- ii. The date of the receipt
- iii. Amount received (cash or cheque or other means of payment)
- iv. Receipt number.

Cheques

When a firm opens a current account with the bank, a chequebook containing cheques issued. The cheques allow the firm to make payments against the account with the bank. When a firm issues a cheque to its creditors for payments, it authorizes the bank to honour payments against the firm's account with the bank. The cheque contains the following information:

- i. Name and account number of the firm (account holder)
- ii. The date of the cheque
- iii. Name of the payee (creditor)
- iv. Name of the firm's bank
- v. Amount payable in words and figures
- vi. The cheque number
- vii. The authorized signature(s)

Petty cash vouchers

A petty cash voucher is raised by a cashier to seek authority for payments (payments of small value in the firm which require cash payments e.g. fuel, bus-fare, office snacks), which is approved by a senior manager and filed for record purpose. It shows:

- i. Date of payment
- ii. Amount paid
- iii. Reason for payment
- iv. Authorized signature(s):
- v. Person approving
- vi. Person receiving

The person receiving the money must then return a document supporting how the money was utilized e.g. fuel receipt, bus ticket e.t.c.

(vii) Other correspondence

These include information received within or outside the firm that has a financial implication in the accounts.

Examples are:

- i. Letters from the firm's lawyers about a debtors balance.
- ii. Hire-purchase/credit sale or credit purchase agreements that relate to non-current assets.
- iii. Memorandum from a senior manager requiring changes to be made in the accounts.
- iv. Bank statement from the bank, e.g. bank charges.

REVIEW QUESTIONS.

1. Name instances when source documents are a must in regard to the correctness of accounting records
2. What source documents are a must when preparing a sales ledger
3. Assume there is an error in the purchases journal, which documents will assist the book-keeper to unearth the cause of the error

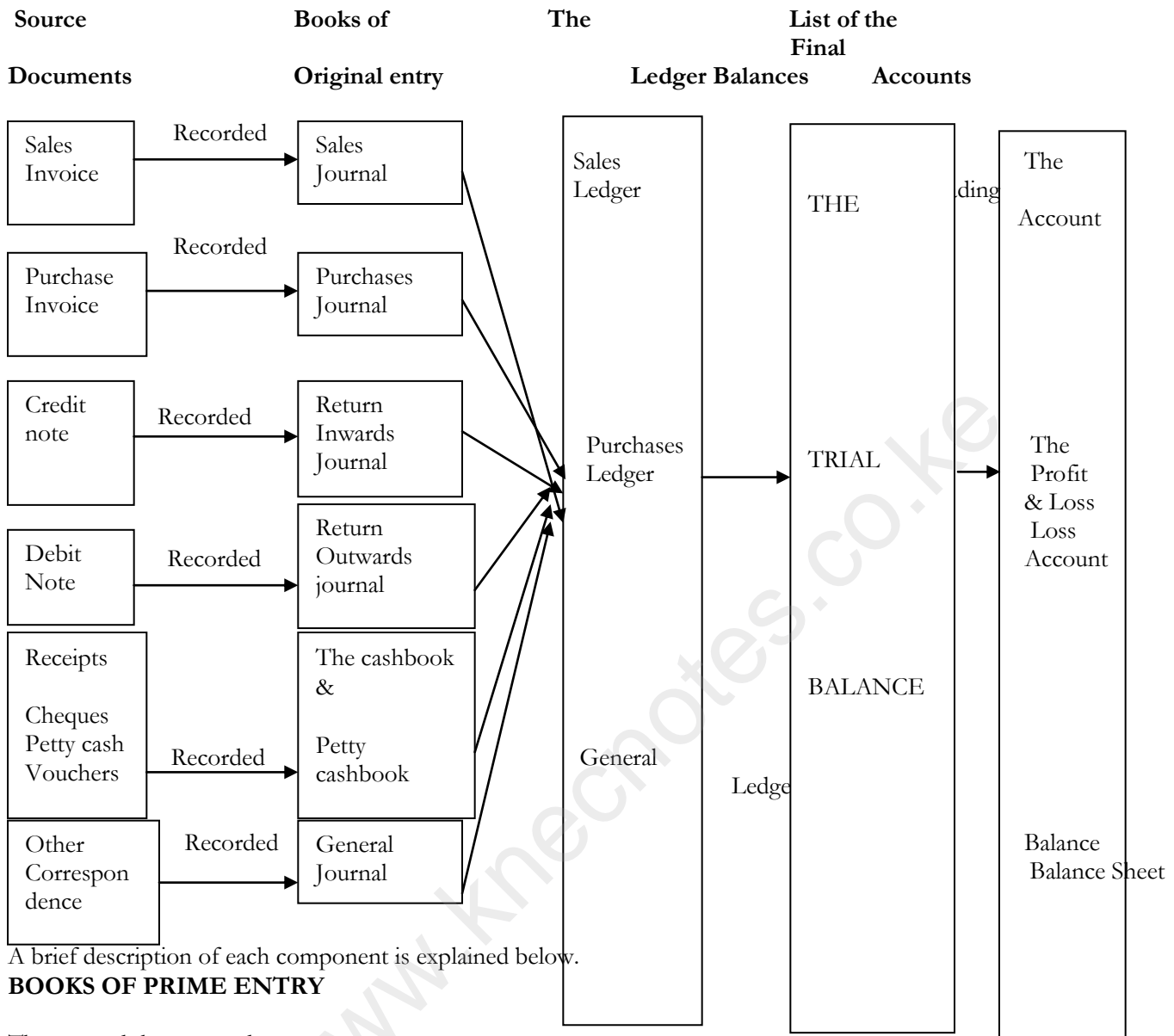
BOOKS OF ORIGINAL ENTRY

By the end of the topic, the trainee should be able to:

- a) Define books of original entry
- b) Classify books of original entries
- c) Explain the preparation of books of original entry
- d) Describe the procedure of posting transactions from the books of original entry to the ledger accounts

BOOKS OF ORIGINAL ENTRY

The diagram below shows the components of an accounting system for a firm that carries out trading activities from the source documents that record the evidence of transactions, where the documents are recorded and the postings to be made.



BOOKS OF PRIME ENTRY

They record the source documents.

Sales Journal

It is also called a Sales Day Book. It records all the sales invoices issued by the firm during a particular financial period. The format is as follows (with simple records of invoice).

SALES JOURNAL			Page 5
Date 19x8	Detail	Folio	Amount £
1 st March	S. Spikes	SL.10	200.00
3 rd March	T. Binns	SL.19	350.00
5 th March	L.Thompson	SL,8	150.00
Total			700.00

The individual entries in the sales journal are posted to the debit side of the debtor's accounts in the sales ledger and the total is posted on the credit side of the sales account in the general ledger.

This is shown below:

Sales Ledger

General Ledger

S Spikes			General Account		
19x8	£	19x8 £	19x8	£	19x8 £
1/3	Sales 200				5/3 Credit sales for 700 period

Sales Ledger

General Ledger

T Binus			L Thompson		
19x8	£	19x8	19x8	£	
3/3	Sales 350				
19x8	£	19x8	£		
3/3	Sales 150				

Example 2.4

You are to enter up the sales journal from the following details. Post the items to the relevant accounts in the sales ledger and then show the transfer to the sales account in the general ledger.

2003			
Mar	1	Credit sales to J Gordon	£1,870
"	3	Credit sales to G Abrahams	£1,660
"	6	Credit sales to V White	£120
"	10	Credit sales to J Gordon	£550
"	17	Credit sales to F Williams	£2,890
"	19	Credit sales to U Richards	£660
"	27	Credit sales to V Wood	£280
"	31	Credit sales to L Simes	£780

Answer

SALES JOURNAL			Page 10
Date (2003)	Detail	Folio	Amount
1/3	J. Gordon		1,870.00
3/3	G. Abrahams		1,660.00
6/3	V. White		120.00
10/3	J. Gordon		550.00
17/3	F. Williams		2,890.00
19/3	U. Richards		660.00
27/3	V. Wood		280.00
31/3	L. Simes		780.00
			8,810.00

Sales Ledger

J Gordon				U Richards			
2003	£	2003	£	2003	£	2003	£
1/3	1570			19/3 Sales	660		
10/3	550						
G Abrahams				V Wood			
2003	£	2003	£	2003	£	2003	£
3/3 Sales	1,660			27/3 Sales	280		
U White				L Simes			
2003	£	2003	£	2003	£	2003	£
6/3 Sales	120			31/3 Sales	750		
F Williams				Sales a/c			
2003	£	2003	£	2003	£	2003	£
17/3 Sales	2890					Credit	
						Sales	

Purchases Journal

Purchases journal is also called a purchases day-book. It records all the purchase invoices received by the firm during a particular financial period. It has the following format (including records of invoices).

PURCHASES JOURNAL			Page 15
Date 19x6	Description/Detail	Folio	Amount
1/5	C. Kelly	PL. 10	400

2/5	L. Smailes	PL. 20	350
-----	------------	--------	-----

TOTAL			750
-------	--	--	-----

The individual entries in the purchases journal are posted to the credit side of the creditor's accounts in the purchases ledger and the total is posted to the debit side of purchases account of the general ledger. This is shown below:

C Kelly				Purchases a/c			
19x6	£	19x6	£	19x6	£	19x6	£
		1/5 Purchases	400	31/5 Sundry	750		
					Creditors		

L Smailes			
19x6	£	19x6	£
		2/5 Purchases	250

Returns Inwards Journal

It is also called the returns inwards day-book. It records all the credit notes raised by the firm and sent to customers during a particular financial period, it has the following format.

RETURNS INWARDS JOURNAL			Pg 10
Date	Detail	Folio	Amount
1 March	S. Spikes	SL. 22	£20
2 March	C. Kelly	SL. 18	£18
5 March	T. Bills	SL. 9	£15
TOTAL			£53

Individual entries in a return inwards journal are posted to the credit of the debtors accounts in the sales ledger and the total is posted to the debit side of the return-inwards account of the general ledger.

Sales Ledger

General Ledger

S. Spikes a/c				Returns Inwards a/c			
£		£		£		£	
	1/3	Returns In	20	31/3 Sundry	53		

Debtors

C Kelly a/c

£			£
	2/3	Returns In	18

T. Bills a/c

£			£
	5/3	Returns In	15

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Returns Outwards Journal

It is also called the returns outwards daybook. It records all the debit notes received by the firm from the creditors during a particular financial period. It has the following format.

RETURNS OUTWARDS JOURNAL			
DATE	DETAILS	FOLIO	AMOUNT (£)
2 May	L. Thompson	PL. 15	14
3 May	M. Hyatt	PL. 10	12
4 May	T. Bills	PL. 7	19
TOTAL			35

Individual entries are posted on the debit side of the creditors account in the purchases ledger and on the total to credit side of the returns outwards account in the general ledger.

Purchases Ledger

L. Thompson a/c	
2/5 Returns out	£ 14
M. Hyatt a/c	
3/5 Returns out	£ 12
T. Bills a/c	
4/5 Returns Out	£ 19

General Ledger

Returns Outwards a/c	
31/5 sundry creditors	£ 35

The following example 2.5 shows how the four journals are used.

Example 2. (Frankwood adapted)

You are to enter the following items in the books, post to personal accounts, and show transfers to the general ledger.

19x5

- July 1 Credit purchases from: K Hill £3800; M Norman £500; N Senior £106.
- “ 3 Credit sales to: E Rigby £510; E Phillips £246; F Thompson £356.
- 5 Credit purchases from: R Morton £200; J Cook £180; D Edwards £410; C Davies £66.
- “ 8 Credit sales to: A Green £307; H George £250; J Ferguson £185.
- “ 12 Returns outwards to: M Norman £30; N Senior £16.
- “ 14 Returns inwards from: E Phillips £18; F Thompson £22.
- “ 20 Credit sales to: E Phillips £188; F Powell £310; E Lee £420.
- “ 24 Credit purchases from: Ferguson £550; K Ennevor £900.
- “ 31 Returns inwards from: E Phillips £27; E. Rigby £30.
- “ 31 Returns outwards to: J Cook £13; C Davies £11.

Study the solution provided:

SALES JOURNAL		
DATE	DETAIL	AMOUNT (£)
3 July	E. Rigby	510
3 July	E. Phillips	246
3 July	F. Thompson	356
8 July	A. Green	307
8 July	H. George	250
8 July	J. Ferguson	185
20 July	E. Phillips	188
20 July	F. Powell	310
20 July	E. Lee	420
TOTAL		2,772

Sales Ledger

E Rigby				E Phillips					
19x5		£		19x5		£			
3/7	Sales	510	3/7	Returns		30			
				Inwards					
				20/7	Sales	188	31/7	Retuns in	27

F. Thompson				J. Ferguson			
19x5		£		19x5		£	
3/7	Sales	356	14/7	Returns		22	
				in			
				8/7	Sales	185	

Green				F. Powell			
19x5		£		19x5		£	
8/7	Sales	307		20/7	Sales	310	

H George			E Lee		
19x5		£	19x5	£	19x5
8/7	Sales	250	20/7	Sales	420

PURCHASES JOURNAL

DATE	DETAIL	AMOUNT (£)
1 July	K. Hill	380
1 July	M. Norman	500
1 July	N. Senior	106
5 July	R. Mortan	200
5 July	J. Cook	180
5 July	D. Edwards	410
5 July	C. Davies	66
24 July	C. Ferguson	550
24 July	K. Ennevor	900
Total		3,292

Purchases Ledger

N. Senior			
1995		£	1995
12/7	Returns out	16	1/7 Purchases
			22

M. Norman			
1995		£	1995
30/7	Returns out	30	1/7 Purchases
			500

J. Cook			
1995		£	1995
31/7	Returns out	13	5/7 Purchases
			180

C. Davies			
1995		£	1995
31/7	Returns out	11	5/7 Purchases
			60

K. Hill			
1995		£	1995
			1/7 Purchases
			380

R. Morton			
1995		£	1995
			5/7 Purchases
			200

D. Edwards			
1995		£	1995

		5/7 Purchases	410
C. Ferguson			
1995	£	1995 27/7 Purchases	£ 550
K. Ennevor			
1995	£	1995 24/7 Purchases	£ 900

RETURNS INWARDS JOURNAL		
DATE	DETAILS	AMOUNT
14 July	E. Phillips	18
14 July	F. Thompson	22
31 July	E. Phillips	27
31 July	E. Rigby	30
		97

RETURNS OUTWARDS JOURNAL		
12 July	M. Norman	30
12 July	N. Senior	16
31 July	J. Cook	13
31 July	C. Davies	11
		70

General Ledger

Sales a/c

1995	£	1995 31/7 Sundry debtors	£ 2772
------	---	-----------------------------	-----------

Purchases a/c

1995	£	1995	£
31/7 Sundry creditors	3292		

Returns Inwards a/c

1995	£	1995	£
31/7 Sundry debtors	97		

Returns Outwards a/c

1995	£	1995	£
		31/7 Sundry creditors	70

THE CASH BOOK

Specific Objectives.

By the end of the topic, the trainee should be able to:

- a) Define the cash book
- b) Explain the types of cash book
- c) Distinguish between the types of discounts
- d) Record transactions in a three column cash book

A cashbook records all the receipts (cash and cheques from customers and debtors or other sources of income) and all the payments (to creditors or suppliers and other expenses) for a particular financial period. The cashbook will also show us the cash at bank and cash in hand position of the firm.

There are two types of cashbooks:

- i. Cash in hand cashbook, which records the cash transactions in the firm or business.
- ii. Cash at bank cashbook, which records the transactions at/with, the bank.

The cashbook is the most important book of prime entry because it forms part of the general ledger and records the source documents (receipts and cheques). The cash at bank cashbook and cash in hand cashbook are combined together to get a two-column cashbook. The format is as follows:

Two-column cashbook.

CASH BOOK

Date	Details	Cash (£)	Bank (£)	Date	Details	Cash (£)	Bank (£)

Additional columns for discounts allowed and discounts received can be included with the cash at bank columns to get a 3 – column cashbook. The format is as follows:

Date	Details	Discount Allowed	Cash (£)	Bank (£)	Date	Details	Discounts Received	Bank (£)	Cash (£)

The balance carried down (Bal c/d) for cash in hand and cash at bank will form part of the ledger balances and the discounts allowed and discounts received columns will be added and the totals posted to the respective discount accounts. The discount allowed total will be posted to the debit side of the discount allowed account in the general ledger and the total of the discount received will be posted to the credit side of the discount-received account of the general ledger.

Cash at bank can have either a credit or debit balance. A debit balance means the firm has some cash at the bank and a credit balance means that the account at the bank is overdrawn. (the firm owes the bank some money).

Example 2.7

Write up a two-column cashbook from the following details, and balance off as at the end of the month:

2003

- May 1 Started business with capital in cash £1,000.
- “ 2 Paid rent by cash £100.
- “ 3 F Lake lent us £5,000, paid by cheque.
- “ 4 We paid B McKenzie by cheque £650.
- “ 5 Cash sales £980.
- “ 7 N Miller paid us by cheque £620.
- “ 9 We paid B Burton in cash £220.
- “ 11 Cash sales paid direct into the bank £530.

- “ 15 G Moores paid us in cash £650.
 “ 16 We took £500 out of the cash till and paid it into the bank account.
 “ 19 We repaid F Lake £1,000 by cheque.
 “ 22 Cash sales paid direct into the bank £660.
 “ 26 Paid motor expenses by cheque £120.
 “ 30 Withdrew £1,000 cash from the bank for business use.
 “ 31 Paid wages in cash £970.

Cash Book					
	Cash	Bank		Cash	Bank
Capital	1000				
F Lake (loan)		5000			
Sales	980				
N Miller		620			
Sales		530			
G Moores	650				
Cash C					
Sales					
Bank C					

Cash Book					
	Cash	Bank		Cash	Bank
Capital	1000		Rent	100	
F. Lake (Loan)		5000	B McKenzie		650
Sales		980	B Burton	220	
N Miller		620	Bank C	500	
Sales		530	F Lake (loan)		1000
G Moores	650		Motor Expenses	120	100
Cash C		500	Cash C		
Sales		660	Wages	970	
Bank C		1000	Balances c/d	1840	4540
	<u>3630</u>	<u>7310</u>		<u>3630</u>	<u>7310</u>

REVIEW QUESTION

A three-column cashbook is to be written up from the following details, balanced off, and the relevant discount accounts in the general ledger shown.

- 19x8
 Mar 1 Balances brought forward: Cash £230; Bank £4,756.
 “ 2 The following paid their accounts by cheque, in each case deducting 5 percent discounts: R Burton £140; E Taylor £220; R Harris £800.
 “ 4 Paid rent by cheque £120.
 “ 6 J Cotton lent us £1,000 paying by cheque.
 “ 8 We paid the following accounts by cheque in each case deducting a 2 ½ per cent cash discount: N Black £360; P Towers £480; C Rowse £300.

“	10	Paid motor expenses in cash £44.
“	12	H Hankins pays his account of £77, by cheque £74, deducting £3 cash discount.
“	15	Paid wages in cash £160.
“	18	The following paid their accounts by cheque, in each case deducting 5 per cent cash discount: C Winston £260; R Wilson & Son £340; H Winter £460.
“	21	Cash withdrawn from the bank £350 for business use.
“	24	Cash Drawings £120.
“	25	Paid T Briers his account of £140, by cash £133, having deducted £7 cash discount.
“	29	Bought fixtures paying by cheque £650.
“	31	Received commission by cheque £88.

Required:

- a) Prepare a three column cash book
- b) Open discounts accounts to show the requisite entries

THE PETTY CASH BOOK

Specific Objectives.

By the end of the topic, the trainee should be able to:

- a) Define cash book
- b) Explain the meaning of the imprest system
- c) Explain the purpose of maintaining a petty cash book
- d) Explain the preparation of a petty cash book

Petty Cash Book and the imprest system of Accounting.

Petty Cash Book is a record of all the petty cash vouchers raised and kept by the cashier. The petty cash vouchers will show summary expenses paid by the cashier and this information is listed and classified in the petty cash book under the headings of the relevant expenses such as:

- Postage and stationery
- Traveling
- Cleaning expenses.

The format is as shown:

Petty Cash Book

Receipts	Date	Detail	Payments Amount	Expenses			The Ledger
				Postage	Stationery	Traveling	

The balance c/d of the petty cash book will signify the balance of cash in hand or form part of cash in hand. The totals of the expenses are posted to the debit side of the expense accounts. If a firm operates another cashbook in addition to the petty cash book, then the totals of the expenses will also be posted on the credit side of the cash in hand cashbook.

The Imprest system

This system of accounting operates on a simple principle that the cashier is refunded the exact amount spent on the expenses during a particular financial period. At the beginning of each period, a cash float is agreed upon and the cashier is given this amount to start with. Once the cashier makes payments for the period he will get a total of all the payments made against which he will claim a reimbursement of the same amount that will bring back the amount to the cash float at the beginning of the period.

This is demonstrated as follows:

Start with (float)	£ 1,000
Expenses paid	<u>(720)</u>
Balance	280
Reimbursement	<u>720</u>
Cash float	<u>1,000</u>

REVIEW QUESTION

A cashier in a firm starts with £2,000 in the month of March (that is the cash float). In the following week, the following payments are made:

1 st March – bought stamps for	£ 80
2 nd March – paid bus fare for	120
2 nd March – cleaning materials	240
3 rd March – bought fuel	150
3 rd March – cleaning wages	300
4 th March – bought stamps	200
4 th March – paid L. Thompson (creditor)	400
5 th March – fuel costs	150

On the 5th of March the cashier requested for a refund of the cash spent and this amount was reimbursed back.

Required:

Prepare a detailed petty cash book showing the balance to be carried forward to the next period and the relevant expense accounts, as they would appear on the General Ledger.

BANK RECONCILIATION STATEMENTS

Specific Objectives.

By the end of the topic, the trainee should be able to:

- To define what is a bank reconciliation statement
- Explain the purpose of preparing a reconciliation statement
- Explain the causes of the difference between bank statements and the cash book balance

d) Explain the steps/procedures in preparing bank reconciliation statement

BANK RECONCILIATION STATEMENTS

The cashbook for cash at bank records all the transactions taking place at the bank i.e. the movements of the account held with the bank. The bank will send information relating to this account using a bank statement for the firm to compare. Ideally, the records as per the bank and the cashbook should be the same and therefore the balance carried down in the cashbook should be the same as the balance carried down by the bank in the bank statement.

In practice however, this is not the case and the two (balance as per the bank and firm) are different. A bank reconciliation statement explains the difference between the balance at the bank as per the cashbook and balance at bank as per the bank statement.

Causes of the differences:

Items Appearing In The Cashbook And Not Reflected In The Bank Statement.

Unpresented Cheques: Cheques issued by the firm for payment to the creditors or to other supplies but have not been presented to the firm's bank for payment.

Uncredited deposits/cheques: These are cheques received from customers and other sources for which the firm has banked but the bank has not yet availed the funds by crediting the firm's account.

Errors made in the cashbook

These include:

- Payments over/understated
- Deposits over/understated
- Deposits and payments misposted
- Overcasting and undercasting the Bal c/d in the cashbook.

ii) Items appearing in the bank statement and not reflected in the cashbook:

Bank charges: These charges include service, commission or cheques.

Interest charges on overdrafts.

Direct Debits (standing orders) e.g. to pay Alico insurance.

Dishonored cheques

A cheque would be dishonored because:

- Stale cheques
- Post – dated cheques
- Insufficient funds
- Differences in amounts in words and figures.

Direct credits

Interest Income/Dividend income

Errors of The Bank Statement (Made By The Bank).

Such errors include:

- Overstating/understating.
- Deposits
- Withdrawals

The Purposes of a bank reconciliation statement.

1. To update the cashbook with some of the items appearing in the bank statement e.g. bank charges, interest charges and dishonoured cheques and make adjustments for any errors reflected in the cashbook.
2. To detect and prevent errors or frauds relating to the cashbook.
3. To detect and prevent errors or frauds relating to the bank.

Steps in preparing a bank reconciliation statement.

1. To update the cashbook with the items appearing in the bank statement and not appearing in the cashbook except for errors in the bank statement. Adjustments should also be made for errors in the cashbook.
2. Compare the debit side of the cashbook with the credit side of the bank statement to determine the uncredited deposits by the bank.
3. Compare the credit side of the cashbook with the debit side of the bank statement to determine the unrepresented cheques.
4. Prepare the bank reconciliation statement which will show:
 - a) Unpresented cheques
 - b) Uncredited deposits
 - c) Errors on the bank statement
 - d) The updated cashbook balance.

The format is as follows:

(Format 1)

Name:

Bank Reconciliation Statement as at 31/12

	£	£
Balance at bank as per cashbook (updated)		x
Add: Un presented cheques	x	
Errors on Bank Statement (see note 1)	x	<u>x</u>
		x
Less: Uncredited deposits	x	
Errors on Bank Statement (see note 2)	x	<u>(x)</u>
Balance at bank as per Balance Sheet		<u>x</u>

Note 1: These types of errors will have an effect of increasing the balance at bank e.g. an overstated deposit or an understated payment by the bank.

Note 2: These types of errors will have an effect of decreasing the balance at bank e.g. an understated deposit or an overstated payment by the bank, or making an unknown payment.

Format 2

Name:

Bank Reconciliation Statement as at 31/12

	£	£
Balance at bank as per bank statement		x
Add: Uncredited deposits	x	
Add errors on bank statement (note 2)	x	<u>x</u>
		x
Less: Unpresented cheques	x	
Errors on bank statement (note 1)	<u>x</u>	<u>(x)</u>
Balance at bank as per cashbook (updated)		x
		===

Example 4.8

Draw up a bank reconciliation statement, after writing the cashbook up to date, ascertaining the balance on the bank statement, from the following as on 31 March 2003:

Cash at bank as per bank column of the cashbook (Dr)		£	38,960
Bankings made but not yet entered on bank statement			6,060
Bank charges on bank statement but not yet in cashbook			280
Un presented cheques C Clarke entered on bank statement, but not in cash book	550		1170 Standing order to ABC Ltd
Credit transfer from A Wood entered on bank statement, but not yet in cashbook			1,890

Solution

Cashbook – Bank

19X9	£	19X9	£
31/3 Bal b/d	38960	Bank charges	280
A Wood (credit transfer)	<u>1890</u>	ABC (standing order)	550
	<u>40,850</u>	31/3 Bal C/D	40,020
			<u>40,850</u>

Bank Reconciliation as at 31/03/2003

Balance at bank as per cashbook	£	40,020	£
Add: Unpresented cheques			<u>1,170</u>
			41,190
Less: Uncredited deposits			<u>(6,060)</u>
Balance at bank as per Balance Sheet			35,130
			=====

Example 4.9

The following are extracts from the cashbook and the bank statement of J Richards. You are required to:

- Write the cashbook up to date, and state the new balance as on 31 December 2002, and
- Draw up a bank reconciliation statement as on 31 December 2002.

Cashbook

2002	Dr	£	2002	Cr	£
Dec 1	Balance b/d	1,740	Dec 8	A Dailey	349
Dec 7	J Map	88	Dec 15	R Mason	33
Dec 22	J Cream	73	Dec 28	G Small	115
Dec 31	K Wood	249	Dec 31	Balance c/d	1,831
Dec 31	M Barrett	178			
		<u>2,328</u>			<u>2,328</u>

Bank Statement

2002		Dr	Cr	Balance
		£	£	£
Dec 1	Balance b/d			1,740
Dec 7	Cheque	88	1,828	
Dec 11	A Dailey	349		1,479
Dec 20	R Mason	33		1,446
Dec 22	Cheque		73	1,519
Dec 31	Credit transfer: J Walters		54	1,573
Dec 31	Bank charges	22		1,551

Cashbook –Bank

<u>2002</u>	£	<u>2002</u>	£
31/12 Bal b/d	1,831	31/1 Bank charges	22
31/12 J. Walters (C/T)	54	31/12 Bal C/D	1,863
	<u>1,885</u>		<u>1,885</u>

J. Richards

Bank Reconciliation Statement as at 31/12/2002

Balance at bank as per cashbook – bank	£		£
Add: Unpresented cheques – (G Small)			1,863
			<u>115</u>
			1,978
Less: Uncredited deposits			
K Wood	249		
M. Barret	<u>178</u>		<u>(427)</u>
Balance at bank as per balance sheet			<u>1,551</u>
OR:			
Balance at bank as per balance sheet			1,551
Add: Uncredited deposits:			
K. Wood			249
M. Barret			<u>178</u>
			1,978
Less: Unpresented cheques			<u>(115)</u>
Balance at bank as per cashbook – bank			<u>1,863</u>

REVIEW QUESTIONS:

1. (a) Explain the term “bank reconciliation” and state the reasons for its preparation.
- (b) Ssemakula, a sole trader received his bank statement for the month of June 2001. At that date the bank balance was Sh. 706,500 whereas his cash book balance was Sh.2,366,500. His accountant investigated the matter and discovered the following discrepancies:
 1. Bank charges of Sh.3, 000 had not been entered in the cashbook.
 2. Cheques drawn by Ssemakula totaling Sh.22, 500 had not yet been presented to the bank.
 3. He had not entered receipts of Sh.26, 500 in his cashbook.
 4. The bank had not credited Mr Ssemakula with receipts of Sh.98, 500 paid into the bank on 30 June 2001.
 5. Standing order payments amounting to Sh.62, 000 had not been entered into the cashbook.
 6. In the cashbook Ssemakula had entered a payment of Sh.74, 900 as Sh.79, 400.
 7. A cheque for Sh.15, 000 from a debtor had been returned by the bank marked “refer to drawer” but had not been written back into the cashbook.
 8. Ssemakula had brought forward the opening cash balance of Sh.329, 250 as a debit balance instead of a credit balance.
 9. An old cheque payment amounting to Sh.44, 000 had been written back in the cashbook but the bank had already honored it.
 10. Some of Ssemakula’s customers had agreed to settle their debts by paying directly into his bank account. Unfortunately, the bank had credited some deposits amounting to Sh.832, 500 to another customer’s account.

However acting on information from his customers Ssemakula had actually entered the expected receipts from the debtors in his cashbook.

Required:

- i. A statement showing Ssemakula's adjusted cashbook balance as at 30 June 2001. A bank reconciliation statement as at 30 June 2001.
 - ii. An updated cash book
2. (a) What is the purpose of preparing a bank reconciliation statement? (4marks)
 (b) The following is the bank statement of Kakamega Retail Traders for the month of October 1996:

Date 1996	Particulars	Debit Sh.	Credit Sh.	Balance Sh.
October 1	Balance b/d			365,875
2	Cheque no. 63	31,000		334,875
2	Cheque no. 67	3,548		331,327
2	Cheque no. 65	13,000		318,327
2	Deposit	82,000		400,327
4	Cheque no. 69		6,000	394,327
4	Cheque no. 68		3,115	391,212
4	Cheque no. 64		51,000	340,212
4	Deposit	7,280		347,492
7	Cheque no. 70		7,000	340,492
7	Cheque no. 71		51,500	288,992
7	Deposit	36,100		325,092
8	Cheque no. 66		9,000	316,092
8	Deposit	28,000		344,092
October 9	Cheque no. 72		1,330	342,762
9	Cheque no. 73		6,250	336,512
9	Deposit	51,000		387,512
15	Cheque no. 74		2,800	384,712
15	Deposit	20,560		405,272
16	Cheque no. 75		65,000	340,272
16	Deposit	18,014		358,286
17	Deposit	34,500		392,786
19	Cheque no. 76	8,500		384,286
19	Deposit	42,750		427,036
21	Cheque no. 79		2,410	424,626
21	Cheque no. 77		12,506	412,120
21	Cheque no. 78		4,000	408,120
21	Cheque no. 81	6,500		401,620
21	Deposit	9,000		410,620
23	Cheque no. 82	16,240		394,380
23	Deposit	63,000		457,380
26	Cheque no. 84		1,500	455,880
26	Dividends		8,750	464,630
26	Deposit	62,500		527,130

28	Cheque no. 88		35,500	491,630
28	Standing order (Insurance)	10,400		481,230
28	Cheque no. 85	27,000		454,230
28	Cheque no. 87	22,500		431,730
28	Deposit	13,025		444,755
31	Service charge	750		444,005
31	Deposit	28,050		472,055

The following is the bank column of the cashbook:

Date 1996	Particulars	Debit Sh.	Date 1996	Particulars	Credit Sh.
October 1	Balance b/d	365,875	October 1	Cheque no. 65	13,000
1	Deposited at bank	7,280	1	Cheque no. 66	9,000
3	Deposited at bank	36,100	1	Cheque no. 67	3,548
5	Deposited at bank	28,000	2	Cheque no. 68	3,115
8	Deposited at bank	51,000	4	Cheque no. 69	6,000
10	Deposited at bank	20,560	5	Cheque no. 70	7,000
15	Deposited at bank	18,014	5	Cheque no. 71	51,500
15	Deposited at bank	34,500	7	Cheque no. 72	1,330
17	Deposited at bank	42,750	8	Cheque no. 73	6,250
19	Deposited at bank	15,700	10	Cheque no. 74	2,800
19	Deposited at bank	9,000	11	Cheque no. 75	65,000
22	Deposited at bank	36,000	15	Cheque no. 76	5,800
24	Deposited at bank	26,500	18	Cheque no. 77	12,506
27	Deposited at bank	13,025	19	Cheque no. 78	4,000
28	Deposited at bank	28,050	19	Cheque no. 79	2,410
29	Deposited at bank	171,010	19	Cheque no. 80	3,860
31	Deposited at bank	31,525	19	Cheque no. 81	6,500
			22	Cheque no. 82	16,240
			23	Cheque no.	815,000
			26	Cheque no. 84	1,500
			28	Cheque no. 85	27,000
			28	Cheque no. 86	10,520
			28	Cheque no. 87	22,500
			28	Cheque no. 88	53,500
			30	Cheque no. 89	2,500
			31	Cheque no. 90	64,529
			31	Cheque no. 91	15,500
			31	Balance c/d	<u>502,481</u>
		<u>934,889</u>			<u>934,889</u>

Notes:

1. The bank reconciliation on 30 September 1996 showed that one deposit was in transit and two cheques had not yet been presented to the bank.
2. Deposits of Sh.62, 500 and Sh.36, 000 had been entered in the cashbook as Sh.26, 500 and Sh.36, 000 and in the bank statement as Sh.62, 500 and Sh.63, 000, respectively.
3. A cheque from Mkulima for Sh.15, 700 was deposited on 18 October 1996 but was dishonored and the advice was received on 4 November 1996.

4. Counterfoils for cheques no. 76 and no. 88 showed they had been drawn for Sh.5, 800 and Sh.33, 500 respectively.

Required:

- a) A correct cashbook balance.
- b) A bank reconciliation statement on 31 October 1996.**
- c) An updated cash book
- d)**

4. On 10 January 19X9, Frank Mercer received his monthly bank statement for December 19X9. The statement showed the following.

MIDWEST BANK				
F Mercer: Statement of Account				
Date	Particulars	Debits	Credits	Balance
19X8		\$	\$	\$
Dec 1	Balance			1,862
Dec 5	417864	243		1,619
Dec 5	Dividend		26	1,645
Dec 5	Bank Giro Credit		212	1,857
Dec 8	417866	174		1,683
Dec 10	417867	17		1,666
Dec 11	Sundry Credit			1,851
Dec 14	Standing Order	32	185	1,819
Dec 20	417865	307		1,512
Dec 20	Bank Giro Credit			1,630
Dec 21	417868	95	118	1,535
Dec 21	416870	161		1,374
Dec 24	Bank charges	18		1,356
Dec 27	Bank Giro Credit			1,403
Dec 28	Direct Debit	88	47	1,315
Dec 29	417873	12		1,303
Dec 29	Bank Giro Credit			1,582
Dec 31	417871	25	279	1,557

His cashbook for the corresponding period was as follows.

CASH BOOK

19x8		\$	19x8		Cheque No	\$
Dec 1	Balance b/d	1,862	Dec 1	Electricity		243
Dec 4	J Shannon	212	Dec 2	P Simpson	864	307
Dec 9	M Lipton	185	Dec 5	D Underhill	865	174
Dec 19	G Hurst	118	Dec 6	A Young	866	17
Dec 26	M Evans	47	Dec 10	T Unwin	867	95
Dec 27	J Smith	279	Dec 14	B Oliver	868	71
Dec 29	V Owen	98	Dec 16	Rent	869	161
Dec 30	K Walters	134	Dec 20	M Peters	870	25
			Dec 21	L Philips	871	37
			Dec 22	W Hamilton	872	12
			Dec 31	Balance c/d	873	<u>1,793</u>
						<u>2,935</u>
		<u>2,935</u>				

Required

- a) Bring the cash book balance of \$1,793 up to date as at 31 December 19X8. (10 marks)
- b) Draw up a bank reconciliation statement as at 31 December 19X8

CONTROL ACCOUNTS.

Specific objectives.

By the end of the topic, the trainee should be able to:-

- Define control accounts
- Explain the uses of control accounts
- Explain the preparation of control accounts

CONTROL ACCOUNTS

Control accounts are so called because they control a section of the ledgers. By control we mean that the total on the control accounts should be the same as the totals on the ledger accounts. There are two main types of control accounts:

- Sales ledger control Account** – also called total debtors. The balance on the sales ledger control account should be the same as the total of the balances in the sale ledger.
- Purchases Ledger Control Account** – also called total creditors. The balance carried down (Bal c/d) on the purchases Ledger Control Account should be the same as the total of the balances in the purchases ledger.

Example (Sales Ledger Control a/c)

Sales Ledger Control A/c			
Sales	1400	CashBook	700
		Bal C/D	700
	<u>1400</u>		<u>1400</u>

Sales = 200 + 300 + 400 + 500
Cashbook = 50 + 100 + 250 + 300
Balance c/d = 150 + 150 + 200 + 200

SALES LEDGER

Debtor A a/c			
Sales	200	C/B	50
		Bal c/d	150
	<u>200</u>		<u>200</u>

Debtor B a/c			
Sales	400	C/B	250
		Bal c/d	150
	<u>400</u>		<u>400</u>

Debtor C a/c			
Sales	300	C/B	100
		Bal c/d	200
	<u>300</u>		<u>300</u>

Debtor D a/c			
Sales	500	C/B	300
		Bal c/d	200
	<u>500</u>		<u>500</u>

Example: Purchases Ledger Control a/c

Purchases Ledger Control a/c			
C/B	1900	Purchases	2600
Bal c/d	700		
	<u>2600</u>		<u>2600</u>

PURCHASES LEDGER

Creditor A			
C/B	400	Purchases	600
Bal c/d	200		
	<u>600</u>		<u>600</u>

Creditor B			
C/B	450	Purchases	700
Bal c/d	250		
	<u>700</u>		<u>700</u>

Creditor C			
C/B	350	Purchases	500
Bal c/d	150		
	<u>500</u>		<u>500</u>

Creditor D			
C/B	700	Purchases	800
Bal c/d	100		
	<u>800</u>		<u>800</u>

Purpose of Control Accounts

1. Provide for arithmetical check on the postings made in the individual accounts (either in the sales ledger or purchases ledger.)
2. To provide for a quick total of the balances to be shown in the trial balance as debtors and creditors.
3. To detect and prevent errors and frauds in the customers and suppliers account.
4. To facilitate delegation of duties among the debtors and creditors clerks.

FORMAT OF A SALES LEDGER CONTROL

Sales Ledger Control a/c	
1. Balance b/d of the total debit balances from previous period	1. Total credit balances of the sales ledger brought forward
2. Total credit sales for the period (from the sales journal)	2. Total cash received from credit customers/debtors (from cash book)
3. Refunds to customers (from cashbook)	3. Total cheques received from credit customers/debtors (from cash book)
4. Dishonored cheques (from cashbook)	4. Total returns-inwards (returns-inwards)

	journal)
5. Bad debts recovered (from general journal)	5. Total cash discount allowed to customers (from cash book)
	6. Bad debtors written-off (from general journal)
	7. Cash received from bad debtors recovered (cash book)
	8. Purchases Ledger contra
	9. Allowances to customers (price reduction in excess to discounts allowed)
6. Total credit balances of the sales Ledger carried forward	10. Total debit balance carried down to the next period – to be derived after posting all those transactions

Refunds to Customers

Sometimes a firm can refund some cash on the customers account. This takes place when there is a credit balance on the debtor's a/c and the customer is not a creditor too.

The entry will be:

Dr. Debtor's a/c
Cr. Cashbook

Example:

Debtor A			
	£		£
Sales	1000	Cashbook	950
(Refunds) C/B	100	Discounts	50
		Returns	100
	1100		1100

If the firm has not paid this amount owed to the customer, then it's carried forward to the next period then is a credit balance in the customer's a/c. Therefore, if a firm has several customer, this information will be shown in the control a/cs as total balance c/f (debit side).

Contra against the purchases ledger balances:

Some debtors may also be creditors in the same firm and therefore, if the amount due to them as creditors is less than what they owe as debtors, then the credit balance is transferred from their creditors a/c to their debtors a/c as a contra entry.

Example:

Debtor (A)			
Sales	2000	Contra- purchases	1000
		Bal c/d	1000
	2000		1100
Creditor (A)			
Contra - Debtor	1000	Purchases	1000

FORMAT OF A PURCHASES LEDGER CONTROL ACCOUNT

Purchases Ledger Control A/C

1. Total debit balances from purchases ledger brought forward from previous period	1. Total credit balance brought forward (of purchases ledger from the previous period)
2. Total cash paid to creditors (from cash book)	2. Total credit purchases for the period (from purchases journal)
3. Total cheques paid to creditors (from cash book)	3. Refunds from suppliers (from cash book)
4. Total cash discounts received (from cash book)	
5. Allowances by suppliers	
6. Sales ledger contra	
7. Total returns outwards (from returns-outwards journal)	
8. Total credit balance (to be derived after posting entries)	4. Total debit balances (of the purchases ledger carried forward)

NOTES:

The following notes should be taken into consideration:

- 1) Cash received from CASH SALES should NOT be included in sales ledger control a/c.
- 2) Only cash discounts (allowable & receivables) should be included. Trade discounts should NOT be included.
- 3) Provision for doubtful debts is NOT included in the sales ledger control a/c. i.e. increase or decrease in provisions for doubtful debts will not affect this account.
- 4) Cash purchases are NOT posted to the Purchases Ledger Control A/C. However in some cases it can be included especially where there are incomplete records (Topic to be covered later).
- 5) Interest due that is charged on over due customers' account may also be shown on the debit side of the sales ledger control. However when trying to determine the turnover under incomplete records then it is wise to omit it.

Example 5.1

You are required to prepare a purchases ledger control account from the following for the month of June. The balance of the account is to be taken as the amount of creditors as on 30 June.

2003		£
June 1	Purchases ledger balances	36,760
	Totals for June:	
	Purchases journal	422,570
	Returns outwards journal	10,980
	Cheques paid to suppliers	387,650
	Discounts received from suppliers	8,870
June 30	Purchases ledger balances	?

Solution

Purchases Ledger Control A/C			
2003	£		£
Returns out	10,980	Bal b/d (1/6)	36,760
Bank	387,950		
Discounts received	8,870		
Bal c/d (30/6)	<u>51,830</u>	Purchases	<u>422,570</u>
	<u>459,330</u>		<u>459,330</u>

Example 5.2

Prepare a sales ledger control account from the following:

£

2003			
May 1	Debit balances		64,200
	Totals for May:		
	Sales journal		128,000
	Cash and cheques received from debtors		103,700
	Discounts allowed		3,950
	Debit balances in the sales ledger set off against credit balances in the purchases ledger		1,450
May 31	Debit balances		?
	Credit balances		500

Solution

Sales Ledger Control A/C			
2003		£	2003
1/5	Bal b/d	64,200	Cash book
	Sales	128,000	Discounts allowed
			Purchases contra
31/5	Bal c/d	<u>500</u>	31/5
		<u>192,700</u>	Bal c/d
			83,600
			<u>192,700</u>

- (a) Explain the purposes for which control accounts are prepared. (3 marks)
 (b) The balances and transactions affecting the control accounts of Kopesha Ltd. for the month of November 1997 are listed below:-

	Sh.	
Balances on 1 November 1997:		
Sales ledger	9,123,000	(debit)
	211,000	(credit)
Purchases ledger	4,490,000	(credit)
	88,000	(debit)
Transactions during November 1997:		
Purchases on credit	18,135,000	
Allowances from suppliers	629,000	
Receipts from customers by cheques	27,370,000	
Sale on credit	36,755,000	
Discount received	1,105,000	
Payments to creditors by cheques	15,413,000	
Contra settlements	3,046,000	
Bills of exchange receivable	6,506,000	
Allowances to customers	1,720,000	
Customers cheques dishonored	489,000	
Cash received from credit customers	4,201,000	
Refunds to customers for overpayments	53,000	
Discounts allowed	732,000	
Balances on 30 November 1997		
Sales ledger	136,000	(credit)
Purchases ledger	67,000	(debit)

Required:

The sales ledger and purchases ledger control accounts for the month of November 1997 and show the respective debit and credit closing balances on 30 November 1997.

(17 marks)

(Total: 20 marks)

- (a)
- i) Provide for arithmetical check on the postings made in the individual accounts (either in the sales ledger or purchases ledger.)
 - ii) To provide for a quick total of the balances to be shown in the trial balance as debtors and creditors.
 - iii) To detect and prevent errors and frauds in the customers and suppliers account.
 - iv) To facilitate delegation of duties among the debtors and creditors clerks.

Kopesha Ltd

		Sales Ledger Control A/C			
1997		Sh	1997		Sh
1/11	Bal b/d	9,123,000	1/11	Bal b/d	211,000
	Sales	36,755,000		Bank	27,370,000
	Dishonored cheques	489,000		Contra	3,046,000
	Refunds to customers	53,000		Bills of exchange receivable	6,506,000
				Allowances	720,000

			Cash	4,201,000	
			Discounts allowed	732,000	
30/11	Bal c/d	<u>136,000</u>	30/11	Bal c/d	<u>2,770,000</u>
		<u>46,556,000</u>			<u>46,556,000</u>

Purchases Ledger Control A/C

1997		Sh	1997		Sh
1/11	Bal b/d	88,000	1/11	Bal b/d	4,490,000
	Allowances from suppliers	629,000		Purchases	18,135,000
	Discounts received	1,105,000			
	Bank	15,413,000			
	Contra settlement	3,046,000			
30/11	Bal c/d	<u>2,411,000</u>	30/11	Bal c/d	<u>67,000</u>
		<u>22,692,000</u>			<u>22,692,000</u>

REVIEW QUESTION

Poesha Limited keeps sales and purchases control accounts in the General Ledger. The transactions for the month ended 30 April 2000 were as follows:

	Sh
Credit balances on 1 April 2000	-Sales ledger 154,000
	-Purchases ledger 569,000
Debit balances on 1 April 2000	-Sales ledger 956,000
	-Purchases ledger 196,000
Credit balances on 30 April 2000	-Sales ledger 178,000
Debit balances on 30 April 2000	Purchases ledger 189,000
Credit purchases	2,450,000
Credit sales	4,563,000
Cheques received from debtors	3,140,000
Cash received from debtors	1,367,000
Cheque payments to creditors	1,994,000
Cash payments to creditors	352,000
Bad debts written off	68,000
Discounts received	104,000
Discounts allowed	169,000
Contra entry to sales ledger from purchases ledger	234,000
Refunds to debtors	62,000
Returns outwards	138,000
Returns inwards	231,000

Required:

Sales ledger and purchases ledger control accounts for the month ended 30 April 2000.

ACCOUNTING CONCEPTS BASES AND POLICIES

Specific Objectives.

By the end of the topic, the learner should be able to:

- a) Define accounting concept, convention and bases
- b) Explain the various types of accounting concept, convention and bases

I) concepts/conventions/principles

Accounting Concepts are broad basic assumptions that underlie the periodic financial accounts of business enterprises.

Examples of concepts include:

- i) **The going concern concept:** implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or to make drastic cutbacks to the scale of operations. Financial statements should be prepared under the going concern basis unless the entity is being (or is going to be) liquidated or if it has ceased (or is about to cease) trading. The directors of a company must also disclose any significant doubts about the company's future if and when they arise.
The main significance of the going concern concept is that the assets of the business should not be valued at their 'break-up' value, which is the amount that they would sell for if they were sold off piecemeal and the business were thus broken up.
- ii) **The accruals concept (or matching concept):** states that revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate.
Assume that a firm makes a profit of £100 by matching the revenue (£200) earned from the sale of 20 units against the cost (£100) of acquiring them.
If, however, the firm had only sold eighteen units, it would have been incorrect to charge profit and loss account with the cost of twenty units; there is still two units in stock. If the firm intends to sell them later, it is likely to make a profit on the sale. Therefore, only the purchase cost of eighteen units (£90) should be matched with the sales revenue, leaving a profit of £90.

The balance sheet would therefore look like this:

	£
<i>Assets</i>	
Stock (at cost, i.e. 2 x £5)	10
Debtors (18 x £10)	<u>180</u>
	190
<i>Liabilities</i>	
Creditors	<u>100</u>
	<u>90</u>
Capital (profit for the period)	<u>90</u>

If, however the firm had decided to give up selling units, then the going concern concept would no longer apply and the value of the two units in the balance sheet would be a break-up valuation rather than cost. Similarly, if the two unsold units were now unlikely to be sold at more than their cost of £5 each (say, because of damage or a fall in demand) then

they should be recorded on the balance sheet at their net realizable value (i.e. the likely eventual sales price less any expenses incurred to make them saleable, e.g. paint) rather than cost. This shows the application of the prudence concept. (See below).

In this example, the concepts of going concern and matching are linked. Because the business is assumed to be a going concern it is possible to carry forward the cost of the unsold units as a charge against profits of the next period.

Essentially, the accruals concept states that, in computing profit, revenue earned must be matched against the expenditure incurred in earning it.

- iii) **The Prudence Concept:** The prudence concept states that where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business's financial position or results.
- Therefore, revenue and profits are not anticipated but are recognized by inclusion in the profit and loss account only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty: provision is made for all liabilities (expenses and losses) whether the amount of these is known with certainty or is best estimate in the light of the information available.
- Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities or losses.

The other aspect of the prudence concept is that where a loss is foreseen, it should be anticipated and taken into account immediately. If a business purchases stock for £1,200 but because of a sudden slump in the market only £900 is likely to be realized when the stock is sold the prudence concept dictates that the stock should be valued at £900. It is not enough to wait until the stock is sold, and then recognize the £300 loss; it must be recognized as soon as it is foreseen.

A profit can be considered to be a realized profit when it is in the form of:

- Cash
- Another asset that has a reasonably certain cash value. This includes amounts owing from debtors, provided that there is a reasonable certainty that the debtors will eventually pay up what they owe.

A company begins trading on 1 January 20X2 and sells goods worth £100,000 during the year to 31 December. At 31 December there are debts outstanding of £15,000. Of these, the company is now doubtful whether £6,000 will ever be paid.

The company should make a provision for doubtful debts of £6,000. Sales for 20x5 will be shown in the profit and loss account at their full value of £100,000, but the provision for doubtful debts would be a charge of £6,000. Because there is some uncertainty that the sales will be realized in the form of cash, the prudence concept dictates that the £6,000 should not be included in the profit for the year.

- iv) **The consistency concept:** The consistency concept states that in preparing accounts consistency should be observed in two respects.
- a) Similar items within a single set of accounts should be given similar accounting treatment.
 - b) The same treatment should be applied from one period to another in accounting for similar items. This enables valid comparisons to be made from one period to the next.
- v) **The entity concept:** The concept is that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited company (and so recognized in law as a separate entity) or a sole proprietorship or partnership (in which case the business is not separately recognized by the law).

- vi) **The money measurement concept:** The money measurement concept states that accounts will only deal with those items to which a monetary value can be attributed.

For example, in the balance sheet of a business, monetary values can be attributed to such assets as machinery (e.g. the original cost of the machinery; or the amount it would cost to replace the machinery) and stocks of goods (e.g. the original cost of goods, or, theoretically, the price at which the goods are likely to be sold).

The monetary measurement concept introduces limitations to the subject matter of accounts. A business may have intangible assets such as the flair of a good manager or the loyalty of its workforce. These may be important enough to

give it a clear superiority over an otherwise identical business, but because they cannot be evaluated in monetary terms they do not appear anywhere in the accounts.

- vii) **The separate valuation principle:** The separate valuation principle states that, in determining the amount to be attributed to an asset or liability in the balance sheet, each component item of the asset or liability must be determined separately.
These separate valuations must then be aggregated to arrive at the balance sheet figure. For example, if a company's stock comprises 50 separate items, a valuation must (in theory) be arrived at for each item separately; the 50 figures must then be aggregated and the total is the stock figure which should appear in the balance sheet.
- viii) **The materiality concept:** An item is considered material if its omission or misstatement will affect the decision making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts.
An error that is too trivial to affect anyone's understanding of the accounts is referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.
Determining whether or not an item is material is a very subjective exercise. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example to define material items as those with a value greater than 5% of the net profit disclosed by the accounts). But some items disclosed in accounts are regarded as particularly sensitive and even a very small misstatement of such an item would be regarded as a material error. An example in the accounts of a limited company might be the amount of remuneration paid to directors of the company. The assessment of an item as material or immaterial may affect its treatment in the accounts. For example, the profit and loss account of a business will show the expenses incurred by the business grouped under suitable captions (heating and lighting expenses, rent and rates expenses etc); but in the case of very small expenses it may be appropriate to lump them together under a caption such as 'sundry expenses', because a more detailed breakdown would be inappropriate for such immaterial amounts.

Example:

- a) If a balance sheet shows fixed assets of £2 million and stocks of £30,000 an error of £20,000 in the depreciation calculations might not be regarded as material, whereas an error of £20,000 in the stock valuation probably would be. In other words, the total of which the erroneous item forms part must be considered.
- b) If a business has a bank loan of £50,000 balance and a £55,000 balance on bank deposit account, it might well be regarded as a material misstatement if these two amounts were displayed on the balance sheet as 'cash at bank £5,000'. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error.
- ix) **The historical cost convention:** A basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that resources are normally stated in accounts at historical cost, i.e. at the amount that the business paid to acquire them. An important advantage of this procedure is that the objectivity of accounts is maximized: there is usually objective, documentary evidence to prove the amount paid to purchase an asset or pay an expense. Historical cost means transactions are recorded at the cost when they occurred.

In general, accountants prefer to deal with costs, rather than with 'values'. This is because valuations tend to be subjective and to vary according to what the valuation is for. For example, suppose that a company acquires a machine to manufacture its products. The machine has an expected useful life of four years. At the end of two years the company is preparing a balance sheet and has decided what monetary amount to attribute to the asset.

- x) **Objectivity (neutrality):** An accountant must show objectivity in his work. This means he should try to strip his answers of any personal opinion or prejudice and should be as precise and as detailed as the situation warrants. The result of this should be that any number of accountants will give the same answer independently of each other. Objectivity means that accountants must be free from bias. They must adopt a neutral stance when analysing accounting data. In practice objectivity is difficult. Two accountants faced with the same accounting data may come to different conclusions as to the correct treatment. It was to combat subjectivity that accounting standards were developed.

-
- xi) **The realization concept:** Realization: Revenue and profits are recognized when realized. The concept states that revenue and profits are not anticipated but are recognized by inclusion in the income statement only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty.
 - xii) **Duality:** Every transaction has two-fold effect in the accounts and is the basis of double entry bookkeeping.
 - xiii) **Substance over form:** The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form e.g. a non current asset on Hire purchase although is not legally owned by the enterprise until it is fully paid for, it is reflected in the accounts as an asset and depreciation provided for in the normal accounting way.

Example 3.1

It is generally agreed that sales revenue should only be 'realized' and so 'recognized' in the trading, profit and loss account when:

- a) The sale transaction is for a specific quantity of goods at a known price, so that the sales value of the transaction is known for certain.
- b) The sale transaction has been completed, or else it is certain that it will be completed (e.g. in the case of long-term contract work, when the job is well under way but not yet completed by the end of an accounting period).
- c) The critical event in the sale transaction has occurred. The critical event is the event after which:
 - i) It becomes virtually certain that cash will eventually be received from the customer.
 - ii) Cash is actually received.

Usually, revenue is 'recognized'

- (a) When a cash sale is made.
- (b) The customer promises to pay on or before a specified future date, and the debt is legally enforceable.

The prudence concept is applied here in the sense that revenue should not be anticipated, and included in the trading, profit and loss account, before it is reasonably certain to 'happen'.

Required

Given that prudence is the main consideration, discuss under what circumstances, if any, revenue might be recognized at the following stages of a sale.

- (a) Goods have been acquired by the business, which it confidently expects to resell very quickly.
- (b) A customer places a firm order for goods.
- (c) Goods are delivered to the customer.
- (d) The customer is invoiced for goods.
- (e) The customer pays for the goods.
- (f) The customer's cheque in payment for the goods has been cleared by the bank.

Answer

- (a) A sale must never be recognized before a customer has even ordered the goods. There is no certainty about the value of the sale, nor when it will take place, even if it is virtually certain that goods will be sold.
- (b) A sale must never be recognized when the customer places an order. Even though the order will be for a specific quantity of goods at a specific price, it is not yet certain that the sale transaction will go through. The customer may cancel an order, the supplier might be unable to deliver the goods as ordered or it may be decided that the customer is not a good credit risk.
- (c) A sale will be recognized when delivery of the goods is made only when:
 - i) The sale is for cash, and so the cash is received at the same time.
 - ii) The sale is on credit and the customer accepts delivery (e.g. by signing a delivery note).
- (d) The critical event for a credit sale is usually the dispatch of an invoice to the customer. There is then a legally enforceable debt payable on specified terms, for a completed sale transaction.
- (e) The critical event for a cash sale is when delivery takes place and when cash is received, both take place at the same time. It would be too cautious or 'prudent' to await cash payment for a credit sale transaction before recognizing the sale, unless the customer is a high credit risk and there is a serious doubt about his ability or intention to pay.
- (f) It would again be over-cautious to wait for clearance of the customer's cheques before recognizing sales revenue. Such a precaution would only be justified in cases where there is a very high risk of the bank refusing to honour the cheque.

II) Bases

Bases are the methods that have been developed for expressing or applying fundamental accounting concepts to financial transactions and items. Examples include:

- Depreciation of Non current Assets (e.g. by straight line or reducing balance method)
- Treatment and amortization of intangible assets (patents and trade marks)
- Stocks and work in progress (FIFO, LIFO and AVCO)

III) Policies

Accounting policies are the specific accounting bases judged by business enterprises to be the most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts.

Qualities of Useful Financial Information

The four principal qualities of useful financial information are understandability, relevance, reliability and comparability.

Understandability: an essential quality of the information provided in the financial statements is that it is readily understandable by users. For these reason users are assumed to have a reasonable knowledge of business and economic activities and accounting.

Relevance: information has the quality of being relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting their past evaluations. The relevance of information is affected by its nature and materiality.

Reliability: information is useful when it is free from material error and bias and can be depended upon by users to represent faithfully that which it purports to represent or could reasonably be expected to represent. To be reliable then the information should:

- Be represented faithfully,
- Be accounted for and presented in accordance with their substance and economic reality and not merely their legal form,
- Be neutral i.e. free from bias,
- Include some degree of caution especially where uncertainties surround some events and transactions (prudence),
- Be complete i.e. must be within the bounds of materiality and cost. An omission can cause information to be false.

Comparability: users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different accounting policies, changes in the various policies and the effect of these changes in the accounts. Compliance with accounting standards also helps achieve this comparability.

The Accounting Profession in Kenya

The Accountants Act Cap 531 (1977) establishes the Institute of Certified Public Accountants of Kenya (**ICPAK**) and two boards, to be known as the Registration of Kenya Accountants Board (**RAB**) and Kenya Accountants and Secretaries National Examinations Board (**IASNEB**)

The following are the functions of **ICPAK** as outlined by the Act;

- a) To promote standards of professional competence and practice amongst members of the institute.
- b) To promote research into the subjects of accountancy and finance, and related matters, and the publication of books, periodicals, journals and articles in connexion therewith;
- c) To promote the international recognition of the institute;
- d) To advise the Examinations board on matters relating to examination standards and policies;
- e) To carry out any other functions prescribed for it under any of the provisions of the Act or under any other written law; and
- f) To do anything incidental or conducive to the performance of any of the preceding functions.

A council known as the Council of the institute governs the Institute, which consists of the Chairman, nine members from the institute and one member appointed by the Minister of finance.

The Registration of Accountants Board (**RAB**) functions include issuing out practicing certificates and registration of qualified persons as members of the institute.

The Act also outlines the following as the functions of **IASNEB**:

- a) To prepare syllabuses for accountants' and secretaries' examinations, to make rules with respect to examinations, to arrange and conduct examinations and issue certificates to candidates who have satisfied examination requirements;
- b) To promote recognition of its examinations in foreign countries; and
- c) To do anything incidental or conducive to the performance of any preceding functions.

REVIEW QUESTIONS

1. Why are these accounting policies necessary in the interpretation of the accounting information
2. Explain the meaning of the term 'subject over form' in relation to the policy of treating assets in financial records
3. Outline the reason why the accounting bases and policies must be disclosed to the users of final accounts
4. Briefly explain the meaning and the significance of the following:
 - a) Accounting concepts.
 - b) Accounting bases.
 - c) Accounting policies.
 - d) Accounting standards.

CAPITAL AND REVENUE EXPENDITURE

Specific Objectives

By the end of the topic, the trainee should be able to:-

- a) Explain the terms capital and revenue expenditure

-
- b) Explain the recording of capital and expenditure in the books of accounts
 - c) Classify expenditure into capital and revenue Expenditure

Capital Expenditure: This is the amount spent on the acquisition of a non-current asset or adding value to a non-current asset.

Examples of expenses incurred in acquisition:

- i. Purchase price/cost of the asset.
- ii. Delivery/carriage inwards costs (e.g. shipping charges or import taxes).
- iii. Costs incurred to get the asset in use (e.g. assembly, testing)
- iv. Installation
- v. Demolition costs in order to construct a new building.
- vi. Architect fees for construction and supervision
- vii. Legal fees incurred in acquisition of a new asset (e.g. lease agreement)

Examples of expenses incurred in adding value to an asset:

- i. Modify plant to increase its useful life.
- ii. Upgrading plant to improve quality of output.
- iii. Adopting or upgrading the production process to improve or reduce costs.

Revenue Expenditure: There's an amount spent by the firm in the normal trading process or to assist in earning revenues or income. Examples:

- i. Postage and stationery.
- ii. Carriage outwards (sales).
- iii. Repairs and maintenance.

Example 4.10

For the business of K Spinns, a wholesaler, classify the following between 'capital' and 'revenue' expenditure:

- a) Purchase of an extra motor van.
- b) Cost of rebuilding warehouse wall, which had fallen down.
- c) Building extension to the warehouse.
- d) Painting extension to warehouse when it is first built.
- e) Repainting extension to warehouse three years later than that done in (d).
- f) Carriage costs on bricks for new warehouse extension.
- g) Carriage costs on purchases.
- h) Carriage costs on sales.
- i) Legal costs of collecting debts.
- j) Legal charges on acquiring new premises for office.
- k) Fire insurance premium.
- l) Costs of erecting new machine.

Solution.

- a) Capital expenditure
- b) Revenue expenditure
- c) Capital expenditure
- d) Capital expenditure
- e) Revenue expenditure
- f) Capital expenditure
- g) Revenue expenditure
- h) Revenue expenditure
- i) Revenue expenditure
- j) Capital expenditure
- k) Revenue expenditure
- l) Capital expenditure.

ADJUSTMENTS TO FINAL ACCOUNTS

Specific objectives.

By the end of the topic, the trainee should be able to:-

- a) Explain the meaning of final year accounts
- b) Explain the purpose of making end of year adjustments
- c) Explain the procedure of making adjustments in the final accounts

a) ACCRUALS AND PREPAYMENTS

Revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate. Therefore all incomes and expenses that relate to a particular financial period will be matched together to determine the profit for the year.

ACCRUALS

Income:

Accrued Income

This is income that relates to the current year but cash has not yet been received. An accrued income should be reported in the profit & loss account and the same income will be shown in the balance sheet as a current asset.

Example 4.1

A firm lets out part of its properties and receives rent of £2,000 per month, assuming that this is the first year of renting and rent is received in arrears (rent 4 January is received early Feb).

The ledger accounts of the firm will be as follows:

Cashbook	
<u>Year 1</u>	£
Feb (rent 4 Jan)	2,000
Mar (rent 4 Feb)	2,000
April (rent 4 Mar)	2,000
May (rent 4 Apr)	2,000
June (rent 4 May)	2,000
July (rent 4 Jun)	2,000
Aug (rent 4 July)	2,000
Sept (rent 4 Aug)	2,000
Oct (rent 4 Sept)	2,000
Nov (rent 4 Oct)	2,000
Dec (rent 4 Nov)	2,000
	<u>22,000</u>

Rent – Income

Year 1	£	Year 1	£
		Jan C/B	2,000
		Feb C/B	2,000
		Mar C/B	2,000
		April C/B	2,000
		May C/B	2,000
		Jun C/B	2,000
		July C/B	2,000
		Aug C/B	2,000
		Sept C/B	2,000
		Oct C/B	2,000
31/12 P&L	24,000	Nov C/B	2,000
	<u>24,000</u>	Dec Accrued c/f	2,000
			<u>24,000</u>

Although the cashbook is showing that rent received amounts £22,000, the full rental income of £24,000 will be reported in the Profit & Loss a/c as rent income and the accrued rent for Dec of £2,000 will be reported in the balance sheet as a current asset.

Expenses: Accrued Expenses

An accrued expense is an expense that is payable or due for payment but has not yet been paid during that period.

An accrued expense should be charged in the P&L account and shown in the balance sheet as a current liability.

Assume in the above example that the firm is meant to pay the rent, thus it becomes an expense with the facts still the same i.e. £2,000 payable in arrears. The ledger account will be as follows.

Cashbook

Year 1	£	Year 1	£
		Feb (rent 4 Jan)	2,000
		Mar (rent 4 Feb)	2,000
		Apr (rent 4 Mar)	2,000
		May (rent 4 Apr)	2,000
		June (rent 4 May)	2,000
		July (rent 4 June)	2,000
		Aug (rent 4 July)	2,000
		Sept (rent 4 Aug)	2,000
		Oct (rent 4 Sept)	2,000
		Nov (rent 4 Oct)	2,000
		Dec (rent 4 Nov)	2,000

Rent – Expenses

Year 1	£	Year 1	P&L	£
C/B Rent for Jan	2,000			
Rent for Feb	2,000			
Rent for Mar	2,000			
Rent for Apr	2,000			
Rent for May	2,000			
Rent for June	2,000			
Rent for July	2,000			
Rent for Aug	2,000			
Rent for Sept	2,000			
Rent for Oct.	2,000			
Rent for Nov	2,000			
31/12 Bal c/d	2,000	31/12		24,000
	<u>24,000</u>			<u>24,000</u>

The cashbook shows that the rent for the 11 months was paid for. However in the P&L a/c we should report rent for the full year of £24,000 and the £2,000, rent for Dec being the accrued expense will be shown in the balance sheet as a current liability.

PREPAYMENTS

Prepaid Income

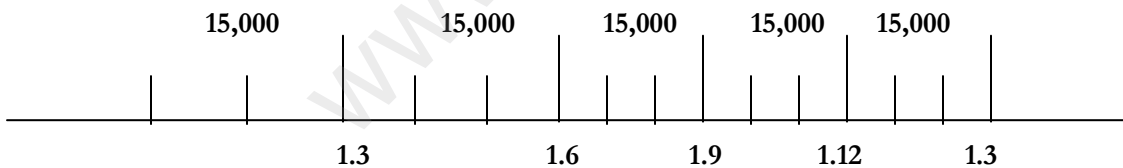
This is income that is not yet due but cash has been received for it. This happens where an income is payable in advance e.g. Rent payable 3 months in advance.

A prepaid income should not be reported in the current financial period but should be carried forward and reported in the period it relates to.

The accounting treatment will be to show it as a current liability.

Example 4.2

A firm receives rent income of £5,000 per month payable quarterly in advance. Assuming that the firm's rental income began in 1st March and the financial year, end is on 31st Dec. The ledger accounts will be:



Cashbook

Year 1	£	Year 1	£
1/3 Rent	15,000		
1/6 Rent	15,000		
1/9 Rent	15,000		
1/12 Rent	15,000		

Rent – Income

Year 1	£	Year 1	£
		1/3	Cashbook 15,000

			1/6	Cashbook	15,000
P&L	(10 x 5,000)	50,000	1/9	Cashbook	15,000
31/12	Bal c/d	<u>10,000</u>	1/12	Cashbook	<u>15,000</u>
		<u>60,000</u>			<u>60,000</u>

Rent for the 4 quarters of 12 months has been received as per the cashbook but because the end of the financial year is at 31 Dec, rent for 2 months is pre-paid. This £10,000 is not charged in the P&L but is carried forward as current liability in the balance sheet.

Prepaid Expenses

A prepaid expense is an expense that is not payable but cash has already been paid. A prepaid expense should not be charged in the P&L a/c but should be carried forward to the next financial period and should be shown in the balance sheet as a current asset.

Example

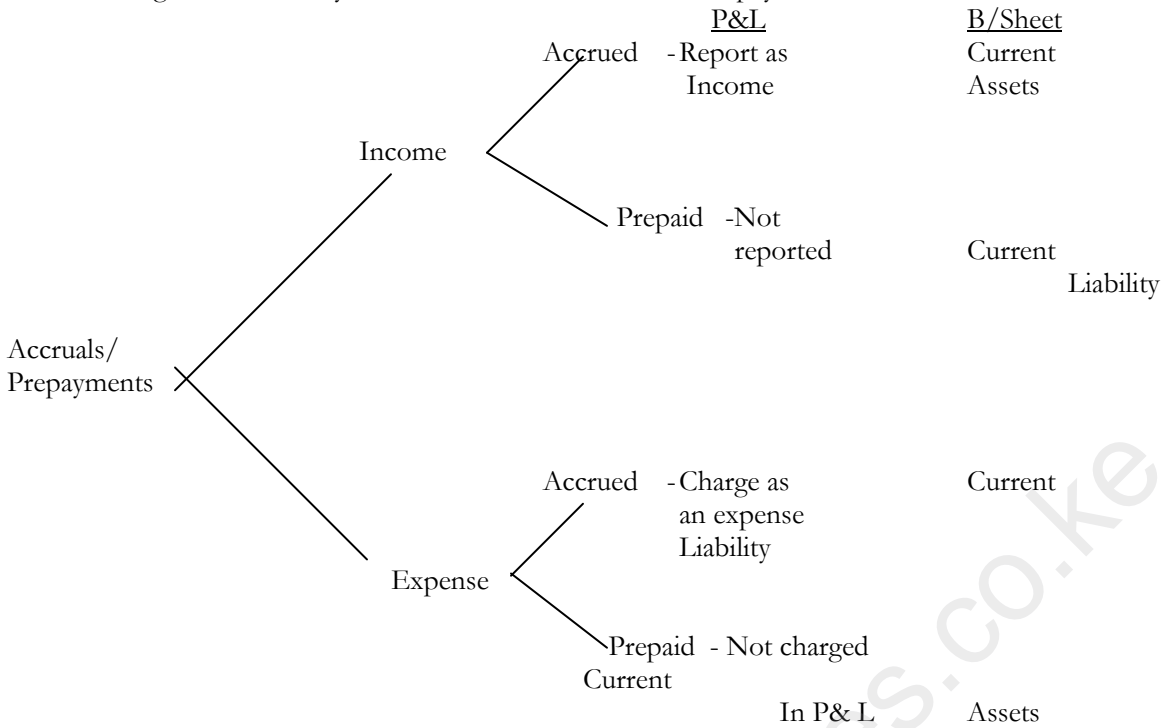
Assume as in the previous illustration, that all the facts are as stated except that rent is an expense. The ledger accounts is as follows:

Cashbook					
Year 1		£	Year 1		£
			1/3	Rent	15,000
			1/6	Rent	15,000
			1/9	Rent	15,000
			1/12	Rent	15,000

Rent – Expenses					
Year 1		£	Year 1		£
1/3	C/B (Mar, April, May)	15,000			
1/6	C/B (June, July, Aug)	15,000			
1/9	C/B (Sept, Oct, Nov)	15,000	P&L	(10 x 5,000)	50,000
1/12	C/B (Dec, Jan, Feb)	<u>15,000</u>	31/12 Bal c/d (2 x 5,000)		<u>10,000</u>
		<u>60,000</u>			<u>60,000</u>

Rent of £10,000 for 2 months is carried forward to the next financial period and shown in the balance sheet as a current asset.

The following is the summary of treatment for Accruals and Prepayments:



Accrued Incomes and Expenses and Prepaid Incomes and Expenses are shown in the Balance Sheet as follows:

Balance Sheet Extracts

	£	£
Current Assets		
Stock		x
Debtors		x
Accrued Incomes/Prepaid Expenses		x
Cash at bank		x
Cash in hand		x
		<u>x</u>
		x
Current Liabilities		
Bank overdraft	x	
Creditors	x	
Prepaid Incomes/Accrued Expenses	<u>x</u>	
	X	

The accruals and expenses items may also be adjusted in the relevant income and expense accounts so that the correct amount of expense or income is reported in the profit and loss account for the year.

Example 4.4

The financial year of H Seamers ended on 31 December 2002. Show the ledger accounts for the following items including the balance transferred to the necessary part of the final accounts, also the balances carried down to 2003:

- Motor expenses: Paid in 2002 £7,440; Owing at 31 December 2002 £2,800.
- Insurance: Paid in 2002 £42,000; Prepaid as at 31 December 2002 £3,500.

- c) Stationery: Paid during 2002 £18,000; Owing as at 31 December 2001 £25,000; Owing as at 31 December 2002 £49,000.
- d) Rates: Paid during 2002 £95,000; Prepaid as at 31 December 2001 £2,200; Prepaid as at 31 December 2002 £2,900.
- e) Seamers sub-lets part of the premises. Receives £5,500 during the year ended 31 December 2002. Tenant owed Seamers £1,800 on 31 December 2001 and £2,100 on 31 December 2002

a) Motor Expenses

19X6		£	19X6		£
	Cashbook	7,440			
31/12	Bal c/d	<u>280</u>	P/L a/c		<u>7220</u>
		<u>7200</u>			<u>7200</u>
			19x7		
			1/1 Bal b/d		280

b) Insurance

19x6		£	19x6		£
	Cashbook	4,200	31/12 P&L a/c		3850
		<u>4,200</u>	31/12 Bal c/d		<u>350</u>
					4200
19x7					
1/1	Bal b/d	350			
		====			

c) Stationery

19x6		£	19x6		£
	Cashbook	18,000	1/1 Bal b/d		2,500
31/12	Bal c/d	<u>4,900</u>	P&L a/c		<u>20,400</u>
		22,900			22,900
		=====			=====
			19x7		
			1/1 Bal b/d		4,900

		Rates			
19x6		£	19x6		£
1/1	Bal b/d	2200		P&L	8800
	Cashbook	<u>9500</u>	31/12	Bal c/d	<u>2900</u>
		<u>11,700</u>			<u>11,700</u>
19x7					
1/1	Bal b/d	2900			

		Rent – Income			
19x6		£	19x6		£
1/1	Bal b/d	1800		Cashbook	5500
	P&L	<u>5800</u>	31/12	Bal c/d	<u>2100</u>
		<u>7600</u>			<u>7600</u>
19x7					
1/1	Bal b/d	2100			

Procedures/Steps in making adjustments in the Final Accounts

- 1) Prepare a statement of affairs at the beginning of the period (a list of all assets and liabilities) to determine the beginning capital.
- 2) Open and post the balances and transactions to these 3 relevant accounts (i.e. the cashbook (for both cash in hand and bank), sales ledger control account and purchases ledger control account. Any other account can be opened where necessary.
- 3) Make adjustments for any accruals or prepayments.
- 4) Extract a list of the balances. (Trial balance).
- 5) Prepare the final accounts.

b) BAD AND DOUBTFUL DEBTS

Some debtors may not pay up their accounts for various reasons e.g. a debtor may go out of business. When a debtor is not able to pay up his/her account this becomes a bad debt. Therefore the business/firm should write it off from the accounts and thus it becomes an expense that should be charged in the profit & loss account.

In practice a firm may also be unable to collect all the amounts due from debtors. This is because a section of the debtors will not honor their obligations. The problem posed by this situation is that it is difficult to identify the debtors who are unlikely to pay their accounts. Furthermore the amount that will not be collected may also be difficult to ascertain. These debts that the firm may not collect are called doubtful debts. A firm should therefore provide for such debts by charging the provision in the profit and loss account. Provision for doubtful debts maybe specific or general. Specific relate to a debtor whom we can identify and we are doubtful that he may pay the debt (if one of our debtor goes out of business).

Accounting For Bad & Doubtful Debts.

Bad debts

When a debt becomes bad the following entries will be made:

- i. Debit bad debts account
Credit debtors account with the amount owing.

- ii. Debit Profit and Loss Account.

Credit bad – debts account to transfer the balance on the bad – debts account to the Profit and Loss Account.

Doubtful Debts

A provision for doubtful debts can either be for a specific or a general provision. A specific provision is where a debtor is known and chances of recovering the debt are low.

The general provision is where a provision is made on the balance of the total debtors i.e. Debtors less Bad debts and specific provision.

The accounting treatment of provision for doubtful debts depends on the year of trading and the entries will be as follows. If it is the 1st year of trading (1st year of making provision):

- i. Debit P&L a/c.
- ii. Credit provision for doubtful debts (with total amount of the provision).

In the subsequent periods, it will depend on whether if it is an increase or decrease required on the provision.

If it is an increase:

- i. Debit P&L a/c.
- ii. Credit provision for doubtful debts (with increase only).

If it is a decrease:

- i. Debit provision for doubtful debts.
- ii. Credit P&L a/c (with the decrease in provision only).

Example

Debtors	x
Bad debts	<u>(x)</u>
	x
Specific Provision	<u>(x)</u>
	x
General Provision	<u>(x)</u>
	<u>⊖</u>

A firm started trading in the year 1999, the balance on the debtor's account was £400,000. Bad debts amounting to £40,000 were written off from this balance, there was a specific provision of £5,000 to be made to one of the debtors and a general provision of £5% was to be made on the balance of the debtors. The ledger accounts of 1999 were as follows:

Debtors		Provision for doubtful debts			
<u>1999</u>	£	<u>1999</u>	£	<u>1999</u>	£
Bal B/d	400,000	Bad debts	40,000	31/12 Bal c/d	22,750
		Bal c/d	<u>360,000</u>	31/12 P&L	22,750
	<u>400,000</u>		<u>400,000</u>		

Bad debts			
<u>1999</u>	£	<u>1999</u>	£
Debtors	<u>40,000</u>	31/12 P&L	<u>40,000</u>

	£
Debtors	400,000
Bad debts	<u>(40,000)</u>
	360,000
Specific Provision	<u>(5,000)</u>
	355,000
General Provision (5%)	<u>(17,750)</u>
	<u>337,250</u>

Profit & Loss A/C (Extract) for the year ended 31/12/99

	£	£
Expenses:		
Bad debts	40,000	
Increase in provision for D/debts	22,750	

Balance Sheet (Extract) as at 31/12/99

	£	£
Current Assets		
Stocks		x
Debtors	360,000	
Provision for D/debts	<u>(22,750)</u>	<u>337,250</u>
	337,250	337,250

In the year 2,000, the debtors balance goes up to £500,000 from which bad debts of £50,000 needs to be written off there is no specific provision but the general provision is to be maintained at 5%. The ledger accounts will be as follows:

Debtors	500,000
Bad debts	<u>(50,000)</u>
	450,000
General Provision (5%)	<u>22,500</u>
	<u>427,500</u>

Debtors

2000	£	2000	£
Bal b\d	500,000	Bad Debts	50,000
	<u>500,000</u>	Bal c\d	<u>450,000</u>
			<u>500,000</u>

Provision for Doubtful Debts

2000	£	2000	£
P\L	250	1\1 Bal b\d	22,750
Bal c\d	<u>22,500</u>		
	<u>22,750</u>		<u>22,750</u>

Bad Debts

2000	£	2000	£
Debtors	<u>50,000</u>	31\12 P&L	<u>50,000</u>

Profit And Loss Account (Extract) for year ended 31/12/2002.

	£		£
Incomes			
Decrease in provision for D/debts			250
Expenses			
Bad debts	50,000		

Balance Sheet (Extract) as at 31/12/2002

	£		£
Current Assets			
Debtors	450,000		
Provision for bad debts	<u>(22,500)</u>		
	427,500		

In the year 2001 the debtors balance goes up to £600,000 from which bad debts of £50,000 need to be written off, there is no specific provision but the general provision is to be maintained at 5% the ledger accounts is as shown:

	£
Debtors	600,000
Bad debts	<u>(50,000)</u>
	550,000
General provision %	<u>(27,500)</u>
	<u>522,500</u>

Debtors

2001	£	2001	£
Bal b\d	600,000	Bad Debts	50,000
	<u>600,000</u>	Bal c\d	<u>550,000</u>
			<u>600,000</u>

		Provision for Doubtful Debts	
2001	£	2001	£
Bal c\ d	<u>27,500</u>	1\1 Bal b\ d	22,500
	<u>22,500</u>	P& L	<u>5,000</u>
			<u>27,500</u>

		Bad Debts	
2001	£	2001	£
Debtors	<u>50,000</u>	31\12 P& L	<u>50,000</u>

Profit And Loss Account (Extract) for the year ended 31/12/2001

	£	£
Expenses		
Bad debts	50,000	
Increase in provision	5,000	

Balance Sheet (Extract) as at 31/12/2001

	£	£
Current Assets		
Debtors	550,000	
Less: Provision for Doubtful Debts	<u>(27,500)</u>	522,500

Example 4.6

In a new business during the year ended 31 December 2002 the following debts are found to be bad, and are written off on the dates shown:

30 April	H Gordon	£1,100
31 August	D Bellamy Ltd	£640
31 October	J Alderton	£120

On 31 December 2002 the schedule of remaining debtors, amounting in total to £68,500, is examined, and it is decided to make a provision for doubtful debts of £2,200.

You are required to show:

- The Bad Debts Account, and the Provision for Doubtful Debts Account.
- The charge to the Profit and Loss Account.
- The relevant extracts from the Balance Sheet as at 31 December 2002.

		Bad Debts	
Debtors	£ 70,036	2002	£ 2002
Bad debts	<u>(1,860)</u>	Bad debts	1860
	68,500		31/12 P\L 1860
	<u>66,300</u>		Provision for D/Debt <u>(2,200)</u>
Provision for doubtful debts			
2002	£	2002	£
31/12 Bal c/d	<u>2,200</u>	31/12 P&L	<u>2,200</u>

Profit & Loss Account (Extract)

		£	£
Expenses			
Bad debts		1,860	
Increase in provision for Doubtful debts		2,200	

Balance Sheet (Extract)

		£	£
Current Assets			
Debtor		8,500	
Less: Provision for D/Debts		<u>(2,200)</u>	
		6,300	

Example 4.2

A business started trading on 1 January 2001. During the two years ended 31 December 2001 and 2002 the following debts were written off to the Bad Debts Account on the dates stated:

31 August 2001	W Best	£850
30 September 2001	S Avon	£1,400
28 February 2002	L J Friend	£1,800
31 August 2002	N Kelly	£600
30 November 2002	A Oliver	£2,500

On 31 December 2001 there had been a total of debtors remaining of £405,000. It was decided to make a provision for doubtful debts of £5,500.

On 31 December 2002 there had been a total of debtors remaining of £473,000. It was decided to make a provision for doubtful debts of £6,000.

You are required to show:

- The Bad Debts Account and the Provision for Doubtful Debts Account for each of the two years.
- The relevant extracts from the Balance Sheet as at 31 December 2001 and 2002.

Solutions

Bad debts =	2,250
	405,000
Provision	<u>(5,500)</u>

399,500

Bad Debts

2001	£	2001	£
31\8 W.Best	850		
30\9 S.Aron	1400	31\12 P&L	2250
	<u>2250</u>		<u>2250</u>

Provision for D/Debts

2001	£	2001	£
31\12 Bal c\ d	550	31\12 P&L	550
2001	£	2001	£
1\1 Bal c\ d	600	1\1 Bal b\ d	550
	<u>600</u>	31\12 P&L	50
			<u>600</u>

Bad Debts

<u>2001</u>	£	<u>2001</u>	£
28/2 J. Friend	1,800		
31/8 N. Kelly	600		
30/11 A. Oliver	<u>2,500</u>	31/13 P&L	<u>4,900</u>
	<u>4,900</u>		<u>4,900</u>

Profit & Loss Account (Extract)

	£	£
19x6		
Expenses		
Bad debts	2,250	
Provision for Doubtful Debts	5,000	
19x7		
Bad debts	4,900	
Increase in provision for D/Debts	500	

Balance Sheet as at 19x6

	£	£
Current Assets		
Debtors	405,000	
Less provision	<u>(5,500)</u>	399,500
19x7		
Debtors	473,000	
Less: provision	<u>(6,000)</u>	467,000

Provision for discounts allowable.

In some cases a firm may create a provision for discounts allowable in addition to provision for doubtful debts. This happens where a firm anticipates that some of the debtors may take up cash discounts offered by the firm. The accounting treatment is similar to accounting for provision for doubtful debts. The provision should be made after creating a provision for doubtful debts (debtors figure less either general/specific provision for doubtful debts).

Debtors	x
Bad debts	<u>(x)</u>
	x
Specific provision	<u>(x)</u>
	x
	<u>(x)</u>
	x
Provision for discount allowed (on balance)	<u>(x)</u>
	<u>x</u>

Profit & Loss Account (Extract)

	£	£
Incomes		
Decrease in provision for D/Debts		x
Decrease in provision for discounts allowed		x
Expenses		
Bad debts	x	
Increase in provision for D/Debts	x	
Increase in provision for discounts allowed	x	

Balance Sheet (Extract)

	£	£
Current Assets		
Debtors	x	
Less: provision for Doubtful Debts	(x)	
Less: provision for discounts allowed	(x)	x

Bad Debts Recovered

A firm may be able to recover a debt that was previously written off. The following entries will be made if this happens:

- i. Debit – Debtors
Credit – credit bad debts recovered account – to restore the bad debt recoverable.
N/B: This should be the amount to be recovered.
- ii. Debit – Cashbook
Credit – Debtors with the cash received.
- iii. Debit – bad debts recovered account.
Credit – P & L account with the same balance as bad debts account.

REVIEW QUESTION

1. A firm recovers debts amounting to £10,000 that had been written off in the previous periods. In the same financial period the firm writes off bad debts amounting £30,000.

REQUIRED:

- a) Bad debts account to record the above transaction
- b) Bad debts recovered account
- c) Profit and loss extracts

Bad debts A/C

£	£

Bad debts recovered A/C

£	£

ACCOUNTING FOR FIXED ASSETS

Specific Objectives

By the end of the topic, the trainee should be able to:-

- a) Define depreciation
- b) Explain the causes of depreciation
- c) Explain the reasons for providing for depreciation
- d) Explain the methods used to provide for depreciation
- e) Explain the double entry for depreciation
- f) Maintain accounts for the disposal of fixed assets
- g) Explain the contents of a fixed assets movement schedule

It is the loss of value of a non-current asset throughout its period of use by the firm. IAS 16 on property, plant and equipment defines depreciation as the allocation of a depreciable amount of a non-current asset over its estimated useful life.

Under the matching concept, all incomes or revenues and expenses for a particular period should be reported in the financial statements and because depreciation is an expense of the business therefore, it will be charged in the P&L A/C.

Causes of Depreciation

1. *Physical Factors*

- a) Wear and tear: Some non-current assets depreciate or lose value due to use overtime e.g. machinery and motor vehicles.
- b) Rot/decay/rust:: This happens on assets that are not well maintained by the firm e.g. Some machines.

2. *Economic Factors*

- a) Inadequacy: Some assets lose value due to them becoming inadequate e.g. when a business grows or expands then some buildings may become inadequate due to space. Also some machines that are unable to manufacture a large number of goods.
- b) Obsolescence: Some assets become obsolete due to change in technology or different methods of production e.g. computers.

3. *Time Factors*

Some assets have a legal fixed time e.g. properties on lease.

4. *Depletion*

This occurs when some assets have a wasting character due to extraction of raw materials, minerals or oil. Such assets include mines, oil wells, and quarries.

Methods of Calculating Depreciation

These are the methods developed to assist in estimating the amount of depreciation to be charged in the P&L a/c as an expense.

The methods chosen by a firm should be in accordance with the agreed accounting practice, accounting standards and suit the firm's non-current assets. There are 2 main methods of estimating depreciation and 5 others that will apply in a firm's situation.

The main methods are: *Straight-line method* and *Reducing Balance method*. The other 5 methods include:

- i. Sum of the digits methods – uses a formular.
- ii. Revaluation method – applies to a non-current asset of low value.
- iii. Machine-Hour method – depreciation is based on number of hours a machine is expected to operate (manufacturing process).
- iv. Unit of output method – depreciation is based on the number of units a machine is expected to produce.
- v. Depletion of units – depreciation is based on number of units extracted from the asset.

Straight-Line Method

This method ensures that a uniform amount of depreciation is charged in the P&L a/c for a particular asset and is based on the following formular:

$$\begin{aligned} \text{Depreciation for year} &= \frac{\text{Cost of asset} - \text{Residual Value}}{\text{Estimated useful life}} = \frac{\pounds 100,000 - \pounds 20,000}{8} \\ &= \pounds 10,000 \text{ per year.} \end{aligned}$$

Cost of Asset – Residual Value

Estimated useful life of asset.

Residual Value

The amount the firm expects to sell the asset after the period of use in the firm, also called Sales Value / Scrap Value.

Estimated Useful Life

The period the asset is expected to be used in the firm.

Example 4.1

A firm buys a machine for £100,000 which it expects to use in the firm for eight years. After the eight years the machine will be sold for £20,000. Under the straight-line method, the depreciation amount will be computed as follows:

This means for this asset £10,000 will be charged in the P&L account as depreciation expense on the machine.

The straight line method assumes that benefits accruing on use of a non-current asset are spread out evenly over the life of the asset e.g. buildings use straight-line method.

Percentage rate based on cost as opposed to number of years can also be used to calculate the depreciation.

Reducing Balance Method

The firm determines a fixed percentage rate that is applied on the cost of the asset during the first period of use. The same rate is applied in the subsequent financial periods but the rate is applied on the reduced value of the asset. (Cost of asset – total depreciation provided to date).

This method ensures that higher amount of depreciation are charged in the P&L account in the earlier periods of use and lower amounts in the latter periods of use as shown in the following example:

Example 4.12

Assume a firm buys machinery for £100,000 and provides depreciation on machines at 20% p.a. on reducing balance method. The depreciation charged to the P&L will be as follows for the next 3 years.

Year 1

Cost	£	100,000	
Depreciation 20% of 100,000		(20,000)	→ P&L YR 1
		<hr/>	

Balance to YR 2 80,000

Year 2

Depreciation 20% of 80,000		80,000	
		(16,000)	→ P&L YR 2
		<hr/>	→

Balance to YR 3 64,000

Year 3

Depreciation 20 % of 64,000		64,000	
		(12,800)	→ P&L YR 3
		<hr/>	→

Balance to YR 4 51,200

Reducing balance method (diminishing balance method) assumes that benefits accruing from the use of an asset are higher in the first periods of use and lower in the latter periods e.g.

- Fixtures, furniture and fitting.
- Plant and machinery.
- Motor vehicles.

ACCOUNTING TREATMENT ON DEPRECIATION

When non-current assets are depreciated, a new account for each type of asset is opened; this account is called a provision for depreciation whereby the following entries will be made:

Debit – P&L a/c

Credit – Provision for depreciation a/c

With the amount of depreciation charged for the period.

Example on straight-line method

The entries will be as follows:

Debit – P&L a/c with £10,000

Credit – Provision for depreciation. Machines a/c with £10,000 being depreciation provided for the machine.

The ledger accounts will be as follows:

Machinery		Provision for Depreciation Machinery	
Cashbook	£ <u>100,000</u>	31/12 Bal c/d	£ <u>100,000</u>
		31/12 Bal c/d	£ <u>10,000</u>
		P&L	£ <u>10,000</u>

The final accounts extracts will be shown as follows:

(a) Profit And Loss Account (Extract) for the year ended

Expenses	£	£
Depreciation:		
Buildings	x	
Plant and machinery	10,000	
Furniture, Fixtures and Fittings	x	
Motor vehicles	x	

(b) Balance sheet (Extract) as at _____

Non Current Assets	Cost £	Total Depreciation (£)	NBV (Net Book Value) £
Land	x	-	x
Buildings	x	(x)	x
Plant and Machinery	x	(x)	x
Furniture, Fixtures & fittings	x	(x)	x
Motor vehicles	<u>x</u>	<u>(x)</u>	<u>x</u>
	<u>x</u>	<u>x</u>	<u>x</u>

Example 4.13

A company starts in business on 1 January 2002. You are to write up the motor cars account and the provision for depreciation account for the year ended 31 December 2002 from the information given below. Depreciation is at the rate of 20 per cent per annum. Using the basis of one month's ownership needs one month's depreciation.

2002 Bought two motor vans for £12,000 each on 1 January
 Bought one motor van for £14,000 on 1 July.

Motorcars a/c

<u>2002</u>		£	<u>2002</u>		£
1/1	Cashbook	24,000			
1/7	Cashbook	<u>14,000</u>	31/12	Bal c/d	<u>38,000</u>
		<u>38,000</u>			<u>38,000</u>

Calculation for depreciation

$$1/1 \quad 24,000 \times \frac{20}{100} \times \frac{12}{12} = £4,800 + 1/7(14,000 \times \frac{20}{100} \times \frac{6}{12} = 1,400)$$

$$= £4,800 + 1,400 = £6,200$$

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Provision- Depreciation for Motor cars A/c

<u>2002</u>	£	<u>2002</u>	£
31/12 Bal c/d	6,200	31/12 P&L	6,200

Profit And Loss Account (Extract) for the period.

Expenses	£	£
Depreciation:		
Motor vans	6200	

Balance Sheet (Extract) as at 31/12/2002

Non-current Assets	<u>Cost</u>	Total <u>Depreciation</u>	<u>NBV</u>
Motor vans	38,000	(6200)	31,800

Example 4.14

A company starts in business on 1 January 1999, the financial year end being 31 December. You are to show:

- a. The plant account.
- b. The provision for depreciation account.
- c. The balance sheet extracts for each of the years 1999, 2000, 2001, 2002.

The machinery bought was:

1999	1 January	1 plant costing £8,000
2000	1 July	2 plant costing £5,000 each
	1 October	1 plant costing £6,000
2002	1 April	1 plant costing £2,000

Depreciation is at the rate of 10 per cent per annum, using the straight-line method, plant being depreciated for each proportion of a year.

Plant a/c

<u>1999</u>	£	<u>199</u>	£
1/1 Cashbook	<u>8000</u>	31/12 Bal c/d	<u>8000</u>
<u>2000</u>		<u>2000</u>	
1/1 Bal b/d	8000		
1/7 Cashbook	10,000		
1/10 Cashbook	<u>6,000</u>	31/12 Bal c/d	<u>24,000</u>
	<u>24,000</u>		<u>24,000</u>
<u>2001</u>		<u>2001</u>	
1/1 Bal b/d	<u>24,000</u>	31/12 Bal c/d	<u>24,000</u>
<u>2002</u>		<u>2002</u>	
1/1 Bal b/d	24,000		
1/4 Cashbook	<u>2,000</u>	31/12 Bal c/d	<u>26,000</u>
	<u>26,000</u>		<u>26,000</u>

Calculation for Depreciation

<u>1999</u>	£	<u>Accumulated Depreciation</u>
£8,000 x 10/100 x 12/12 =	800	800
<u>2000</u>		
£10,000 x 10/100 x 6/12 =	500	
£6,000 x 10/100 x 3/12 =	150	
£8,000 x 10/100 x 12/12 =	<u>800</u>	
	1,450	2,250
<u>2001</u>		
£24,000 x 10/100 x 12/12 =	2400	4,650
<u>2002</u>		
£24,000 x 10/100 x 12/12 =	2400	
£2,000 x 10/100 x 9/12 =	<u>150</u>	
	<u>2,250</u>	<u>7,200</u>

Provision – Depreciation Machines

<u>1999</u>		£	<u>1999</u>		£
31/12	Bal c/d	<u>800</u>	31/12	P&L	<u>800</u>
<u>2000</u>		£	<u>2000</u>		£
31/12	Bal c/d	<u>2,250</u>	1/1	Bal b/d	800
		<u>2,250</u>		P&L	<u>1,450</u>
					<u>2,250</u>
<u>2001</u>		£	<u>2001</u>		£
31/12	Bal c/d	<u>4,650</u>	1/1	Bal b/d	2,250
		<u>4,650</u>		P&L	<u>2,400</u>
					<u>4,650</u>
<u>2002</u>		£	<u>2002</u>		£
31/12	Bal c/d	<u>7,200</u>	1/1	Bal b/d	4,650
		<u>7,200</u>		P&L	<u>2,550</u>
					<u>7,200</u>

Balance Sheet (Extract) as at 31/12/99 – 31/12/02

<u>Non Current Assets</u>	<u>Cost</u>	<u>Total Depreciation</u>	<u>NBV</u>
<u>1999</u>			
Motor vans	<u>8,000</u>	<u>(800)</u>	<u>7,200</u>
<u>1999</u>			
Motor vans	<u>24,000</u>	<u>(2,250)</u>	<u>21,750</u>
<u>1999</u>			
Motor vans	<u>24,000</u>	<u>(4,650)</u>	<u>19,350</u>
<u>1999</u>			
Motor vans	<u>26,000</u>	<u>(7,200)</u>	<u>18,800</u>

DISPOSALS OF ASSETS

A firm may dispose off its non-current assets in the following 3 ways:

- i. Selling the asset.
- ii. Asset being written-off from damage/accident/theft.
- iii. Asset is scrapped/not used anymore.

When an asset is disposed and is no longer used by the firm, the appropriate entries should be made in the asset account and the total depreciation provided to date on the asset and the entries required will depend on the type of disposal.

When the asset is sold, the following entries will be made:

- (a) Debit – asset disposal a/c
 Credit – asset a/c

With the cost of the asset being disposed.

(b) Debit – provision for depreciation of asset a/c.

Credit – asset disposal a/c

With the total depreciation provided to date on the asset.

(c) Debit – cashbook.

Credit – asset disposal a/c

With the cash received on disposal.

When an asset is written off as a result of damage/accident/theft. If it was insured and the insurance company accept liability but by the end of the period the insurance company has not yet paid.

(a) Debit – asset disposal a/c

Credit – asset a/c

With the cost of the asset damaged.

(b) Debit – provision for depreciation of asset a/c

Credit – asset disposal a/c

(c) Debit – insurance receivable a/c

Credit – asset disposal a/c

With the amount expected from the insurance.

If the insurance pays before the end of the financial period, it will not be necessary to create an insurance debtor so the following entries will be made:

Debit – cashbook.

Credit – asset disposal a/c

If the asset is not used anymore or scrapped by the firm, the appropriate entries will be made in the asset account and provision for depreciation a/c only.

Debit – asset disposal a/c

Credit – asset a/c

With the cost of the asset no longer in use.

Debit – provision for depreciation for asset

Credit – asset disposal a/c

With the total depreciation provided to date.

The balance in the disposal a/c after the above entries will either be a debit balance or a credit balance. A credit balance represents a profit on disposal, which is reported in the profit and loss a/c together with other incomes. The entry will be:

Debit – asset disposal a/c

Credit – P&L a/c

With the balance in the account.

A debit balance in the asset disposal a/c is loss on disposal which is reported in the P&L a/c as an expense and therefore the entry will be.

Example 4.15

A firm has a motor vehicle costing £1,000 total depreciation provided to date is £800. The firm decides to trade in the motor vehicle with a new one the value of the new one being £500. The supplier of the new vehicle agree with the firm that the old motor vehicle is worth £300, therefore the difference will be paid by cash.

Motor vehicle a/c			
Bal b/d	£	Motor vehicle disposal	£
	1,000		1,000

Disposals	300		
Cashbook	<u>200</u>	Bal c/d	<u>500</u>
	1,500		1,500
	=====		=====

Motor Vehicle Disposal a/c

Motor vehicle a/c	£	1,000	Provision for depreciation	£	800
P&L		<u>100</u>	Motor vehicle		<u>300</u>
		<u>1,100</u>			<u>1,100</u>

JOURNAL ENTRIES

	£	£
Debit – motor vehicles disposal	1,000	
Credit – motor vehicles a/c		1,000
(Motor vehicle being traded in now transferred to disposal a/c)		
Debit – Provision for depreciation – motor vehicles	800	
Credit – Motor vehicle disposal a/c		800
(Total depreciation provided for motor vehicle)		
Debit – Motor vehicle a/c	500	
Credit – Asset disposal a/c		300
- Cashbook		200
(New motor vehicle acquired by trade-in value of £300 and cheque payment of £200)		
Debit – Asset disposal a/c	100	
Credit – P&L		100
(Profit made on disposal)		

In case of a loss,

Debit – P&L a/c
 Credit – asset disposal a/c

If the firm trades in an old asset for a new one, the following entries will be made in addition to the movements in the asset and depreciation a/c.

Debit – asset a/c (value of the new asset)
 Credit – cashbook (cash paid as difference of new value i.e. trade in value of old asset)
 Asset disposal a/c (with trade-in value of old asset)

Example 4.16

A company depreciates its plant at the rate of 20 per cent per annum, straight line method, for each month of ownership. From the following details draw up the plant account and the provision for depreciation account for each of the years 1999, 2000, 2001 and 2002.

- 1999 Bought plant costing £900 on 1 January.
- Bought plant costing £600 on 1 October.
- 2001 Bought plant costing £550 on 1 July.
- 2002 Sold plant which had been bought for £900 on 1 January 1999 for the sum of £275 on 30 September 2002.

You are also required to draw up the plant disposal account and the extracts from the balance sheet as at the end of each year.

Example

Plant a/c				
<u>1999</u>		£	<u>1999</u>	£
1/1	Cashbook	900		
1/10	Cashbook	<u>600</u>	31/12	Bal c/d <u>1,500</u>
		<u>1,500</u>		<u>1,500</u>
<u>2000</u>		£	<u>2000</u>	£
1/1	Bal b/d	<u>1,500</u>	31/12	Bal c/d <u>1,500</u>
<u>2001</u>		£	<u>2001</u>	£
1/1	Bal b/d	1,500		
1/7	Cashbook	<u>550</u>	31/12	Bal c/d <u>2,050</u>
		<u>2,050</u>		<u>2,050</u>
<u>2002</u>			<u>2002</u>	
1/1	Bal b/d	2,050	30/9	Disposal 900
		<u>2,050</u>	31/12	Bal c/d <u>1,150</u>
				<u>2,050</u>

Plant Provision for Depreciation a/c

<u>1999</u>		£	<u>1999</u>		£
31/12	Bal c/d	<u>210</u>	31/12	P&L	<u>210</u>
<u>2000</u>			<u>2000</u>		
31/12	Bal c/d	<u>510</u>	1/1	Bal b/d	210
		<u>510</u>		P&L	<u>300</u>
					<u>510</u>
<u>2001</u>			<u>2001</u>		
31/12	Bal c/d	<u>865</u>	1/1	Bal b/d	510
		<u>865</u>		P&L	<u>355</u>
					<u>865</u>
<u>2002</u>			<u>2002</u>		
31/12	Disposals	675	1/1	Bal b/d	865
	Bal c/d	<u>555</u>		P&L	<u>365</u>
		<u>1,230</u>			<u>1,230</u>

Calculation for Depreciation

Date	Cost	Months	Depreciation charge	£
------	------	--------	---------------------	---

1999					
1/1	900	12	$20/100 \times 900 \times 12/12$	=	180
1/10	600	3	$20/100 \times 600 \times 3/12$	=	<u>30</u>
					<u>210</u>
2000					
1/1	1,500	12	$20/100 \times 1,500 \times 12/12$	=	<u>300</u>
2001					
1/1	1,500	12	$20/100 \times 1,500 \times 12/12$	=	<u>300</u>
1/2	550	6	$20/100 \times 550 \times 6/12$	=	<u>55</u>
					<u>355</u>
2002					
30/9	900	9	$20/100 \times 900 \times 9/12$	=	135
31/12	550	12	$20/100 \times 550 \times 12/12$	=	110
31/12	600	12	$20/100 \times 600 \times 12/12$	=	<u>120</u>
					<u>365</u>

Plant Disposal a/c

<u>2002</u>	£	<u>2002</u>	£
Plant a/c	900	30/9 Provision for depreciation	675
P&L	<u>50</u>	30/9 Cashbook	<u>275</u>
	950		950

Balance Sheet (Extract)

	<u>Non Current Assets</u>	<u>Cost</u>	<u>Total Depreciation</u>	<u>NBV</u>
1999	Plant	1,500	(210)	1,290
2000	Plant	1,500	(510)	990
2001	Plant	2,050	(865)	1,695
2002	Plant	1,150	(555)	595

CHANGE OF DEPRECIATION POLICY

A firm may change its depreciation policy in several ways e.g. from straight line to reducing balance or vice versa, or it may increase/decrease the number of estimated useful years of an asset. A firm should always follow the depreciation policy adopted consistently and incase there is need to change the policy may be due to a new accounting standard or change in circumstances. This change should be disclosed in the financial statements.

When there is change in the depreciation policy this may result in an increase or a decrease in the depreciation to be charged in the Profit and loss account .IAS 16 requires that depreciation should be based on the remaining net book value at the start of the period.

Example 4.17

A firm buys a machine for £100,000 for which it expects to use for the next 10 years. The firm depreciates the machines on a straight-line basis on the years of the number of estimated useful years. In the 4th year, the estimated useful life of the machine is now reduced to 8 years. year.

Required:

Show the charge in the provision for depreciation a/c and the balance carried down for year 4. Change for 10yr – 8 yr is same as change from 10% to 12.5%

Provision for Depreciation

<u>Year 1</u>			<u>Year 1</u>		
31/12	Bal c/d	£ <u>10,000</u>	31/12	P&L	£ <u>10,000</u>
<u>Year 2</u>			<u>Year 2</u>		
31/12	Bal c/d	<u>20,000</u>	1/1	Bal b/d	10,000
		<u>30,000</u>		P&L	<u>10,000</u>
					<u>20,000</u>
<u>Year 3</u>			<u>Year 3</u>		
31/12	Bal c/d	<u>30,000</u>	1/1	Bal b/d	20,000
		<u>30,000</u>	31/12	P&L	<u>10,000</u>
					<u>30,000</u>
<u>Year 4</u>			<u>Year 4</u>		
31/12	Bal c/d	44,000	1/1	Bal b/d	30,000
		<u>44,000</u>	31/12	P&L	14,000
					<u>44,000</u>

Workings:

The net book value at the beginning of Year 4 is £ 70,000 (100,000 - 30,000). And the remaining useful life is 5 (8 years - 3 years). The charge for year 4 for depreciation will be

$$\text{£ } \frac{70,000}{5} = 14,000.$$

Assuming that in this example the life of the machine does not decrease but increases from 10 years to 13 years.

Required: Show the provision of depreciation account in year 4

Provision for Depreciation

<u>Year 1</u>		£	<u>Year 1</u>		£
31/12	Bal c/d	<u>10,000</u>	31/12	P&L	<u>10,000</u>
<u>Year 2</u>			<u>Year 2</u>		
31/12	Bal c/d	<u>20,000</u>	1/1	Bal b/d	10,000
		<u>20,000</u>		P&L	<u>10,000</u>
					<u>20,000</u>
<u>Year 3</u>			<u>Year 3</u>		
31/12	Bal c/d	30,000	1/1	Bal b/d	20,000
		—		P&L	<u>10,000</u>
					<u>30,000</u>
			<u>30,000</u>		<u>30,000</u>
<u>Year 4</u>			<u>Year 4</u>		
31/12	Bal c/d	<u>37,000</u>	1/1	Bal b/d	30,000
		<u>37,000</u>	31/12	P&L	<u>7,000</u>
					<u>37,000</u>

REVALUATION OF NON CURRENT ASSETS

Some of the non-current assets in a firm tend to appreciate in value rather than depreciate e.g. land and buildings. IAS 16 on property, plant and equipment requires that such assets may be carried in the accounts at the revalued amounts (may be based on their market price).

Land is not depreciated, and therefore the adjustments required are minimal, but for buildings, changes should be made at the cost and depreciation reserve account is usually opened for the purpose of these adjustments.

Example 4.18

A firm has the following assets as part of the non-current assets:

	Asset	Cost	Depreciation
(a)	Land	£1,000,000	-
(b)	Buildings	£800,000	40,000

Illustration 1

The firm decides to revalue these two assets to reflect their current market prices and these are revalued at:

Land	-£ 1,200,00	Buildings	-£ 900,000
------	-------------	-----------	------------

The following entries would be made

- (a) Debit – Land A/c – with revaluation gain - £ 200,000

Credit – Revaluation Reserve a/c with the same - £ 200,000

(Revaluation gain on the land \Rightarrow 1,200,000 – 1,000,000)

(b) Debit – Building a/c with revaluation gain - £100,000

Credit – Revaluation Reserve a/c with the same - £100,000

(Revaluation gain on buildings \Rightarrow 900,000 – 800,000)

(c) Debit – Provision for depreciation for buildings a/c with £ 40,000

Credit – Revaluation Reserve a/c with the same £ 40,000

Total credit depreciation charged to date on buildings now transferred to revaluation reserve a/c

The ledger a/c will be as follows:

Land a/c			
	£		£
Bal B/D	1,000,000	Bal C/D	1,200,000
Revaluation reserve	<u>200,000</u>		<u>1,200,000</u>
	<u>1,200,000</u>		<u>1,200,000</u>

Buildings a/c			
	£		£
Bal B/D	800,000	Bal C/D	900,000
Revaluation reserve	<u>100,000</u>		<u>900,000</u>
	<u>900,000</u>		<u>900,000</u>

Revaluation Reserve a/c			
	£		£
Bal C/D	<u>340,000</u>	Land	200,000
	<u>340,000</u>	Buildings	100,000
		Provision for depr.	<u>40,000</u>
			<u>340,000</u>

Provision for depreciation (Buildings)

	£		£
Revaluation	40,000	Bal B/D	40,000
Bal c/d	<u>45,000</u>	P & L	<u>45,000</u>
	<u>85,000</u>		<u>85,000</u>

The balances in the Land and Building a/c will be shown as cost in the Balance Sheet and the revaluation reserve a/c appears together with the capital as a revaluation reserve (especially used in company accounts).

Land	→	1,200,000 – 1,000,000 = 200,000	} 340,000
Buildings	→	900,000 – 760,000 = 140,000	

Any depreciation to be charged for the buildings should be based on the revalued amount (900,000)

If we assume depreciation of 5% for buildings, we shall have £45,000 charged in the P & L and will also be the Bal c/d in the provision for depreciation a/c.

Assume again that the firm decides to revalue its non-current assets or land and buildings downwards in year 3 to the following values:

Land : £900,000

Buildings: £700,000

These amounts are to be reflected in the accounts for year 3.

The Ledger accounts will be as follows:

Year 3		£	Land		£
1/1 Bal B/D		1,200,000	31/12 Revaluation		200,000
			P & L		100,000
			Bal C/D		<u>900,000</u>
		<u>1,200,000</u>			<u>1,200,000</u>

Year 3		£	Buildings		£
1/1 Bal B/D		900,000	31/12 Revaluation		100,000
			P & L		100,000
			Bal C/D		<u>700,000</u>
		<u>900,000</u>			<u>900,000</u>

Year 3		£	Revaluation Reserve		£
31/12 Land		200,000	1/1/ Bal B/D		340,000
31/12 Building		100,000			
31/12 Prov. For depr.		<u>40,000</u>			

340,000

340,000

Property, Plant and Equipment Schedule (Formerly fixed asset movement schedule)

The property, plant and equipment schedule is a summary report on the balances and transactions of the asset and provision for depreciation account as per the requirements of IAS 16 to be reported in the published accounts of companies. The format is as follows:

Property, Plant and Equipment Schedule:

Cost/ Valuation	Freehold property	Leasehold Property		Plant and Machinery	Fixture, Furniture and fittings (£)	Total
		Long leases (£)	Short lease (£)			
Bal as at 1/1/01	x	x	x	x	x	x
Additions	xx	xx	xx	xx	xx	xx
Revaluations (gains)	xx	-	-	-	-	xx
Reclassifications	-	(xx)	xx	-	-	-
Disposals	(xx)	(xx)	(xx)	(xx)	(xx)	(xx)
Bal as at 31/12/01	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>
Depreciation/ Amortization						
Bal as at 1/1/10	xx	-	xx	xx	xx	xx
Change for year	xx	-	xx	xx	xx	xx
Revaluation	(xx)	-	(xx)	(xx)	(xx)	(xx)
Eliminated on Disposal	(xx)	-	(xx)	(xx)	(xx)	(xx)
Bal as at 31/12/01	<u>(xx)</u>	-	<u>(xx)</u>	<u>(xx)</u>	<u>(xx)</u>	<u>(xx)</u>
N.B. V as at 31/12/01	xx	xx	xx	xx	xx	xx
NBV as at 31/12/01	xx	xx	xx	xx	xx	xx

Additional information is in this schedule called reclassifications where some of the non-current assets are transferred into a different class. (e.g.) some of the properties hold under long leases (over 50 years) will be transferred to the short leases classes when their term becomes less than 50 years. This is a reclassification from long lease to short lease and so is shown in the schedule at the value of transfer as a deduction in the long lease class and on addition in the short lease class.

REVIEW QUESTIONS

1. James Mbuvi started a taxi business in Nairobi March 1990 under the firm name Mbuvi Taxis. The firm had two vehicles KA and KB, which had been purchased for Sh.560, 000, and Sh.720, 000 respectively earlier in the year.

In February 1992 vehicle KB was involved in an accident and was written off. The insurance company paid the firm Sh.160, 000 for the vehicle. In the same year the firm purchased two vehicles, KC and KD for Sh.800, 000 each.

In November 1993 vehicle KC was sold for Sh.716, 000. In January 1994 vehicle KE was purchased for Shs.840,000. In March 1994 another vehicle KF was purchased for Sh.960, 000.

The firm's policy is to depreciate vehicles at the rate of 25 per cent on cost on vehicles on hand at the end of the year irrespective of the date of purchase. Depreciation is not provided for vehicle disposed of during the year. The firm's year ends on 31 December.

Required:

- a) Calculate the amount of depreciation charged in the profit and loss account for each of the five years.
- b) Prepare the motor vehicle account (at cost).
- c) Calculate the profit and loss on disposal of each of the vehicles disposed of by the company.

2. Pentland Limited complies its financial statements for the year to 30 June each year. At 1 July 1999 the company's balance sheet included the following figures:

	Cost	Accumulated Depreciation	Net book Value
	£000	£000	£000
Land	4,000	Nil	4,000
Buildings	2,200	800	1,400
Plant and machinery	1,600	600	1,000
Motor vehicles	600	200	400

Depreciation is charged at the following annual rates (all straight line):

Land	Nil
Buildings	2%
Plant and machinery	15%
Motor vehicles	20%

Appropriate depreciation charge is made in the year of purchase, sale or revaluation of an asset

During the year ended 30 June 2000 the following transactions took place:

1. 1 January 2000 The company decided to adopt a policy of revaluing its buildings; and they were revalued to £3.4m.
2. 1 January 2000 Plant which has cost £300,000 was sold for £50,000. Accumulated depreciation on this plant at 30 June 1999 amounted to £230,000. New plant was purchased at a cost of £400,000.
3. 1 April 2000 A new motor vehicle was purchased for £30,000. part of the purchase price was settled by part exchanging another motor vehicle, which had cost £20,000, at an agreed value of £12,000. the balance of £18,000 was paid in cash.
4. The motor vehicle given in part-exchange had a net book value (cost less depreciation) at 30 June 1999 of £10,000

Required:

Prepare ledger accounts to record these transactions in the records of Pentland Limited.

3.a) Briefly explain the nature and purpose of accounting for depreciation.

b) The chief accountant of Jitegemea Ltd has encountered difficulties while accounting for fixed assets and the related depreciation in the company's draft accounts for the year ended 30 April 2000. He has decided to seek your professional advice and presented the following balances of fixed assets as at 1 May 1999:

	Acquisition Cost Sh.	Accumulated Depreciation Sh.	Depreciation Rates %
Furniture	900,000	300,000	12.5
Trucks	3,525,000	1,470,000	25
Plant and machinery	7,387,500	4,462,500	10
Land	2,775,000	-	Nil
Buildings	2,925,000	292,500	2.5

The following additional information was also available:

1. It is the company's policy to write off cost of the assets using above percentages on cost.
2. Depreciation is fully charged in the year of acquisition and none in the year of disposal.
3. A three year old machine acquired for sh.187,500 was sold for sh.15,750.
4. It has been decided to adjust and charge depreciation on buildings at 4%.
5. A used delivery truck purchased three years ago for sh.248,250 was traded in during the year at a value of sh.157,500 in part exchange of the new delivery truck costing sh.450,000.
6. Land, buildings and machinery were acquired for sh.1,350,000 from a company that went out of business. At the time of acquisition sh.90,000 was paid to have the assets revalued by a professionally qualified valuer. The revaluation indicated the following market values.

	Sh.
Land	900,000
Buildings	600,000
Machinery	300,000

Required:

A schedule of movement of fixed assets as requested by the Chief Accountant for inclusion in the company's accounts for the year ended 30 April 2000.

FINAL ACCOUNTS FOR SOLE-TRADERS.

Specific Objectives.

By the end of the topic, the trainee should be able to:-

- Define final accounts
- Explain the types of final accounts
- Explain the preparation of final accounts

	£	£	£
Sales			XX
Less Returns inwards			(XX)
			XX
Less cost of sales			
Opening stock		XX	
Purchases	XX		
Add carriage in	XX		
	XX		
Less Returns out	(XX)	XX	
		XX	
Less closing stock		(XX)	(XX)
Gross profit			XX
Discount received			XX
Other incomes (rent, interests, dividends)			XX
Profit on disposal of			XX

non-current assets			
Reduction in provision for doubtful debts		XX	
Reduction in provision for discount allowable		XX	
Interest on overdue debtors balances		XX	
		XX	
Less Expenses			
Bad debts	XX		
Depreciation: (eg) Plant	XX		
	XX		
Motor vehicle			
Increase in provision for doubtful debts	XX		
Increase in provision for discount allowable	XX		
Loss on disposal of non current assets	XX		
Loss of other assets (eg) stock	XX		
Interest charged by creditors	XX		
Other expenses:	XX		
Rent			
Insurance	XX		
Postage	XX		
Interest on loan etc	XX		(XX)
NET PROFIT			<u>XX</u>

BALANCE SHEET AS AT 31 DEC.....

<u>Non current assets</u>	£	£	£
Land	XX	-	XX
Buildings	XX	(XX)	XX
Plant and machinery	XX	(XX)	XX
Fixtures, furniture and fittings	XX	(XX)	XX
Motor vehicle	XX	(XX)	XX
	<u>XX</u>	<u>XX</u>	XX
<u>Current assets</u>			
Stock		XX	
Debtors	XX		
Less provision for doubtful debts	(XX)	XX	
Accrued income		XX	
Prepaid expenses		XX	
Cash at bank		XX	
Cash in hand		XX	

Current liabilities

Bank overdraft	XX			
Trade creditors	XX			Non current liabilities
Prepaid income	XX	(XX)		
Net current assets				<u>XX</u>
Net assets		<u>XX</u>		<u>Loan</u>
Capital			XX	Example 5.11 Given the question 5.10, the final accounts for the year ended 30 April 19X2 will be as follows: Mr Chai Trading and Profit and Loss Account for year ended 30 April 19X7
Add net profit			XX	
Less drawings			(XX)	
Non current liabilities			XX	
Loan			<u>XX</u>	
Non current liabilities			<u>XX</u>	
Loan			<u>XX</u>	
Non current liabilities			<u>XX</u>	
Loan			<u>XX</u>	
Non current liabilities			<u>XX</u>	
Loan			<u>XX</u>	
Sales	£		£	£
Less Returns inwards				259,870
				<u>(5,624)</u>
				254,246
Less cost of sales				
Opening			15,654	

stock			
Purchases	135,680		
Add carriage in			
	147,510		
Less	<u>(13,407)</u>	134,103	
Returns out			
Cost of goods available for sale		149,757	
Less		<u>(17,750)</u>	<u>(132,007)</u>
closing stock			
Gross profit			122,239
Add:			<u>1,750</u>
Discount received			123,989
<u>Less</u>			
<u>Expenses</u>			
Discount allowed		2,306	
Carriage outwards		4,562	
Rent, rates and insurance		19,418	
Heating and lighting		12,370	
Postage, stationery and telephone		2,410	
Advertisin g		5,980	
Salaries and Wages		38,521	
Bad debts		2,008	
Provision for bad debts		223	

Provision for depreciation – fixtures and fitting	<u>12,074</u>	<u>99,872</u>
Net profit		<u>24,117</u>

Mr Chai
Balance Sheet as at 30 April 19X7

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<u>Non current asset</u>	£	£	£
Fixtures and fittings	120,740	(63,020)	57,720
<u>Current assets</u>			
Stock		17,750	
Debtors	24,500		
Less provision for doubtful debts	<u>(735)</u>	23,765	
Prepayments		6,555	
Cash at bank		4,440	
Cash in hand		34	
		53,044	
<u>Current liabilities</u>			
Creditors	19,840		
Accruals	<u>1,360</u>	<u>(21,200)</u>	<u>31,844</u>
			<u>89,564</u>
Capital			83,887
Add net profit			24,117
			108,004
Less drawings			<u>(18,440)</u>
			<u>89,564</u>
		£	£
Sales			138,078
Purchases		82,350	
Carriage		5,144	
Drawings		7,800	
Rent, rates and insurance		6,622	
Postage and stationery		3,001	
Advertising		<u>1,330</u>	
Salaries and wages		26,420	
Bad debts		877	
Provision for bad debts			130
Debtors		12,120	
Creditors			6,471
Cash in hand		177	
Cash at bank		1,002	
Stock at at 1 June 19X5		11,927	
Equipment			
At cost		58,000	
Accumulated depreciation			<u>19,000</u>
Capital			<u>53,091</u>
		<u>216,770</u>	<u>216,770</u>

Example 5.12
The following trial balance has been extracted from the ledger of Mr. Yousef, a sole trader.
Mr. Yousef Trading and Profit and Loss Account for the year ended 31 May 19X6.

The following additional information as at 31 May 19X6 is available:

- (a) Rent is accrued by £210.
- (b) Rates have been prepaid by £880.

- (c) £2,211 of carriage represents carriage inwards on purchases.
 (d) Equipment is to be depreciated at 15% per annum using the straight line method.
 (e) The provision for bad debts to be increased by £40.
 (f) Stock at the close of business has been valued at £13,551.

Required:

Prepare a trading and profit and loss account for the year ended 31 May 19X6 and a balance sheet as at that date.

Solution:

Mr. Yousef

Trading and Profit and Loss Account for the year ended 31 May 19X6.

	£	£	£
Sales			138,078
Less cost of sales			
Opening stock		11,927	
Purchases	82,350		
Carriage inwards	<u>2,211</u>	<u>84,561</u>	
		96,488	
Less closing stock		<u>(13,551)</u>	<u>(82,937)</u>
Gross profit			55,141
Less expenses			
Carriage outwards		2,933	
Rent, rates and insurance		5,952	
Postage and stationery		3,001	
Advertising		1,330	
Salaries and wages		26,420	
Bad debts		877	
Increase in provision for bad debts		40	
Depreciation – equipment		<u>8,700</u>	<u>(49,253)</u>
Net profit			<u>5,888</u>

Mr. Yousef

Balance Sheet as at 31 May 19X6.

	£	£	£
Non Current assets			
Equipment	<u>58,000</u>	<u>(27,700)</u>	30,300
Current Assets			
Stocks		<u>13,551</u>	
Debtors	12,120		
Less provision for doubtful debts	<u>(170)</u>	<u>11,950</u>	
Prepayments		880	
Cash in hand		177	
Cash at bank		<u>1,002</u>	
Current Liabilities		27,560	
Creditors	6,471		
Accruals	<u>210</u>	<u>6,681</u>	<u>20,879</u>
			<u>51,179</u>
Capital			53,091
Add: Net Profit			<u>5,888</u>
			58,979
Less Drawings			<u>(7,800)</u>
			<u>51,179</u>

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Example 5.13

The following trial balance has been extracted from the ledger of Herbert Howell, a sole trader, as at 31 May 20X9, the end of his most recent financial year.

Herbert Howell**Trial Balance As At 31 May 20x9**

	Dr	Cr
	£	£
Property at cost	90,000	
Equipment at cost	57,500	
Provision for depreciation (as at 1 June 20X8)		
Property		12,500
Equipment		32,500
Stock as at 1 June 20X8	27,400	
Purchases	259,600	
Sales		405,000
Discounts allowed	3,370	
Discounts received		4,420
Wages and salaries	52,360	
Bad debts	1,720	
Loan interest	1,560	
Carriage out	5,310	
Other operating expenses	38,800	
Trade debtors	46,200	
Trade creditors		33,600
Provision for bad debts		280
Cash on hand	151	
Bank overdraft		14,500
Drawings	28,930	
13% loan		12,000
Capital, as at 1 June 20X8		<u>98,101</u>
	<u>612,901</u>	<u>612,901</u>

The following additional information as at 31 May 20X9 is available:

- (a) Stock as at the close of business was valued at £25,900.
- (b) Depreciation for the year ended 31 May 20X9 has yet to be provided as follows:

Property	-	1% using the straight-line method
Equipment	-	15% using the straight-line method

- (c) Wages and salaries are accrued by £140.
- (d) Other operating expenses include certain expenses prepaid by £500. Other expenses included under this heading are accrued by £200.
- (e) The provision for bad debts is to be adjusted so that it is 0.5% of trade debtors as at 31 May 20X9.
- (f) Purchases include goods valued at £1,040, which were withdrawn by Mr Howell for his own personal use.

Required:

Prepare Mr. Howell's trading and profit and loss account for the year ended 31 May 20X9 and his balance sheet as at 31 May 20X9. **(20 marks)**

Solution:

Sales	£	£
		405,000
<u>Less cost of sales</u>		
Opening stock	27,400	

Purchases	<u>258,560</u>	
	285,960	
Less closing stock	<u>(25,900)</u>	<u>(260,060)</u>
Gross profit		144,940
Discounts received		4,420
Decrease in provision for bad debts		<u>49</u>
		149,409
<u>Less expenses</u>		
Depreciation: Property	900	
Equipment	8,625	
Discounts allowed	3,370	
Wages and salaries	52,500	
Bad debts	1,720	
Loan interest	1,560	
Carriage out	5,310	
Other operating expenses	<u>38,500</u>	<u>(112,485)</u>
NET PROFIT		<u>86,924</u>

Herbert Howell
Balance Sheet as at 31 May 2000

	£	£	£
Non current Assets			
Property	90,000	(13,400)	76,600
Equipment	<u>57,500</u>	<u>(41,125)</u>	<u>16,375</u>
	<u>147,500</u>	<u>54,525</u>	<u>92,975</u>
Current Assets			
Stock		25,900	
Debtor	46,200		
Less provision	(231)	45,969	
Prepayments		500	
Cash in hand		<u>151</u>	
		72,520	
Current liabilities			
Bank overdraft	14,500		
Creditors	33,600		
Accruals	<u>340</u>	<u>(48,440)</u>	
			<u>24,080</u>
			<u>117,055</u>
Capital			98,101
Add net profit			<u>36,924</u>
			135,025
Less drawings			<u>(29,975)</u>
			105,055
Non current liabilities			
Loan (13%)			<u>12,000</u>
			<u>117,055</u>

Workings:

- 1) Depreciation for:
- | | | | |
|-----------|--------------|---|-------|
| Property | 1% X 90,000 | = | 900 |
| Equipment | 15% X 57,500 | = | 8,625 |

- 2) Provision for bad debts
- | | | |
|-------------------------------------|---|-----|
| 0.5% X (46,200) | = | 231 |
| Decrease in provision for bad debts | | |
| 280 – 231 | = | 49 |

-
- 3) Wages and salaries
Paid 52,360
Accruals 140
52,500
- 4) Other operating expenses
Paid 8,800
Pre-paid (500)
8,300
Accruals 200
8,500
- 5) Purchases: $259,600 - 1,040 = 258,560$
Drawings: $28,930 + 1,040 = 29,990$

REVIEW QUESTIONS

1. David Dolgellau, a sole trader has prepared the following balance as at 31 March 2001

	£
Sales	378,500.00
Discount Received	2,400.00
Rent Received	7,500.00
Returns outwards	7,700.00
Creditors	18,700.00
Bank Overdraft	30,000.00
Capital	287,500.00
Purchases	261,700.00
Salaries and Wages	45,700.00
Office expenses	8,400.00
Insurance premiums	3,100.00
Electricity	1,600.00
Stationery	6,200.00
Advertising	8,400.00
Telephone	2,100.00
Business Rates	7,500.00
Discounts allowed	600.00
Returns Inwards	4,100.00
Stocks as at 1 April 2000	120,600.00
Warehouse, shop and office	210,000.00
Fixtures and fittings	12,800.00
Debtors	13,000.00
Cash in till	500.00
Drawings	26,000.00

The following further information was obtained:

- Closing stock was £ 102,500.00
- Electricity charges accrued £ 700.00
- Advertising expenses accrued £ 500.00
- Insurance premiums paid in advance £ 900.00
- Business rates prepaid £ 1,500.00

Required:

Prepare a trial balance, trading, profit and loss account for the year ended 31 March 2001 and balance sheet as at that date.

2. Donald Brown, a sole trader, extracted the following trial balance on 31 December 20X0.

TRIAL BALANCE AS AT 31 DECEMBER 20X0

	Debit	Credit
	£	£
Capital at 1 January 20X0		26,094
Debtors	42,737	
Cash In Hand	1,411	
Creditors		35,404
Fixtures and fittings at cost	42,200	
Discounts allowed	1,304	
Discounts received		1,175
Stock at 1 January 20X0	18,460	
Sales		491,620
Purchases	387,936	
Motor Vehicles at cost	45,730	
Lightning and heating	6,184	
Motor expenses	2,862	
Rent	8,841	
General expenses	7,413	
Balance at bank		19,861
Provision for depreciation		
Fixtures and fitting		2,200
Motor vehicles		15,292
Drawings	<u>26,568</u>	
	<u>591,646</u>	<u>591,646</u>

The following information as at 31 December is also available:

- £218 is owing for motor expenses.
- £680 has been prepaid for rent.
- Depreciation is to be provided of the year as follows:
 - Motor vehicles: 20% on cost
 - Fixtures and fittings: 10% reducing balance method
- Stock at the close of business was valued at £19,926.

Required

Prepare Donald Brown's trading and profit and loss account for the year ended 31 December 20X0 and his balance sheet at that date.

3. The following trial balance has been extracted from the accounts of Brenda Bailey, a sole trader.

Brenda Bailey

Trial Balance As At 30 June 20x9

	Dr	Cr
	£	£
Sales		427,726
Purchases	302,419	
Carriage inwards	476	
Carriage outwards	829	
Wages and salaries	64,210	
Rent and rates	12,466	
Heat and light	4,757	
Stock at 1 July 20X8	15,310	
Drawings	21,600	
Equipment at cost	102,000	
Motor vehicles at cost	43,270	
Provision for depreciation:		
Equipment		22,250
Motor vehicles		8,920
Debtors	50,633	
Creditors		41,792
Bank		3,295
Sundry expenses	8,426	
Cash	477	
Capital		<u>122,890</u>
	<u>626,873</u>	<u>626,873</u>

The following information as at 30 June 20X9 is also available.

- £350 is owing for heat and light.
- £620 has been prepaid for rent and rates.
- Depreciation is to be provided for the year as follows:
 - Equipment - 10% on cost
 - Motor vehicles - 20% on cost
- Stock at the close of business was valued at £16,480

Required

Prepare Brenda Bailey's trading and profit and loss account for the year ended 30 June 20X9 and her balance sheet at that date.

NON PROFIT MAKING ORGANIZATIONS (Club, Associations and Others)

Specific objectives.

By the end of this topic, the trainee should be able:-

-
- a) Define a non-profit making organisation
 - b) Distinguish between a receipts and payments account and income and expenditure
 - c) Explain the relationship between receipts and payments accounts and income and expenditure accounts
 - d) Explain the procedure of preparing statements for non-profit making organisation

Non-profit making organisations

These are some form of organizations that are set up to promote or to cater for the welfare of the members involved and not to make a profit. These include clubs, (e.g. football clubs, sports clubs), welfare associations and any other societies (charitable institutions).

Because these organizations are not trading, the types of accounts to prepare are different from the ones of trading organizations.

Example:

1. Instead of a cashbook, the clubs will maintain a receipts and payments which has similar entries to those of a cashbook.
2. Instead of profit and loss account, we have an income and expenditure account.
3. Because the club is not formed by any one owner (has no owner), it is funded by members' contributions, donations, income from investments to get an accumulated fund instead of capital.

From the income and expenditure account, if the incomes are more than the expenditures for the period, then the club has a surplus and not a net profit.

If the expenditure is more than incomes, then the club has a deficit and not a loss.

The club may carry out some trading activities on a small scale to finance some of the clubs activities and in case a firm has a trading activity, then in addition to the income and expenditure account and the balance sheet, prepare a Bar Trading Account.

Format of the Final Accounts

		Name	
Income and Expenditure Account for the year ended 31 December			
Incomes	£		£
Profit from trading activities			XX
Subscriptions			XX
Income from investments			XX
Donations			XX
Income from other activities [dinner dance, raffles, festivals]			<u>XX</u>
			XX
<u>Expenditure</u>			
Depreciation	XX		
Salaries and wages	XX		
Expenses on other activities [prizes]	XX		
Loss from trading activities	XX		
All other expenses	<u>XX</u>		<u>(XX)</u>
SURPLUS/(DEFICIT)			<u>XX/(XX)</u>

NAME
BALANCE SHEET AS AT 31 DECEMBER

	£	£	£
Non current Assets			
Buildings	XX	(XX)	XX
Fixtures, fittings and equipment	XX	(XX)	XX
Motor vehicle	<u>XX</u>	<u>(XX)</u>	<u>XX</u>
	<u>XX</u>	<u>(XX)</u>	XX
Investments			XX
Current Assets			
Stocks		XX	
Debtors		XX	
Prepayments and accrued income		XX	
Cash at bank/hand (receipts + payments)		<u>XX</u>	
		XX	
Current liabilities			
Creditors	XX		
Accrued expenses and prepaid income	XX		
Bank overdraft	<u>XX</u>	<u>(XX)</u>	<u>XX</u>
			<u>XX</u>
Accumulated fund balance b/f			XX
Add/less surplus / deficit			<u>XX/(XX)</u>
Other funds			
Life membership fund		XX	
Building fund		XX	
Education fund		<u>XX</u>	<u>XX</u>
			<u>XX</u>

Notes To The Above Format:

1. Subscriptions:

These are the amounts received by the club from the members to renew their membership. It is often paid on an annual basis.

- It is income for the club and therefore reported in the income and expenditure account.
- Depending on the policy of a club, any subscriptions due but not received are shown as accrued income (debtors for subscriptions) in the balance sheet.
- Any amounts prepaid are shown as prepaid (creditors for subscriptions).
- Some clubs will not report subscriptions as income until it is received in form of cash.

2. Income from Investments:

Some clubs invest excess cash in the bank (fixed deposit account), shares of limited companies, treasury bills and any other investment that may be available.

- If the club is investing with no specific intention (i.e a general investment) then income from this investment should be reported in the income and expenditure account.
- If the investment is for a specific purpose and relates to a specific fund (e.g building fund) it will not be reported in the income and expenditure account but credited directly to the fund.

3. Other funds

- These are funds set up for a specific purpose and not general. They will be shown together with the accumulated fund.
- Any incomes relating to these funds, will be credited directly to the funds and any expenses will be taken off from these funds e.g. building fund, education fund.

Life Membership Fund

Some members may pay some amount to become life members of the club and if this happens, there may be a need to spread out this income over the expected life of the members in the club.

Depending on the policy of a club, the following accounting treatment may be allowed:

- i. The full amount is reported in the Income and Expenditure account in the year it is received and therefore no balance is retained in the life membership account.
- ii. The amount is shown separately in the life membership fund with no transfer in the Income and Expenditure account and hence no balance in the life membership account.
- iii. To transfer some amounts from the life membership funds to the income and expenditure account over the expected life of membership to the club.

Example 6.7

The following is the receipts and payments account of the Friendship Club for the year ended 31 December 19X1:

	£		£
Balance at bank			
31 December 19X0	102	Bar purchases	4,434
Entrance fees	42	Wages	416
Subscriptions: 19X0	25	Rent	186
19X1	305	Heating and lighting	128
19X2	35	Postage and stationery	33
Bar Sales	5,227	Insurance	18
Sale of investments	750	General expenses	46
		Payments on account of new furniture	450
		Balance at bank, 31 December 19X1	<u>775</u>
	<u>6,486</u>		<u>6,486</u>

The following information is also supplied:

(1)	31 December 19X0	31 December 19X1	
Bar stock, at cost		272	315
Creditors for bar purchases		306	358
Rent due		18	36
Heating and lighting expenses due		16	19
Subscriptions due		25	40
Insurance paid in advance		5	7

- 2) On 31 December 19X0, the club held investments which cost £500. During the year ended 31 December 19X1, these were sold for £750.
- 3) Furniture was valued at £300 on 31 December 19X0. On June 19X1, the club purchased additional furniture at a cost of £520. Depreciation of all furniture is to be provided for at the rate of 10% per annum.

Required:

- (a) Prepare an income and expenditure account for the year ended 31 December 19X1.
- (b) Prepare a balance sheet at that date.

Solution:

Friendship Club

Accumulated Fund As at 1.1.19X1

Assets	£	£
Stock		272
Subscriptions due		25
Insurance prepaid		5
Investments		500
Furniture		300
Balance at bank		<u>102</u>
		1,204
 Liabilities		
Creditors	306	
Rent due	18	
Heating and lighting expenses	<u>16</u>	<u>(340)</u>
Accumulated fund		<u>864</u>

Creditors

	£		£
Receipts and payments	4,434	Balance b/f	306
Balance c/d	<u>358</u>	Purchases	<u>4,486</u>
	<u>4,792</u>		<u>4,792</u>

Subscriptions

	£		£
Balance b/d	25	Receipts & payments	365
Income & expenditure	345		
Balance c/d	<u>35</u>	Balance c/d	<u>40</u>
	<u>405</u>		<u>405</u>

Friendship Club
Bar, Trading Account for the year ended 31 December 19X1

	£	£
Sales		5,227
Less: Cost of Sales		
Opening stock	272	
Purchases	4,486	
	4,758	
Less closing stock	(315)	(4,443)
Gross profit to income & expenditure a/c		<u>784</u>

Friendship Club
Income and Expenditure Account for the year ended 31 December 19X1

	£	£
Profit from bar trading		784
Entrance fees		42
Subscriptions		345
Profit from sale of investments		<u>250</u>
		1,421
Expenditure		
Wages	416	
Rent	204	
Heating and lighting	131	
Postage and stationery	33	
Insurance	16	
General expenses	46	
Depreciation – furniture	<u>56</u>	<u>(902)</u>
Surplus		<u>519</u>

Friendship Club			
Balance Sheet as at 31 December 19X1			
Non current Assets	£	£	£
Furniture	820	(56)	764
Current Assets			
Stock	315		
Subscriptions due	40		
Prepaid expense	7		
Cash at bank	775		
	1,137		
Current liabilities			
Creditors	398		
Prepaid subscriptions	35		
Accrued expenses	55		
Creditors fixtures	<u>70</u>	<u>(518)</u>	<u>619</u>
			<u>1,383</u>
Accumulated fund b/f			864
Add surplus			<u>519</u>
			<u>1,383</u>

Example 6.8 (Exam Type) November 2001

- (a) State and briefly explain any three distinguishing features between (i) a receipts and payments account and (ii) an income and expenditure account. (6 marks)
- (b) The accountant of Mamba Sports Club has extracted the following information from the books of account for the year ended 31 March 2001.

Receipts		Payments	
	Sh		Sh
Balance brought forward	288,000	Salaries and wages	254,000
Subscriptions		New equipment	565,000
Year: 1999/2000	249,000	Repairs and maintenance	124,000
2000/2001	2,050,000	Office expenses	415,000
2001/2002	194,000	Printing and stationery	168,000
Dinner dance	723,000	Purchase of beverages	497,000
Beverage sales	657,000	Dinner dance expenses	315,000
Investments income	400,000	Refund of subscriptions	45,000
		Sports prizes	25,000
		Transport	248,000
		Investments	1,500,000
	_____	Balance carried forward	<u>405,000</u>
	4,561,000		4,561,000

Balances as at	31 March 2000	31 March 2001
Furniture and fittings (net)	240,000	-
Equipment (net)	690,000	-
Investment at cost	3,500,000	-
Subscriptions in arrears	300,000	375,000
Salaries accrued	68,000	72,000
Stock of beverages	162,000	184,000
Subscriptions in advance	85,000	-

Additional information:

1. Subscriptions in arrears are written-off after twelve months.
2. Depreciation is provided for on reducing balance method at 10% and 20% per annum on furniture and fittings and equipment respectively.

3. Investments, which had cost Sh. 500,000, were sold on 30 March 2001 for Sh. 625,000. No entries have been made in the books in this respect.

Required:

- (a) Income and expenditure account for the year ended 31 March 2001. (8 marks)
(b) Balance sheet as at 31 March 2001. (6 marks)

(Total: 20 marks)

Solution:

Mamba Sports Club			
Statement of Affairs			
Assets		Sh	Sh
Furniture and fittings			240,000
Equipment			690,000
Receipts and payments			288,000
Investment at cost			3,500,000
Subscriptions in arrears			300,000
Stock of beverages			<u>162,000</u>
			5,180,000
Liabilities			
Subscriptions accrued	85,000		
Accrued salaries	<u>68,000</u>		<u>(153,000)</u>
			<u>5,027,000</u>

Mamba Sports Club
Trading Account for the year ended 31.3.2001

	Sh	Sh
Sales		657,000
<u>Less cost of sales</u>		
Opening stock	162,000	
Purchases	<u>497,000</u>	
	659,000	
Less closing stock	<u>(184,000)</u>	<u>(475,000)</u>
Profit to income and expenditure		182,000

Subscriptions

2001		2001	
	Sh		£
Balance b/d	300,000	Balance b/f	85,000
Receipts and payments	45,000	Receipt and payment	2,493,000
Income & expenditure	2,465,000	Income & expenditure	51,000
Balance c/f	<u>194,000</u>	Balance c/f	<u>375,000</u>
	<u>3,004,000</u>		<u>3,004,000</u>

Mamba Sports Club
Income and Expenditure Account for the year ended 31 March 2001

	Sh
Incomes	
Profit from trading account	182,000
Subscriptions	2,465,000
Dinner dance	723,000
Investment income	400,000
Profit on sale of investments	<u>125,000</u>
	3,895,000

Example 6.9 (Exam Type) DECEMBER 2000 QUESTION 3

The following trial balance was extracted from the books of Literary and Philosophical Society as at 30 September 2000:

	Sh	Sh
Balance at bank: current account	724,800	
Accumulated fund 1 October 1999		5,771,200
Land and buildings, at cost	3,700,000	
Debtors for subscription	62,000	
Furniture and fittings	1,874,000	
Provision for depreciation of furniture & fittings		284,000
Subscriptions		1,450,800
Lecturer's fees	920,000	
Lecturer's travel and accommodation expenses	358,000	
Donations		108,000
Camera and projector repairs	17,000	
Projectors, cameras and audio equipment	190,400	
Depreciation of equipment		54,400
Rates and water	277,000	
Lighting and heating	367,200	
Rental of rooms		495,000
Wages – Caretaker	880,000	
- Restaurant	1,600,000	
- Bar staff	800,000	
Purchase of food	1,565,800	
Stock – bar 1 October 1999	473,600	
Bar receipts		4,032,000
Bar purchases	2,842,000	
Restaurant receipts		3,642,000
Loan		1,600,000
Deposit account – bank	1,000,000	
Interest payable and receivable		36,000
Creditors for bar and food		<u>178,400</u>
	<u>17,651,800</u>	<u>17,651,800</u>

Additional information:

1. The bar stock was valued at Sh. 642,800 as at 30 September 2000.
2. It is expected that, of the debtors for subscriptions, Sh. 43,600 will not be collectable.
3. The interest account is net. The loan is at a concessional rate of 4% while 10% has been earned on the deposit account. No changes have taken place all year in the principal sums involved.
4. An invoice for Sh. 43,000 of wine had been omitted from the records at the close of the year although the wine had been included in the bar stock valuation.
5. Depreciation for the year is to be provided as follows:
 Furniture and fittings Sh. 194,000
 Projectors, cameras, etc. Sh. 19,000.

Required:

- (a) Bar and restaurant trading account for the year ended 30 September 2000 (6 marks)
- (b) An income and expenditure account for the year ended 30 September 2000 (8 marks)
- (c) A balance sheet as at 30 September 2000 (6 marks)

(Total: 20 marks)

Solution:**Literary and Philosophical Society****Bar and Restaurant Trading Account for the year ended 30 September 2000**

	Sh	Sh
Sales		7,674,000
Less cost of sales		
Opening stock	473,600	
Add purchases	<u>4,450,800</u>	
	4,924,400	
Less closing stock		
Profit to the income and expenditure	<u>(642,800)</u>	<u>(4,281,600)</u>
		<u>3,392,400</u>

Literary and Philosophical Society**Income and Expenditure Account for the year ended 30 September 2000**

	Sh	Sh
Income		
Profit on trading account		992,400
Interest on bank deposit account		100,000
Subscriptions		1,450,000
Donations		108,000
Rental of rooms		<u>495,000</u>
		3,146,200
Expenditure		
Lecturer's fees	920,000	
Depreciation on furniture and fitting	194,000	
Equipment	19,000	
Lecturer's travel and accommodation exp.	358,000	
Camera repairs	17,000	
Rates and water	277,000	
Lighting and heating	867,200	
Caretakers wages	880,000	
Interest on loan	64,000	
Provision for subscription	<u>43,600</u>	<u>(3,139,800)</u>
Surplus		<u>6,400</u>

Literary and Philosophical Society
Balance Sheet as at 30 September 2000

	Sh	Sh	Sh
Non current Assets			
Land and buildings	3,700,000	-	3,700,000
Fixtures and fittings	1,874,000	(478,000)	1,396,000
Equipment	<u>190,400</u>	<u>(73,400)</u>	<u>117,000</u>
	<u>5,764,400</u>	<u>551,400</u>	5,213,000
Current assets			
Stock		642,800	
Debtors of subscription		18,400	
Balance at bank – deposit a/c		1,000,000	
- Current a/c		<u>724,800</u>	
		2,386,000	
Current liabilities			
Creditors		<u>(221,400)</u>	<u>2,164,600</u>
			<u>7,377,600</u>
Accumulated fund b/f			5,771,200
Add surplus			<u>6,400</u>
			5,777,600
Non current liabilities			
4% loan			<u>1,600,000</u>
			<u>7,377,600</u>

REVIEW QUESTION

You have agreed to take over the role of bookkeeper for the AB Sports and Social Club.

The summarized balance sheet on 31.12.94 as prepared by the previous bookkeeper contained the following items. All figures are in £s.

Assets

Heating oil for clubhouse		1,000
Bar and café stocks		7,000
New sports ware, for sale, at cost		3,000
Used sports ware, for hire, at valuation		750
Equipment for grounds person – cost	5,000	
- depreciation	3,500	1,500
Subscriptions due		200
Bank – current account		1,000
- deposit account		10,000

Claims

Accumulated fund		23,150
Creditors – bar and café stocks		1,000
- Sports ware		300

The bank account summary for the year to 31.12.95 contained the following items:

Receipts:

Subscriptions	11,000
Bankings – bar and sale	20,000
Sale of sports ware	5,000
Hire of sports ware	3,000
Interest on deposit account	800

Payments

Rent and repairs of clubhouse	6,000
Heating oil	4,000
Sports ware	4,500
Grounds person	10,000
Bar and café purchases	9,000
Transfer to deposit account	6,000

You discover that the subscriptions due figure as at 31.12.94 was arrived at as follows:

Subscriptions unpaid for 1993	10
Subscriptions unpaid for 1994	230
Subscriptions paid for 1995	40

Corresponding figures at 31.12.95 are:

Subscriptions unpaid for 1993	10
Subscriptions unpaid for 1994	20
Subscriptions unpaid for 1995	90
Subscriptions paid for 1996	200

Subscriptions due for more than 12 months should be written off with effect from 1.1.95

Asset balances at 31.12.95 include:

Heating oil for club house	700
Bar and café stocks	5,000
New sports ware, for sale, at cost	4,000
Used sports ware, for hire, at valuation	1,000

Closing creditors at 31.12.95 are:

For bar and café stocks	800
For sports ware	450
For heating oil for clubhouse	200

$\frac{2}{3}$ rds of the sportswear purchases made in 1995 had been added to stock of new sportswear in the figures given in the list of assets above, and $\frac{1}{3}$ had been added directly to the stock of used sportswear for hire.

Half of the resulting 'new sportswear for sale at cost' at 31.12.95, to transfer these older items into the stock of used sportswear, at a valuation of 25% of their original cost.

No cash balances are held at 31.12.95. The equipment for the grounds person is to be depreciated at 10% per annum, on cost.

Required:

Prepare income and expenditure account and balance sheet for the AB Sports club for 1995, in a form suitable for circulation to members. The information given should be as complete and informative as possible within the limits of the information given to you. All workings must be submitted.

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EMERGING TRENDS AND ISSUES IN FINANCIAL ACCOUNTING

Specific Objectives.

By the end of the topic, the trainee should be able to:-

- a) **Identify the effects of emerging issues in financial accounting**
- b) **Discuss challenges posed by emerging issues and trends in financial accounting**

c) Discuss ways of coping with emerging trends and issues in financial accounting

(a) Use of Ratios

There are 3 important ratios to be looked at:

- 1) Gross profit margin
- 2) Mark up
- 3) Stock turnover

If a firm has a uniform Gross Profit for all the items sold then any information available on sales or purchases can be used to derive the total Gross Profit for the period and in case there is sufficient information on expenses, then the Net Profit can also be derived.

The above ratios are computed as follows:

$$1) \text{ Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales (selling price)}} \times 100$$

E.g. If the selling price of a unit is £100 and Gross Profit made per unit is £25, the Gross Profit Margin will be:

$$\begin{aligned} &= \frac{25}{100} \times 100 \\ &= 25\% \end{aligned}$$

Challenges

Commitment Accounting

This accounting system recognises transactions when the organisation is committed to them. This means that the transaction is not recognised neither when cash is not paid or received, nor when an invoice is received or issued but at an earlier stage when orders are issued or received. Under this system, the organisation is recognising the issue of an order as a commitment to incur expenditure and accounts continuously record commitments. The main purpose of commitment accounting is the budgetary control rather than financial reporting.

Fund Accounting

This system refers to the method of accounting which reports in terms of funds rather than in terms of organisations. This indicates the extent to which different funds are utilized and the form and extent to which individual fund accounts are consolidated in the final accounts. For example, if ten funds are used but they are all consolidated into one operating statement and one balance sheet, then the results might be the same as accounts for a business.

A Member of Parliament

The interest of a Member of Parliament will be on fiscal compliance. This refers to the extent to which the organisation has complied with conditions laid down in the authority to spend.

A Tax Payer

The main interest of a taxpayer will be to evaluate the management and performance. This refers to the need to know whether the money was spent wisely. In other words, this refers to the measurement of efficiency of the Government as regards the expenditure incurred and resultant increase in level of output.