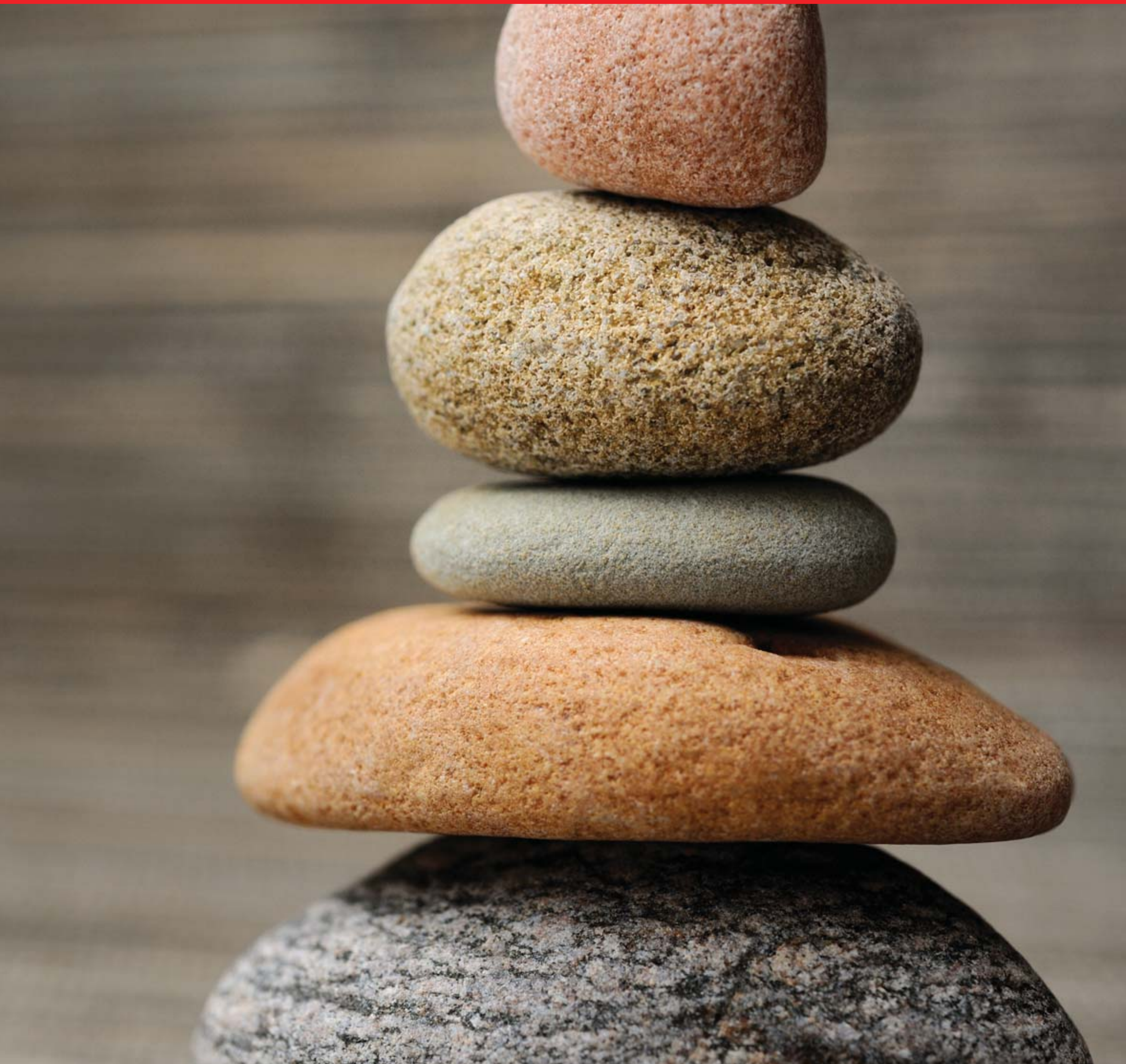
BUSINESS ACCOUNTING (FA4)

CERTIFICATE IN FINANCIAL ACCOUNTING



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IN MALAWI

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PREFACE

INTRODUCTION

The Institute noted a number of difficulties faced by students when preparing for the Institute's examinations. One of the difficulties has been the unavailability of study manuals specifically written for the Institute's examinations. In the past students have relied on text books which were not tailor-made for the Institute's examinations and the Malawian environment.

AIM OF THE MANUALS

The manual has been developed in order to provide resources that will help the Institute's students attain the needed skills. It is therefore recommended that each student should have their own copy.

HOW TO USE THE MANUAL

Students are being advised to read chapter by chapter since subsequent work often builds on topics covered earlier.

Students should also attempt questions at the end of the chapter to test their understanding. The manual will also be supported with a number of resources which students should keep checking on the ICAM website.

TABLE OF CONTENTS

FA4: BUSINESS ACCOUNTING

AIMS OF THE COURSE

i. To develop the student's understanding of the accounting process and the practical uses of accounting.

ii. To develop the student's awareness of the role of computers in accounting.

iii. To enable the student prepare final accounts up to statement of financial position.

iv. To introduce the student to principles of costing.

LEARNING OBJECTIVES

By the end of the course the student should be able to:-

i. Identify the principles on which accounting is based.

ii. Identify, collect, record and summarize accounting information for various forms of businesses.

iii. Recognize and make periodic adjustments to accounting records.

iv. Identify, classify, and allocate various business costs.

FORMAT AND STANDARD OF THE EXAMINATION PAPER

The paper will consist of two sections; section A and section B. **Section A** will be compulsory with one question. The question will be on **preparation of final accounts for various forms of businesses with some adjustments**. This section will carry 40 marks. **Section B** will have **4 questions**, each carrying 20 marks. Candidates will be required to answer **any three** questions from section B.

SPECIFICATION GRID

Syllabus Area	Weighting
Accounting information, principles and concepts.	35
Maintaining, adjustment of financial records.	30
Preparing financial statements.	25
Cost accounting	10

Total	100

Learning Outcomes

In the assessment, candidates may be required to:-

1.1 Accounting and the accounting process

1. Define accounting and its purpose
2. Describe the main financial statements namely:
   i) Statement of profit or loss
   ii) Statement of financial position

1.2 Financial Accounting vs. Management Accounting

1. Describe financial and management accounting
2. Understand the relationship between financial and management accounting
3. Compare and contrast financial and management accounting

1.3 Qualitative characteristics of accounting information

1. Identify the attributes of accounting information to include, but not limited to:
   i) Relevance
   ii) Timeliness
   iii) Accuracy
   iv) Completeness
   v) Reliability
   vi) Targeted audience
   vii) Comparability
   viii) Understandability

1.4 Accounting principles and concepts

1. Understand the role of the accounting regulatory system, including the roles of the IFRS Foundation, the International Accounting Standards Board, and other international bodies
2. Understand the role of International Financial Reporting Standards
3. Distinguish accounting principles from accounting concepts

4 Learn the important underlying accounting concepts, such as:
   i) Historical cost
   ii) Money measurement
   iii) Business entity
   iv) Dual aspect
   v) Time interval
5 Identify the fundamental accounting concepts that include:
   i) Going concern
   ii) Consistency
   iii) Prudence
   iv) Accruals
   v) Separate Determination
   vi) Substance over form
   vii) Materiality

1.5 Users of accounting information and their needs

1 Identify the main users of accounting information and their needs to include:
   i) Management
   ii) Shareholders(current and potential)
   iii) Employees
   iv) Trade Union groups
   v) Banks and lenders
   vi) Tax collectors and government agencies
   vii) Business contact groups
   viii) The general public
   ix) Suppliers

1.6 The role of computers in accounting

1 Describe the accounting documents and management reports produced by computerised accounting systems, and understand the link between the accounting system and other systems in the business
2 Compare and contrast manual and computerised accounting systems
3 Consider the risks to data security, data protection procedures, and the storage of data under computerised accounting systems

1.7 Regulation of accounting in Malawi

1 Understand the evolution of the legal and regulatory environment affecting accounting in Malawi

2 Understand the current regulatory environment of accounting in Malawi, including the main agencies and instruments such as:

i) The Malawi Stock Exchange
ii) The Institute of Chartered Accountants of Malawi
iii) The Malawi Accountants Board
iv) The Companies and Taxation Acts

2.1 Elements of accounting information

In the assessment, candidates may be required to:-

1 Identify the elements of accounting information that include:
   i) Assets, including both current and non current
   ii) Liabilities, including both current and non current
   iii) Owners equity
   iv) Revenue and expenses
2 Learn the distinction between capital and revenue expenditure, including the implication of wrong accounting treatment of expenditure on the financial statements
3 Understand the accounting treatment of capital receipts, joint expenditure, and loan interest

2.2 Types of business transactions

1 Understand a range of business transactions including
   i) Sales
   ii) Purchases
   iii) Receipts
   iv) Payments
   v) Petty cash
   vi) Payroll
2 Understand the implications of cash and credit transactions, including where applicable, the effect of cash and trade discounts

2.2 Source documents

1 Outline the purpose and content of a range of business documents to include but not limited to

   i) Invoice

   ii) Credit note

   iii) Remittance advice
   iv) Statement of account
2 Prepare a petty cash voucher

3 Prepare the financial documents to be sent to credit customers
4 Prepare remittance advice to accompany payment to suppliers

2.3 Books of original entry

1 Identify the types of books of original entry and outline the purpose and content of each book of original entry including its format
2 Outline how the books of original entry integrate with the double entry book-keeping system

3.1 Recording day books

In the assessment, candidates may be required to:-

1 Record sales and purchase transactions taking into account discounts, VAT, and the impact on the value added tax account where applicable, as follows:

   i) Enter supplier invoices and credit notes in the appropriate day books

   ii) Record sales and purchase returns in the appropriate day books

   iii) Prepare the financial documents to be sent to credit customers

   iv) Understand the purpose of an aged receivable analysis

   v) Produce statements to be sent to credit customers

   vi) Explain the need to deal with discrepancies in customer and supplier records quickly and professionally

   vii) Understand how data entry in day books differs when computerised systems are in use

2 Record transactions in the cashbook including any value added tax and discounts effects where applicable, paying particular attention to:

   i) Totaling, balancing, and cross casting the cashbook columns

   ii) Identifying and dealing with discrepancies

3 Enter and analyse petty cash transactions in the petty cashbook including any value added tax effects where applicable, paying attention to:
   i) Balancing off the petty cashbook using imprest and non imprest systems
   ii) Reconciling the petty cashbook with cash in hand
   iii) Preparing and accounting for petty cash reimbursement

4 Prepare and enter the journal entries to process payroll transactions including:

i) Calculation of wages for employees paid by the hour, paid by output, and salaried employees
ii) Accounting for payroll costs and deductions
iii) The employer's responsibilities for taxes, pension contributions, and other deductions
iv) Identity of the different payment methods in a payroll system, e.g. cash, cheques, and automated bank transfers
v) Why authorisation of payroll transactions and security of payroll information is important in an organization

3.2 The concept of double entry

1 Define the accounting equation

2 Understand by applying the accounting equation in situations such as:

i) Introduction of capital

ii) Purchase of an asset by cheque

iv) Purchase or sale of an asset on credit
v) Payment of a liability
vi) Effect of profit and loss on capital
vii) Treatment of drawings

3 Understand how the accounting equation relates to the double entry book keeping system

4 Process financial transactions from the books of original entry into the double entry book keeping system

3.3 Charts and coding of accounts

1 Importance of charting and coding of accounts in processing of financial transactions

2 Define an accounting code and identify different types of codes including:

i) Sequence

ii) Block

iii) Significant digit

iv) Hierachial

vi) Faceted

3 Code supplier and customer accounts

4 Coding general ledger accounts consistent with a predetermined chart of accounts

4.1 Balancing ledger accounts

In the assessment, candidates may be required to:-

1 Understand the five steps towards the balancing of ledger accounts

2 Justify the frequency of balancing of ledger accounts

2 Understand the meaning of such terms as: c/d, b/d and closed off

3 Explain the importance of balancing of receivables and payables ledger accounts

4.2 The trial balance

1 Prepare ledger balances, clearly showing the balances carried down and brought down as appropriate

2 Define and understand the nature of a trial balance

3 Understand the nature and impact of errors and closing inventory on the trial balance, and how these are dealt with.

4.3 Periodic adjustments

1 Understand how the matching concept applies to accruals and prepayments

2 The nature and purpose of accruals

3 The accounting treatment of prepayments, with and without an opening balance

4 The accounting treatment of expenses with prepaid and accrued elements

5 Prepayments and accruals in the financial statements

6 The nature of bad debts and ways in which they may arise

7 Understand the nature and purpose of the allowance for doubtful debts including:

i) How the allowance may be estimated

ii) The accounting entries necessary to recognize the allowance

iii) How the allowance may be increased or decreased

iv) The impact of cash discounts on accounts receivable

8 Understand the nature of non-current assets and purpose of depreciation, including terms such as:

i) Depreciable amount

ii) Useful life

iii) Residual value

9 Explain the purpose and function of an asset register

10 Understand the four most common causes of depreciation

11 Identify and calculate depreciation using the commonly used methods that include:

i) Straight line method

ii) Reducing balance method

12 Understand the case for using other depreciation methods that include:

i) Revaluation method

ii) Depletion unit method

iii) Machine hour method

iv) Sum of the year's digit method

v) Units of output method

13 Understand how the appreciation in the value of non current assets is treated

4.4 Statement of profit or loss

1 Identify the information from the trial balance needed for the preparation of the statement of profit or loss

2 Understand the nature and purpose of the statement of profit or loss and how the following are arrived:

i) Gross profit

ii) Cost of goods sold

iii) Net profit or loss

3 Understand the accounting treatment of returns, carriage, and the adjustment for inventory when preparing the statement of profit or loss

4.5 Statement of financial position

1 Identify the information from the trial balance needed for the preparation of the statement of financial position

2 Understand the purpose and nature of the statement of financial position, and identify the items and layout of:

i) Non current and current assets

ii) Non current and current liabilities

iii) Capital

3 Recognise how the accounting equation underlines the statement of financial position

5.1 Errors and correction of errors

In the assessment, candidates may be required to:-

1 Identify types of errors in a book keeping system that are disclosed by extracting a trial balance

2 Identify types of errors in a book keeping system that are not disclosed by extracting a trial balance

3 Use the journal to correct identified errors

4 Redraft a trial balance following the correction of errors

5 Identify when a suspense account is required and show how to clear the suspense account using the journal

6 Understand situations when errors may or may not affect the statement of profit or loss

5.2 Bank reconciliation statement

1 Explain the purpose of reconciliation between the bank ledger and the corresponding bank statement

2 Identify errors and omissions in the bank ledger account and in the bank statement

3 Identify timing differences

4 Make the correcting entries in the bank ledger account

5 Prepare the reconciliation between the bank statement balance and the corrected bank ledger account

6 Identify the bank balance to be reported in the financial statements

7 Understand the arguments for the timing and frequency of the bank reconciliation statements

8 Understand the process of conducting bank reconciliation under a computerized environment

5.3 Disposal of non current assets

1 Identify the ledger accounts needed for recording the disposal of a non current asset

2 Prepare journal and ledger entries to record the acquisition and disposal of a non current asset

3 Calculate and record profits or losses on disposal of a non current asset for reporting in the statement of profit or loss

4 Calculate the profit or loss of a revalued non current asset

5.4 Receivables and payables control accounts

1 Describe the purpose of control accounts as a checking devise to aid management and help identify book keeping errors

2 Explain why it is important to reconcile control accounts regularly and to deal with discrepancies quickly and professionally

3 Prepare the receivable control account or receivable ledgers by accounting for:

i) Sales

ii) Sales returns

iii) Payments from customers including checking the accuracy and validity of receipts against relevant supporting information

iv) Settlement discounts

v) Irrecoverable debt and allowance for irrecoverable debts including any effect of value added tax where applicable

4 Prepare the payables control account or payables ledgers by accounting for:

i) Purchases

ii) Purchase returns

iii) Payments to suppliers including checking the accuracy and validity of the payments against relevant supporting information

iv) Settlement discounts

5.5 Accounting for inventory

1 Recognise the need for adjustments for inventory in preparing financial statements

2 Record opening and closing inventory

3 Identify the various methods for valuing inventory and calculate the value of closing inventory using the following methods:

i) First in, first out (FIFO)

ii) Last in, first out (LIFO)

iii) Average cost

iv) Periodic weighted average cost

4 Recognise which cost should be included in valuing inventory

5 Understand the impact of accounting concepts on the valuation of inventory

6 Identify the impact of inventory valuation methods on profit and on assets

6.1 The role of costing in business

In the assessment, candidates may be required to:-

1 Understand the linkage between and importance of costs, pricing, and profitability in different types of businesses and organizations

6.2 Cost elements

1 Identify the different elements of cost and concepts on costs as defined by the Chartered Institute of Management Accountants to include, but not limited to the following:

i) Direct materials

ii) Direct labour

iii) Direct other expenses

iv) Indirect materials

v) Indirect labour

vi) Indirect expenses

vii) Prime cost
viii) Conversion cost
ix) Value added
x) Overhead cost

2 Identify cost units appropriate to different manufacturing situations

6.3 The nature and behavior of costs

1 Understand the nature and behavior of the following costs under various process and time conditions:

i) Fixed costs

ii) Variable costs

iii) Semi-variable costs

iv) Stepped-fixed costs

2 Identify and use different methods for estimating costs

6.4 Cost allocation and cost centres

1 Understand that the nature of internal reporting systems and how they will influence the way in which costs are reported in an organization

2 Identify and explain the rationale for reporting costs on the following basis:

i) Cost centre
ii) Revenue centre
iii) Profit centre
iv) Investment centre

6.5 Product costing and pricing

1 Describe the job costing and batch costing methods and why they are associated with absorption costing methodologies

2 Understand the methodology for building up to the product price, including overhead and margin considerations, under the job costing and batch costing methods

3 Understand the impact of costing on profit and assets as reported in the financial statements

<u>REFERENCES</u>

ICAM Manual *Business Accounting*

Frank wood *Business Accounting*

Glautier & Underdown *Accounting Theory & Practice*

CHAPTER 1 INTRODUCTION TO ACCOUNTING

1.0 Learning objectives

The objective of this chapter is to impart on to the students the definition of Accounting, with an emphasis on the differences between two main branches of accounting. It also highlights the common users of accounting information and their information needs as well as qualities of good accounting information.

1.1 Accounting and the accounting process

Accounting is the process of identifying, classifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.

The managers of businesses want to know whether they are making profits or not, how much they owe to different stakeholders and how much the business is owed.
The purpose of accounting is, therefore, to provide the information required by presenting it in standard and logical form.

Accounting can be divided into 'financial accounting' and 'management accounting'.

1.2 Financial accounting

Financial accounting consists of two elements:

- Bookkeeping, is that part of accounting concerned with the recording of business transactions on a day-to-day basis,
- Preparation of financial statements from the book-keeping records. These financial statements summarize the business transactions for a period, normally one year.

1.3 Management accounting

The Charted Institute of Management Accountants defines management accounting as 'the application of professional knowledge and skill in the preparation and presentation of accounting information in such a way as to assist management in the formulation of policies and in the planning and control of the operations of the undertaking'.

1.4 The main differences between Financial Accounting and Management Accounting

The main differences are now summarized through a comparison chart below:

Comparison chart

Attribute	Financial Accounting	Management Accounting
Format:	Financial accounts are supposed to be in accordance with a specific format by IAS so that financial accounts of different organizations can be easily compared.	No specific format is designed for management accounting systems.
Planning and control:	Financial accounting helps in making investment decisions and in credit rating.	Management Accounting helps management to record, plan and control activities to aid decision-making process.
External Vs. Internal:	A financial accounting system produces information that is used by parties external to the organization, such as shareholders, banks and creditors.	A management accounting system produces information that is used within an organization, by managers and employees.
Focus:	Financial accounting focuses on history.	Management accounting focuses on future & present.
Users:	Financial accounting reports are primarily used by external users, such as shareholders, banks and creditors.	Management accounting reports are exclusively used by internal users viz. managers and employees.
Reporting frequency and duration:	Well-defined - annually, semi-annually, quarterly	As needed - daily, weekly, monthly.
Optional:	Preparing financial accounting reports are mandatory especially for limited companies.	There are no legal requirements to prepare reports on management accounting.
Objectives:	The main objectives of financial accounting are :i) to disclose the end results of the business, and ii) to depict the financial condition of the business on a particular date.	The main objectives of Management Accounting are to help management by providing information that is used by management to plan, evaluate, and control.
Legal/rules:	Drafted according to GAAP - General Accepted Accounting Procedures.	Drafted according to management suitability.
Accounting process:	Follows a full process of recording, classifying, and summarising for the purpose of analysis and interpretation of the financial information.	Cost accounts are not preserved under Management Accounting. The necessary data from financial statements and cost ledgers are analyzed.
Segment reporting:	Pertains to the entire organization or materially significant business units.	May pertain to smaller business units or individual departments, in addition to the entire organization.

Attribute	Financial Accounting	Management Accounting
Nature of information:	Focus on quantitative information	Focus on both qualitative and quantitative information

1.5 The main financial statements and the needs of their users

There are two main financial statements that are normally prepared by various organizations. These are:

(a) The Statement of Profit and Loss and Comprehensive Income (Trading profit and loss account)
This is basically used to show the financial performance of the business by stating whether the business has made a profit or a loss. It is normally divided into two parts with one part reporting the amount of **Gross profit** that the business has made and the other part reporting the amount of **Net profit** made by the business.

(b) The Statement of Financial Position (Balance sheet)
This is used to show the financial position of the business as at a particular date in terms of assets, liabilities and capital that the business has at that particular point in time.

Other financial statements that business organizations prepare include:

(a) the cash flow statement,
(b) the statement of changes in equity and
(c) group accounts

For this syllabus we will only look at the income statement and the statement of financial position.

1.6 Users of accounting information and their needs

There are many stakeholders interested in the financial information of businesses with diverse needs.

- **Management**

Management will be interested in the analysis of revenues and expenses so as to obtain information that is useful when formulating plans and making decisions. When the budget for the business has been prepared, the accounting function can produce figures for what actually happens as the period progresses and compare it with the budgets. Deviations from plans can then be investigated and appropriate action taken.

- **Shareholders/ (owners) and potential shareholders**

Shareholders need to be informed about the way in which management has used the funds which the shareholders or owners have invested in the business. This involves reporting on past events, however, shareholders and potential shareholders will additionally be interested in the future performance and the historical information will act as a guide to the future if they have to decide whether to sell their shares or vote on proposals.

- **Financial analysts/ advisors**

Financial analysts who advise investors such as insurance companies, pension funds, unit trusts and investment trusts are some of the most sophisticated users of accounting information.

- **Employees and their trade union representatives**

These need financial information in order to be able to assess the performance of the business. Employees are mainly interested in the security of their jobs and promotion through growth as the years go by. The trade unions use the financial **information** to substantiate claims for higher wages for their members and better conditions of service. Hence, the success of different divisions is of much interest to these stakeholders.

- **Banks/lenders**

These includes some lenders who have financed the business over long periods of time by lending money which will be repaid after so many years, and short-term lenders such as banks that permit a business to overdraw its accounts over a number of weeks or months, and suppliers of raw materials, which permit them to buy goods from them and pay later.

Lenders will be interested in the security of their loans, and will examine the financial statements to make sure that the company will repay the capital on due dates and meet the interest requirements as they fall due. Hence the availability of cash and value of assets making up the security will be important to them.

- **Tax collectors and Government agencies**

The tax authorities will be interested in the assessment of the profits on which to charge the tax for period, whereas other agencies will wish to collect information that would show trends in the economy.

- **The business contact group**

Customers will be interested to assess the company's ability to satisfy long term contracts when an order is about to be placed, and competitors will use the information for comparison purposes.

- **The public**

Environmental pressure groups, members of the community in which the business operates may be interested in the affairs of the business.

- **Conclusion**

It can be noted that financial statements serve a variety of user groups that have different interests and different levels of complexity.

1.7 Qualitative characteristics of accounting information

These are the attributes that make the information provided in the financial statements to be more meaningful to the users. These include:

(a) Relevance and purpose

Good quality information should have a purpose and be relevant for that purpose. If information does not have a purpose then it is useless and might as well not be produced. Information is relevant if it has the ability to influence the economic decisions of users

Information provided by the financial statements must be relevant. In cases where the users have to make a choice between alternative options, the option selected should be the one that would be of most use in taking economic decisions, that is, it should provide maximum information that is relevant.

Relevant information has predictive value or confirmatory value. Where the information enables the users to evaluate or assess past, present and future events, it is predictive. Information is confirmatory if it helps users to confirm or to correct their past evaluations and assessments. It is possible for information to have both predictive and confirmatory value.

For information to have predictive value, it does not have to be presented in an explicit forecast form, but the ability to make predictions will be helped by the manner in which information relating to past transactions and events is displayed.

(b) Timeliness

Information should be communicated to a manager in time for him to do something about it. For example a monthly report detailing a problem should be produced quickly enough to enable the manager to take corrective action

(c) Accuracy

The report should be as accurate as possible, it should not contain material errors.

(d) Complete

Information should be as complete as it needs to be, but it should not be excessive. A report that draws attention to significant items will be useful. Sometimes management only want to be informed when something out-of- the-ordinary has happened. (Reporting by exception.)

(e) Communicated to the right person

Within a business, management information should be directed to the managers who will use it or do something about it

(f) Reliability

Information provided by the financial statements must be reliable.
Information is reliable when:

(i) the users can depend on it as faithfully representing what it purports to represent or what could be reasonably expected to represent;

(ii) it is free from deliberate or systematic bias (neutrality);

(iii) it is free from material error;

(iv) it is complete within the context of materiality; and

(v) in conditions of uncertainty, a certain level of caution has been applied in exercising judgment and making the necessary estimates (prudence).

- **Faithful representation**

For the information to represent faithfully the transactions and events it purports to represent, it is important that they are accounted for and presented in accordance with their substance and economic reality rather than their legal form

- **Neutrality**

Information must be free from bias **(neutrality)**. Financial statements will not be deemed neutral if the selection and presentation of information is such that it influences the making of a decision or judgment in order to achieve a predetermined result

- **Completeness**

Information must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading hence unreliable or insufficient in relation to its relevance

- **Prudence**

Prudence is the inclusion of a certain level of caution in exercising judgments required in making the estimates under conditions of uncertainty, in such a way that assets and/or income should not be overstated or liabilities and/or expenses should not be understated. In exercising prudence, it is not permissible to create hidden reserves or make excessive provisions, deliberate understatement of assets or income, or deliberate overstatement of liabilities or expenses.

(g) Comparability

The financial statements should enable users to make comparison of an entity over time to identify trends in its performance and financial position. They should also enable the users to compare and evaluate the relative performance and financial position of different entities. Therefore, consistency is required.

It is important that users should be able to identify differences between accounting policies adopted from period to period, accounting policies adopted in accounting for like transactions and other similar events, and accounting policies adopted by different organizations.

(h) Understandability

Users need to be able to understand the information provided to them. If he does not understand it, or misunderstands it, he is unlikely to use it or will take a bad decision.

Understandability depends on two factors:

(a) The way in which the information is presented; and

(b) The capabilities of the users

Users are assumed to have reasonable knowledge of business and economic activities and are willing to study the information provided to them reasonably well

(i) Materiality

Information is **material** to the financial statements if its misstatement or omission may reasonably be expected to influence the economic decisions of users.

Financial statements need to include all material information and immaterial information need not be shown in the financial statements

As to whether information is material will depend on the size and nature of the item being judged in the particular circumstances.

(j) Appropriate channel of communication

This refers to the method by which the information is given, for example; verbal, formal, informal, e-mail and so on.

1.8 Limitations on the qualitative characteristics

In certain circumstances there is need to strike a balance to enable the objectives of the financial statements to be met when a conflict arises between characteristics.

(a) Relevance and reliability

When there is a conflict, it is normally appropriate to use the information that is the most relevant of whichever information is available. For example, there may be a conflict over timeliness. Delays in providing information will make it out of date and, therefore, less relevant, but there is need to clear all uncertainties to make the information reliable which would result in delays. Financial statements should only be provided when they are sufficiently reliable.

(b) Neutrality and prudence

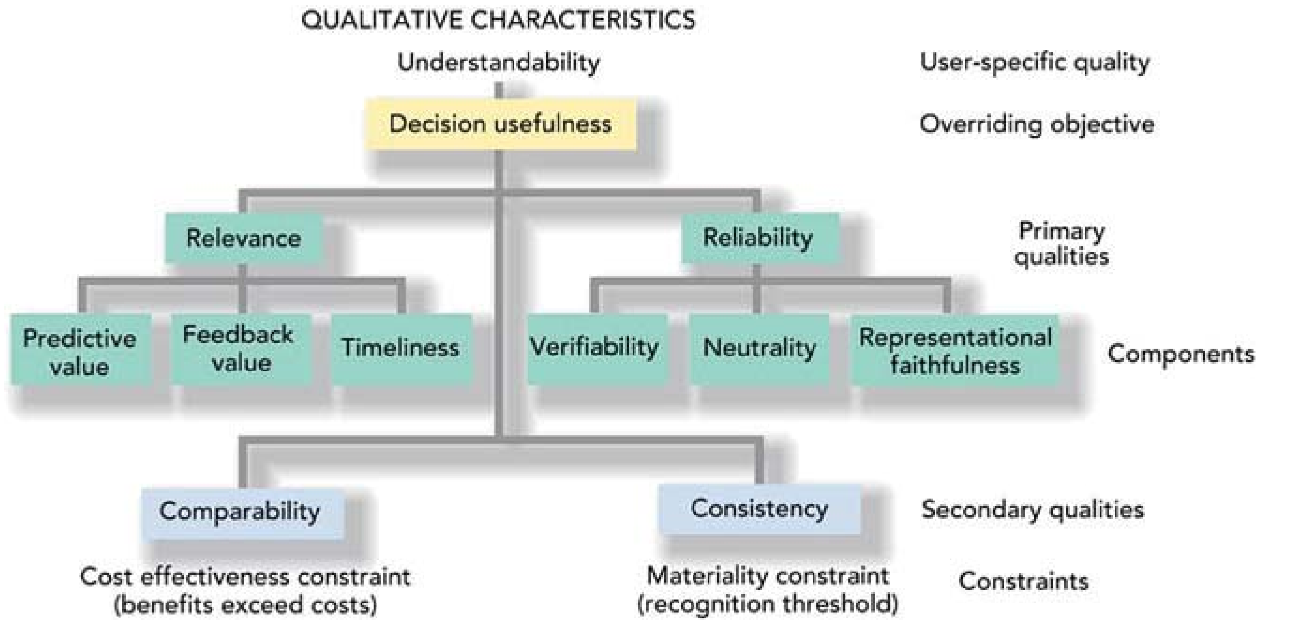
Neutrality means freedom from bias, whereas prudence might involve bias because it seeks to ensure that assets and gains are not overstated and liabilities and losses are not understated in situation of uncertainty. It is, therefore, important to ensure that deliberate understatements of assets and gains or overstatement of liabilities and expenses is avoided.

(c) Understandability

Information that is relevant and reliable should be included even if other users may not understand it.

Alternatively, the qualities can be presented in a tabular form as follows:

GRAPHIC
Hierarchy of Desirable Characteristics of Accounting Information



1.9 Accounting concepts

(a) Introduction

Financial statements are prepared for different stakeholders to use irrespective of their varying needs. It is therefore necessary that all the various stakeholders should believe that the assumptions upon which the financial statements are based are valid and appropriate. If they don't they will not trust the financial statements.

Basic accounting concepts are the broad assumptions which underlie the periodic financial statements of business entities.

(b) Underlying accounting concepts

These are accounting concepts which have been applied ever since financial statements were first produced for external reporting purposes and they have now become second nature to accountants and are not generally reinforced, other than through custom and practice

These basic underlying concepts include:

(i) The historic cost concept
This concept determines the basis for valuation of assets. It states that assets should be valued at cost. Thus the value of an asset in the statement of financial position should be based on the price that was paid for it..

(ii) The money measurement concept
This states that accounting information is only concerned with facts that can be measured in monetary units and those facts which most people will agree as to the monetary value of the transaction.

This means that accounting can never tell you every thing a bout a business. For instance accounting does not show the following:

- whether the business has good or bad managers
- whether there are serious problems with the workforce
- whether a rival product is about to take away the business's customers
- whether the government is about to pass a law which will cost the business a lot of extra expenses in future

(iii) The business entity concept

This concept implies that the affairs of a business entity are to be treated as being separate from the non – business activities of its owners. Thus income and expenditure, assets and liabilities of the business should not be combined with those of the owner when preparing the financial statements of the business.

The only time when the personal resources of the proprietor affects the accounting records of a business is when they introduce new capital into the business or take drawings out of the business.

(iv) The dual aspect concept

This states that there are two aspects of accounting, one represented by the assets of the business and the other by the claims against those assets (i.e. liabilities). The concept states that these two aspects must always be equal to each other. This is shown by the accounting equation which states that **Assets = Capital + Liabilities.**

Double entry is the name given to the method of recording transactions under the dual aspect concept where every transaction leads to two accounting entries, in one account a credit entry is made and in another account a debit entry is made. The total of the debit entries and credit entries made from all business transactions should always be equal.

(v) The time interval concept

This states that financial statements are prepared at regular intervals of one year. On the other hand, management accounts which are for internal use may be prepared more frequently for instance on monthly basis.

(c) Fundamental accounting concepts

These comprise of a set of concepts considered so important that they have been enforced through accounting standards and / or through the companies Acts. They include the following:

(i) going concern concept

This concept implies that the business will continue to operate for the foreseeable future and that there is no intention to put the company into liquidation or to make drastic cut backs to the scale of operations.

The main significance of this 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 when the business breaks up, but rather assets should be valued at their historic cost less accumulated depreciation. (i.e. at their net book value).

(ii) consistency concept

Accounting is not an exact science. There are many areas in which judgment must be used to calculate or estimate the money values of items appearing in accounts.

Consistency requires that similar items should be accorded similar accounting treatment.

In preparing accounts, consistency should be observed in two respects.

- Similar items within a single set of accounts should be given similar accounting treatment.
- The same treatment should be applied from one accounting period to another in accounting for similar items. This allows valid comparisons to be made from one period to the next.

How ever, a business can change the method used e.g. depreciation method, but when such a change occurs and the profits calculated in that year are affected by a material amount then the effect of the change should be stated either in the fundamental statements or the reports that accompany them.

(iii) Prudence

Very often accountants have to use their judgment to decide which figure to take for an item. The prudence concept states that accountants should always exercise caution when dealing with uncertainty while at the same time ensuring that financial statements are neutral such that assets or income are not overstated and liabilities or expenses are not understated.

For instance, assume that the business is selling washing machines. Each machine costs K100, 000 to buy, but can be sold for K150, 000. Stocks of these machines should be valued at K100, 000. Valuing the machines at K150, 000 would mean that the business is anticipating making a profit before the profit is realized (i.e. obtained in a sale)

In another example, assume a business buys some goods for K1,200 but because of a sudden slump in the market it has reached to the extent that only K900 is likely to be received when the goods are sold. The prudence concept states that the stocks of these goods should be valued at K900 and K300 deducted as an expense from profit. It is not enough to wait until the goods are sold and then recognize the K300 loss, the loss should be recognized as soon as it is foreseen.

(iv) The accruals concept

The accruals concept states that net profit is the difference between revenue and the expense incurred in generating the revenues.

i.e. Revenue – Expenses = Net profit

Determining the expenses used up to obtain revenues is referred to as matching expenses against revenues. This concept implies that all income and charges relating to the period to which the financial statements relate should be taken into account without regard to the date of receipt or payment.

(v) Separate determination

In determining the aggregate amount of each asset or liability, the amount of each individual asset or liability should be determined separately from all other assets and liabilities. For instance if a business has three machines, the amount at which machinery is shown in the statement of financial position should be the sum of the values calculated individually for each of the three machines. Only when individual values have been derived should a total be calculated.

The separate determination also prohibits the netting off of potential gains. For instance if the business is being sued by a customer for K10, 000 and there is a high probability that the business will lose the case, the prudence requires the K10, 000 to be included as liability in the financial statements. However, if the same business is suing a supplier for K6,000 where it has a good probability of winning the case, the concept of separate determination does not allow the business to offset the two claims, leaving a net liability of K4,000 to appear in the financial statements, but only the probable K10, 000 expense should be recognized in the financial statements.

(vi) Substance over form

When the legal form of a transaction differs from its real substance, accountants should show the transaction in accordance with its real substance which is basically, how the transaction affects the economic situation of the business. For instance assume that a business bought a car on hire purchase

From a legal point of view, the car does not belong to the business until all the hire purchase installments have been paid, and an option has been taken up whereby the business takes over legal possession of the car.

On the other hand, from an economic point of view, the business has used the car for business purposes, just as any other car owned by the business. In this case the business will show the car bought on hire purchase in its ledger accounts and balance sheet as though it were legally owned by the business, but also showing separately the amount still owed for it. In this case, the substance of the transaction has taken precedence over the legal form of the transaction.

(vii) Materiality

Under materiality concept, only material items should appear in the financial statements. Items are material if their omission or misstatement would influence the economic decisions of users based on the financial statements.

An error which is too trivial to affect a user's understanding of the financial statements is said to be immaterial hence it may be overlooked.

1.10 The role of computers in accounting

1.10.1How computers are linked together

Computers are linked together through a network. A network is a group of two or more computer systems linked together. There are many types of computer networks, including:

- **local-area networks (LANs) :** The computers are geographically close together (that is, in the same building).
- **wide-area networks (WANs) :** The computers are farther apart and are connected by telephone lines or radio waves.

- **campus-area networks (CANs):** The computers are within a limited geographic area, such as a campus or military base.
- **metropolitan-area networks MANs):** A data network designed for a town or city.
- **home-area networks (HANs):** A network contained within a user's home that connects a person's digital devices.

Special forms of these networks emerged over the last few years as a result of the extension of the Internet. It is now becoming increasingly common for businesses to have an '**Intranet**', a network based on Internet technologies where data and information private to the business is made available to employees of the business. Some also have '**Extranets**' where data and information private to the business is made available to the specific group of outsiders, for example making a company's stock records available on-line to the major customers.

Ready made software *vs* tailor-made programmes

The software used may be developed in-house (by employees) or written under contract with an outside business or agency. Such systems are tailored to exactly what the business wants and are sometimes referred to as 'bespoke' systems.

Expensive, specially designed software (often called 'customised' software) of this type will be used, generally, only by large businesses. Many medium-sized and smaller businesses will not require such solutions, and will rely on 'off-the-shelf' software packages. Most of these are flexible enough to be adapted to meet the major needs of most businesses.

Most financial accounting and bookkeeping programs are purchased off-the-shelf and then developed in-house.

1.10.2Introduction to spread sheets and database packages

The spreadsheet is the software tool most used by accountants. Spreadsheets first appeared in 1979. The screen is divided into vertical columns and horizontal rows. Each cell is referred to by its co-ordinate, cell C12 is in column C row 12. Formulae can be entered to link cells.

Spreadsheets can be used for presenting financial plans and budgets as a table, calculating tax, investment and loans with ease, calculating statistics using built-in functions (such as averages, standard deviations, time series and regression analysis), consolidation (merging of branch or departmental accounts), creating multi-dimensional spreadsheets that enable far deeper analysis of data, facilitating currency conversion, and timetabling and roster planning of staff within organizations or departments.

On the other hand, databases are designed for more general purpose rather than for specific tasks that accountants perform. They are organized into collections of related files into which records are held. In order to create databases, computing expertise and sound knowledge of accounting system is required.

Security aspects – the importance of backing up data and using passwords
One of the most important principles in computing is the discipline of backing up data held on computer. Backing up is now performed easily by simply copying the relevant files to another computer or storage medium. This serves the purpose that, if anything ever goes wrong with the data, then the business can always revert to a back up copy of the data. Software packages routinely used by accountants, such as spreadsheets, can be programmed to automatically back up work every few minutes so that it is not all lost should the computer or program crash.

When computers are being used along with an accounting package, it is normally possible for passwords to be set up to restrict which personnel have access to certain parts of the computerized elements of the accounting system.

1.10.3 Regulations relating to the storage of personal data on computer
Most businesses that make extensive use of computers for accounts, payroll, and any other applications that involve personal details of individuals need to protect the data. The Data Protection Act 1998 must be observed when personal data is held on the computer.

SUMMARY OF THE CHAPTER

This chapter introduced students to accounting by defining two main categories of accounting. Also, there were clarifications that were made for selected fields of study that are closely linked to accounting. The main financial statements, their uses and respective needs were explained. Finally, qualitative characteristics of accounting information and key accounting concepts were described in detail.

END OF CHAPTER QUESTIONS

Q1
State the differences between financial accounting and management accounting.

Q2
Identify any ***five*** *qualitative characteristics of accounting information.*

Q3
Define reliability and its attributes.

CHAPTER 2

REGULATION OF ACCOUNTING IN MALAWI

2.0 Learning objectives
This chapter aims to introduce the regime that regulates the accounting profession in Malawi. It therefore highlights the relevant regulatory framework and the institutions that regulate/ enforce the required standards and systems within the profession.

2.1 Malawi Stock Exchange
The main provisions that regulate listed companies in Malawi are contained in three documents. These are:
MSE Listing Requirements – Section 8 sets out financial information which may be required to be included in listing particulars, pre-listing statements, circulars, interim and preliminary reports and the annual financial statements. Section 5 is also relevant as it outlines the different methods of bringing securities to listing and includes specific requirements to be followed in relation to each method.

Listing Requirements on Alternative Markets – the relevant guideline is 16.8. All the provisions of Section 5 of the MSE Listings Requirements are applicable with the exception that the period of the immediate past performance is one year instead of three years.

Members' rules - The Board shall ensure that proper books of account are kept of the financial affairs of the Exchange and that these books of account shall be kept at the principal office of the Exchange. Such books will be preserved by the Secretary for a period of seven (7) years from the date of the last entry therein and shall at all reasonable times be open for inspection by any member of the Board. Within five (3) months of the end of every financial year the Board will ensure that an annual report, audited Accounts consisting of a Balance sheet and a Revenue and Expenditure Account and any subsidiary statements and accounts as may be necessary or required by law shall be prepared and signed by the Chairman and two members of the Board.

The Secretary will lodge a signed copy of these documents together with the Annual Report of the Board with the Registrar within not more than five (5) months of the end of the financial year. Copies will also be circulated to every member of the Exchange.

2.2 The Society of Accountants in Malawi and MAB
The Society of accountants in Malawi has not been directly and exclusively charged with the regulation of the profession in Malawi. However the successor institution Institute of the

Chartered Accounts in Malawi through the Malawi Accountants Board division does the regulating.

In May 2013 the Malawi Parliament passed Public Accounts and Auditors bill into law. The effect of the enactment has been:

to repeal the Public Accountants and Auditors Act of 1982 and introduce a new legislation that will reform the regulation and control of the accountancy profession in the country

To set up a body representing accountants and auditors in the country through allowing the establishment of Malawi Accountants Board

To allow the country to have its own regulatory accountancy board which will also be administering accountancy exams thereby avoiding reliance on foreign accountancy professional bodies to administer exams, thereby easing the problems that students encounter when processing their exams

Public Accountants Examinations Council (PAEC) is thus abolished and a new body known as the Institute of Chartered Accountants in Malawi (ICAM) formed.

This restructuring has provided for a stronger Government regulation with a mechanism to oversee the activities of the profession, National qualification of accounts profession as there will be a removal of dual membership of foreign accountancy bodies and corruption fight since the profession is a strong gate keeper in the fight against corruption and money laundering.

2.3 Companies Act

Chapter 46:03 of Laws of Malawi covers Accounts and Audit in Part X. There are sections covering Keeping of Accounting Records, Annual Return, Circulation of Statement of Accounts and Reports, Group Accounts, Directors' Report, Auditors and Penalties among other contents.

2.4 International Accounting Standards

1.1 Financial Reporting Framework in Malawi

In Malawi, all the companies that have public accountability are required to apply Full IFRSs. A company has public accountability if:

- it is a listed company or is in the process of listing with the Malawi Stock Exchange or any other recognised stock exchange. The listing can either be for the company's equity or debt.
- its articles provide for unrestricted transfer of shares or it is a Public Company in terms of the Malawi Companies Act 1984
- it is permitted by its articles to offer shares to the public
- it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, an insurance entity, securities dealer/broker, pension fund or mutual fund

- it is a corporation or company that is owned by the public through the Government for example statutory corporations, also known as Parastatals
- it is has a legal requirement to publish general purpose financial statements in any public media
- it is a material subsidiary of an entity with public accountability

Malawi plans to require the IFRS for SMEs for all other companies.

In May 2013, the Pan African Federation of Accountants (PAFA) recently decided to adopt international standards in accounting and auditing, including IFRSs, IPSASs, ISAs and the IFRS for SMEs.

SUMMARY OF THE CHAPTER

This chapter introduced students to the regulatory environment of the accountancy profession in Malawi.

END OF CHAPTER QUESTIONS

Q1
What is the significance of IFRSs in Malawi? Explain.

CHAPTER 3 ACCOUNTING INFORMATION

3.0 LEARNING OBJECTIVES

By the end of this topic, students will be expected to know the elements of accounting information and how these elements relate to the accounting equation. They will also be able to explain why and how the accounting equation should balance.

3.1 Elements of accounting information

a) Assets

Assets are the resources, that is, items belonging to a business and used in the running of the business. They may be non-current assets, (such as buildings, machinery or office furniture), or current assets (such as inventory, accounts receivable or cash)

An **asset** is something valuable which a business owns or has the use of. Assets include property of all kinds; buildings, machinery, motor vehicles and inventory of goods, and others are debts owed by customers and the amount of money in the bank.

Non- current assets

Non-current assets are assets that have long life, bought with the intention of using them in the business and not meant for resale. This means that non-current assets are held and used in operation over a number of accounting periods.

Current assets

These are assets that are held only for a short time and include inventory held for resale, amounts receivable from customers, cash and other assets with a short life

b) Liabilities

Liabilities are sums of money owed by a business to outsiders such as **a bank** or trade accounts payable.

A liability is something which is owed to somebody else.

'Liabilities' is the accounting term given to debts of the business and are also known as accounts payable.

Liabilities include amounts owed by the business for goods and services supplied to the business and for expenses incurred but not yet paid by the business. Money borrowed by the business is also a liability.

3.2 The accounting equation and statement of financial position

(a) The accounting equation

This is the basic fundamental rule of accounting which states that the assets and liabilities of a business must always be equal. It can be explained by saying that if a business is to be set up and start trading, it will need resources.

If the owner of the business has supplied all of the resources, this can be shown as:

Resources supplied by the owner = resources in the business

In accounting, the amount of the resources supplied by the owner is called capital and the actual resources that the business has are called assets. Hence in this case the accounting equation can be shown as

Capital = Assets

However, usually other people other than the owner provide resources for some of the assets. Liabilities is the name given to the amount owing to these people for these assets. In this case, the accounting equation is changed to:

Capital = Assets – Liabilities

This is the most common way in which the accounting equation is presented. Alternatively, the accounting equation may be shown as:

Assets = Capital + Liabilities

(b) The statement of financial position (balance sheet) and the effects of business transactions

The accounting equation is expressed in a statement of financial position called the balance sheet.

The balance sheet shows the financial position of an organization at a particular point in time. In other words it represents a snapshot of the organization at that date for which it was prepared.

Let us consider the effect of a series of transactions on the balance sheet.

(i) **The introduction of capital**

Assume that on 1 May 2013, Mr. Botha started in business and deposited K60, 000 into a bank account opened specially for the business. The balance sheet would show the following:

Assets: cash at bank	K 60,000
Capital	K 60,000

(ii) The purchase of an asset by cheque

Now suppose that on 3 May 2013, Mr. Botha buys a small shop for K32, 000 paying by cheque. This transaction brings about a decrease in cash at the bank and an additional new asset building. The balance sheet would now show the following:

Assets: shop	K 32, 000
Cash at bank	K28, 000
	K60, 000
Capital	K60, 000

Always the two parts of the balance sheet must be equal as is the case.

(iii) The purchase of an asset and the incurring of a liability

Suppose that on 6 May 2013, Mr. Botha buys some goods for K7,000 from Mr. Phiri, and agrees to pay for them some time later. The effect of this is that a new asset, stock of goods is acquired, and a liability for the goods is created. A person to whom money is owed for the goods acquired is known as a creditor (or a payable). The balance sheet now becomes:

Assets: shop	K32, 000
Stock of goods	K 7, 000
Cash at bank	K 28, 000
	K67, 000
Less creditor	(K 7, 000)
	K60, 000
Capital	K60, 000

(iv) Sale of an asset on credit

Now suppose that on 10 May 2013, goods which cost K600 were sold to Mr. Banda for the same amount, the money to be paid later. The effect in this case is a reduction in the stock of goods and the creation of an asset. A person who owes the business money is called a debtor (or a receivable).

The balance sheet now becomes:

Assets: shop	K32, 000
Stock of goods	K 6, 400
Debtor	K 600
Cash at bank	K28, 000
	K67, 000
Less creditor	(K 7, 000)

	K 60, 000
Capital	K60, 000

(v) Sale of an asset for immediate payment

Suppose that on 31 May 2013, goods which cost K400 were sold to Mr. Jere for the same amount. Mr. Jere paid for them immediately by cheque. In this case, one asset stock of goods is reduced while another asset, cash at bank is increased. The balance sheet now becomes:

Assets: shop	K32, 000
Stock of goods	K 6, 000
Debtor	K 600
Cash at bank	K28, 400
	K67, 000
Less creditor	(K 7, 000)
	K60, 000
Capital	K60, 000

(vi) The payment of a liability

On 15 May 2013, Mr. Botha pays a cheque for K3,000 to Mr. Phiri in part payment of the amount owing. This reduces the asset cash at bank and the liability to the creditor. The balance sheet now becomes:

Assets: shop	K32, 000
Stock of goods	K 6, 000
Debtor	K 600
Cash at bank	K25, 400
	K64, 000
Less creditor	(K 4, 000)
	K60, 000
Capital	K60, 000

(vii) Collection of an asset

Suppose that Mr. Banda, who owed Mr. Botha K600, makes a part payment of K200 by cheque on 31 May 2013. The effect of this is that one asset (debtors) is reduced and another asset (cash at bank) is increased. The balance sheet now becomes:

Assets: shop	K32, 000
Stock of goods	K 6, 000
Debtor	K 400
Cash at bank	K25, 600
	K64, 000
Less creditor	(K 4, 000)
	K60, 000
Capital	K60, 000

3.3 Equality of the accounting equation

As noticed from the examples above every transaction has affected two items. It has either changed two assets by reducing one and increasing the other or changed the liabilities. This is the reason why the two sections of the balance sheet or the accounting equation are always equal.

Some of the examples of the effects of transactions on the accounting equation are:

Example of transaction	effect	
a) Owner pays capital into the bank	increase assets (Bank)	increase capital
b) Buy goods by cheque	decrease asset (Bank)	increase asset (Stock of goods)
c) Buy goods on credit	increase asset (Stock of goods)	increase liability (Trade Payables)
d) Sale of goods on credit	decrease assets (Stock of goods)	increase asset (Trade Receivables)
e) Sale of goods for cash	decrease assets (Stock of goods)	increase asset (Bank)
f) Pay creditor	decrease asset (Bank)	decrease liability (Creditor)
g) Debtors pay money owing By cheque	decrease asset (Receivables)	increase asset (Bank)
h) Owner takes money out of the business bank account for own use (drawings)	decrease asset (Bank)	decrease capital

i) Owner pays creditors from private money outside the business	decrease liability (Creditor)	increase capital

SUMMARY OF THE CHAPTER

The chapter gave explanation to elements of accounting information. It also incorporated the accounting equation as well as illustrating how business transactions affect the statement of financial position in various instances. The reason for always having the two sections of the statement of financial equation or the accounting equal was given.

END OF CHAPTER QUESTIONS

Q1

Using the statement of financial position (or the statement of financial condition), give a detailed example of accounting equation that highlights the equality of the accounting equation.

CHAPTER 4 TYPES OF BUSINESS TRANSACTIONS

4.0 LEARNING OBJECTIVES

By the end of this chapter, students are expected to understand a range of types of business transactions including Sales, Purchases, Receipts, Payments, Petty cash and Payroll. They will also understand the implications of cash and credit transactions, including where applicable, the effect of cash and trade discounts.

4.1 Nature of a transaction

There are many forms which a business deal can take. At this point you may be aware that various events change two items in the statement of financial position. This aspect will be discussed further when we shall be dealing with Double Entry system of accounting, Events which result in such changes are known as 'transactions' This means that if the proprietor asks the price of some goods, but does not buy them, there is no transaction.

Accounting for Sales

Sales of inventory may be on credit or on cash basis.

Suppose that on 3 August 2013 goods were sold for K375,000 to Luwani.

First, an asset account is increased. The increase in the asset of trade receivables requires a debit and the debtor is Luwani, so that the account concerned is that of Luwani. Second, the asset inventory is decreased. For this a credit entry to reduce an asset is needed. The movement of inventory is clearly the result of a 'sale' and so it is the sales account that needs to be credited.

If on 4 August 2013 goods are sold for K55,000 cash being received immediately at the time of sale then the asset of cash is increased so that the cash account must b debited. The asset of inventory is reduced. The reduction of an asset requires a credit and the movement of inventory is represented by 'sales'. Thus the entry needed is a credit in the sales account.

Accounting for Purchases

Similarly, purchases of inventory may be on credit or on cash basis.

Suppose that on 1 August 2013 goods costing K165,000 are bought on credit from Jamali.

First, the twofold effect of the transaction must be considered so that bookkeeping entries can be worked out. The asset of inventory is increased. An increase in asset needs a debit entry in an account. Here the account is one designed for this type of inventory movement. It is clearly a 'purchase, movement so that the account to use must be the purchases account. Second, there is an increase in a liability. This is the liability of the business to Jamali because the goods bought have not yet been paid for. An increase in a liability needs a credit entry. In this case, it would be a credit entry to Jamali's account.

If on 4 August 2013 goods costing K310,000 are bought, cash being paid for them immediately at the time of purchase, as before asset inventory has increased, so a debit entry will be needed. The movement of inventory is that of a 'purchase', so the purchases account needs to be debited. Second, the asset cash is reduced and must be credited.

Accounting for Receipts

All receipts must reflect that an asset cash (if paid for in cash) or bank (if by cheque) has increased by debiting either cash account or bank account and crediting the source (say a debtor's account).

Accounting for Payments

Similarly, all payments must reflect that an asset cash (if paid for in cash) or bank (if by cheque) has reduced by crediting either cash account or bank account and debiting the receiver of the funds (say a creditor's account).

Accounting for Petty cash

Petty cash is recorded through a petty cash book. The question is where does the money paid come from? The **imprest system** is one where the cashier gives the petty cashier enough cash to meet the petty cash needs for the following period. Then at the end of the period, the cashier finds out the amounts spent by the petty cashier, by looking at the entries in the petty cash book. At the same time the petty cashier may give the petty cash vouchers to the cashier so that the entries in the petty cash book may be checked. The cashier then passes cash to the value of the amount spent on petty cash to bring it back up to the level it was at when the period started. This amount is known as petty cash float.

The relevance of discounts

Discounts may be offered to retailers by wholesalers or manufacturers for bulk purchases (trade discount) or in order to induce customers to pay their accounts quickly (cash discounts). Whereas cash discounts always appear in the profit and loss part of the Trading and Profit and Loss account and part of double entry trade discount are just netted off the initial selling price on the invoice but are not part of bookkeeping entries

Accounting for Payroll

Modern accounting systems include a payroll module. Businesses with large number of employees would find this particularly useful as payroll systems require a good deal of regular processing. Some important aspects this module should handle are PAYE, pension, and loans and advances.

This area of accounting is usually under a specialized accounting officer and contains some in-built controls such as salaries and wages control accounts as part of internal checks.

SUMMARY OF THE CHAPTER

The chapter explained the accounting treatment of the main types of business transactions and justified the treatment as given. It also highlighted the operation of key elements in accounting stating how the selected elements are applied in accounting set ups.

END OF CHAPTER QUESTIONS

Q1

Explain your understanding of an 'accounting transaction'.

Q2

In accounting for payroll, list any three items that an accountant would expect the relevant computer applications to handle.

CHAPTER 5 BOOKS OF ORIGINAL ENTRY AND LEDGERS

5.0 LEARNING OBJECTIVES

The objective of this chapter is to introduce to the students books of original entry and ledgers. By the end of this topic, the students will therefore be expected to understand the types of books used in accounting. Uses of these records are explained and coding and control accounts are also mentioned. However, one of the day books, the cash book, is discussed later in detail to underline its importance.

5.1 The growth of a business

When a business is small, all the double entry accounts can be kept in one book called a ledger. With the growth of the business, it becomes impossible to use just one book because of the large number of pages required for a lot of transactions, which would make the book too large to handle. Furthermore, the growth in the business might necessitate the employment of several bookkeepers, and using one book would make it difficult for each one to do his/her work.

As a result of this, there is need to use more books whereby similar types of transactions are put together and have one book in which they are recorded.

5.2 Books of original entry

When transactions take place, there is need to record as much detail as possible of the transactions.

Books of original entry are the books in which transactions are first recorded. Each type of transaction will have a separate book.

The nature of the transaction affects which book it is entered into. The following details of transactions are entered in these books:-

- The date on which each transaction took place (transactions are recorded in date order)
- Details relating to the transaction are entered in the details column.
- A folio column entry is made cross-referencing back to the source document.
- The monetary amounts are entered in columns provided in the books of original entry for that purpose.

5.3 Types of books of original entry

Books of original entry are called "day books" or "journals."

- Sales day book (sales journal) in which credit sales are entered.
- Purchases day book (purchases journal) in which credit purchases are recorded.
- Returns inwards day book (returns inwards journal) in which returns inwards are entered
- Returns outwards day book (Returns outwards journal) in which returns outwards are recorded.

- Cash book in which receipts and payments are recorded (both cash and cheque transactions)
- General journal (journal) for other items

5.4 Using more than one ledger

Entries are made in the books of original entry, and then summarized, and the summary information is entered, in double entry, to accounts kept in various ledgers. The use of a set of ledgers rather than just one big ledger makes it easier to divide the work between different bookkeepers.

5.5 Types of ledgers

Most businesses use the following ledgers:

- Sales ledger. This is for customers' personal accounts
- Purchases ledger. This is for suppliers' personal accounts
- General ledger. This contains the remaining double entry accounts; expenses, income, fixed assets and capital

5.6 Types of accounts

All accounts are sometimes described as either personal or as impersonal accounts.

- ***Personal accounts:*** for debtors and creditors (customers and suppliers)
- ***Impersonal accounts***

  These are divided into "real" accounts and "nominal" accounts.
- ***Real accounts*** are accounts in which possessions such as buildings, machinery, fixtures and stock, are recorded.
- ***Nominal accounts*** are accounts in which expenses, income and capital are recorded
-

5.7 The purchase day book

Purchase day book is used to keep a list of invoices received from suppliers of goods and services to the business. It is a "book" of prime entry or a primary record.

The need for the purchase day book

A business needs to keep track of all of its purchases transactions together so that it knows how much it owes to particular suppliers at any one time.

a. It is simpler to allow the amount it owes to the supplier to build up and then "make a single payment" to each supplier rather than to pay each invoice separately.
b. The business needs to take full advantage of the credit period offered by suppliers and pay close to the end of the credit period of which the supplier allows
c. It will want to keep a record of the total purchases which it makes in each period

Taking advantage of the suppliers' allowed credit periods helps the cash flow of the business. If it pays earlier than it needs:-

1. It may pay more interest on larger bank overdraft it needs
2. Lose interest on a positive amount of cash instead of an overdraft

To meet these needs the source documents must be recorded in the purchases day book

Example of the purchases day book

DATE	SUPPLIER NAME	REF	TOTAL	SALES TAX
12.08.13	Maya Trading	PL 1	K5000	K324
14.08.13	Viwemi Ltd	PL 2	K4300	K134
23.08.13	Twanda Plc	PL 3	K14500	K2110

Note

The purchases day book is regularly summarized and the information is posted to the general ledger by debiting the purchases account and crediting the payables control account. The same information should also be posted to the individual supplier's accounts concerned by crediting their accounts in the payables personal ledger.

Some organizations assign **"**sequential numbers to purchase invoices**"** to ensure that all purchases invoices are included in the reports.

5.8. The purchase returns day book

The purchase returns day book lists credit notes received in respect of the purchase returns in chronological order.

- A business will return goods that are "faulty" or damaged and will expect a credit note from the supplier
- Goods bought on **"**sale or returns**"** basis will be returned if they cannot be sold
- If goods have been ordered by the business and are in good condition but are "surplus to the requirements" the supplier may or may not agree to accept them as returns and to issue a credit note.

Purchase returns might be recorded in the purchases day book as "negative amount"

Note

Purchase returns might be recorded in the purchases day book as "negative amount. The purchase return day book is regularly summarized and posted to the general ledger by debiting the payables control account and crediting the purchase returns account. The individual supplier's accounts will also be debited with the value goods returned in the suppliers personal accounts.

Entering purchase transactions in the day books

This will be similar to the procedure for writing up the sales day book and the sales returns day book.

a. In manual accounting systems, invoice details will be entered in the purchase **day book** and **credit notes** in **the purchase returns day book** by hand.
b. In computerised purchase ledger systems, purchase invoice entering will be done by entering details onto the computer records through a keyboard and a visual display unit (VDU) or monitor.

Analysis of purchases

The purchases day book may have further analysis columns which split the purchases into different categories in addition to the date, transaction reference number, supplier name, supplier account number, and the net total before tax, sales tax and gross total.

The nature of the business will determine how the purchases are analysed. A business may have separate day books for inventory purchases and expenses, an "Expenses day book"

A spreadsheet may be used to analyse purchases in a purchase day book.

Computerised accounting packages may have analysed sales day books and purchases day books.

Coding in the purchases ledger

The purchasing company will have to allocate codes to different suppliers.

In the purchase system the obvious codes are:

- Supplier account number
- Product or service number
- Purchase invoices sequence number

The supplier account number is a unique identification number used to identify and distinguish the suppliers even where they have the same name.

The product or service code identifies the type of the product or service. This enables the company to build controls when posting the general ledger. A sequential numbering of purchase invoices may be put in place to ensure the completeness and assist prevention of fraud.

5.9 The sales daybook

- The sales daybook is used to record all invoices sent to customers for goods which a business sells on credit.
- The sales daybook should contain the following details pertaining to sales invoices issued:

(a) The date of the sale

(b) Name of the customer

(c) Invoice number

(d) Reference number column

(e) Final amount of the invoice

- A sales daybook may appear like this;

Sales daybook

Date	**customer**	**invoice number**	**ref**	**amount**
Sept 1	A. James	145	SL 2	K2300
2	M. Phiri	147	SL 3	K3500
7	J. Mwase	149	SL 4	K2700
15	C. Manase	151	SL 6	K7800
Total				**k16300**

5.10 Posting the day book totals

The day book totals for sales and returns are posted to **the nominal ledger receivables control account**, **the sales tax control** and **the sales account**. The amounts owed by individual customers are entered in the **sales ledger personal accounts** (where these are maintained as memorandum accounts separate from the nominal ledger).

It has been seen above how details of sales may be entered in the sales day book. One of the reasons for maintaining the sales day book was the need to make sure that the business receives the money due from all of the sales it makes. There is therefore need to have a record which shows when the business should ask for the money. The sale day book cannot provide such information for the following reasons:

(a) For many businesses the chronological record of the sales transactions might involve very large numbers of invoices per day or week

(b) The same customer might appear in several places in the sales day book, for purchases he makes on credit at different times, so that a customer may owe money on several unpaid invoices at any point in time.

There is, therefore the need for a way of showing **who** owes **what** amount to the business and **when**

5.11 Personal accounts for receivables

The above need is met by maintaining **personal accounts** for each individual customer in the **receivables ledger**.

(a) Each individual sales transaction is entered in the sales day book and needs to be recorded in the personal receivables ledger account of the customer.

(b) The totals of the day books need to be posted to the total receivables and sales accounts in the general ledger.

Personal accounts are also called **memorandum accounts** to indicate that, recording of transactions in these books are **not** part of the double entry

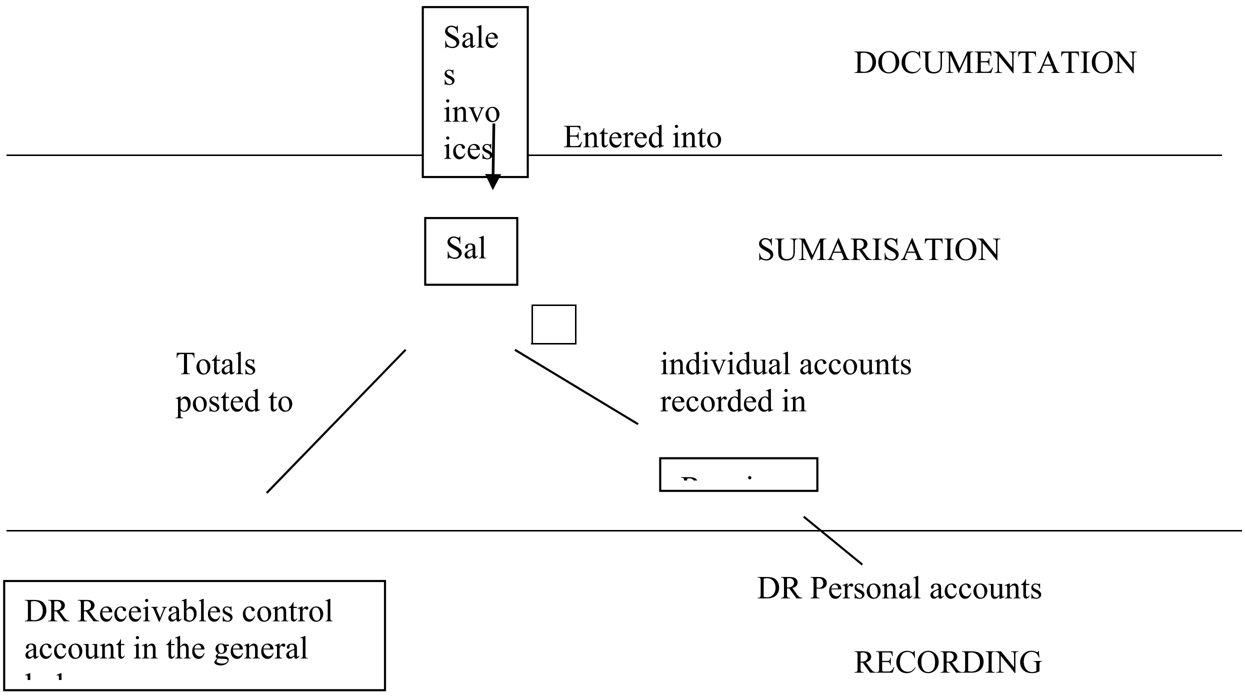
5.12 Recording the double entry

The transactions entered in the sales day book need to be recorded in the double entry system of bookkeeping.

To do this the sales day books must be **totalled** and **ruled off,** to include all transactions since the book was last ruled off as shown on page 1.

The business will also have a cash account as part of its double entry posted from the cash book. This is the general ledger account in which receipts and payments of cash are recorded. However, when there is a credit transaction no entry is made in the cash account because initially no cash was received or paid.

Therefore, the receivables control account (total receivables account) is used as shown on next page.



5.13 The double entry

The sales summarized in the sale day book are transactions that have two aspects:

- An increase in our **assets** (receivables)
- An increase in **income** (sales)

A **receivables control account or 'sales ledger control account",** is

For sales made to credit customers the entries made will be a **debit** to the receivables control account and a **credit** to the sales account.

- The **receivables control account** records an **asset** – the debts owed by customers.
- The **sales account** records **income** – the amount of sales which the business is making.

The basic double entry is shown as follows:

		Mk	Mk
DEBIT	Receivables control account	X	
CREDIT	Sales account		X

There is no need to record each sales transaction separately in the general ledger. The day book totals are used to summarize the transactions.

5.14 VAT

Sales tax is charged on the sales and the business must account to the authorities for the output tax it collects. In order to keep track of the amount it owes to or is owed by the authorities, the business keeps a **Sales Tax Account** (also called **Sales Tax Control Account**) in the general ledger.

The sales tax which customers owe to the business is included in the overall amount owed (total receivables), but the other side of the entry for the amounts of tax invoiced to customers is **an increase in the liability of the business to pay over sales tax to the authorities.** The double entry therefore will take the form of:

		Mk	Mk
DEBIT	Receivables control account	X	
CREDIT	Sales account		X
	Sale Tax account	X	

5.15 Sale returns day book

The double entry arising from posting from a **sales returns day book** will be like a mirror image (the opposite) of the posting of sales. When goods are returned, there is need to reverse the transaction (or part of it) as it was shown in the books when the sale was recorded

			Mk	Mk
DEBIT	Sales returns account		X	
	Sale Tax account	X		
CREDIT	Receivables control account			X

5.16 Sales

It was mentioned above that sales can be analysed into different categories in the sales day book. Instead of maintaining a single account in the general ledger for sales, a business may split sales into a number of general ledger accounts so that it has **a record in the general ledger of the amounts of different types of sales.**

Update the dates in examples

<u>Note.</u>

Information from the sales daybook will be summarized at the end of a period and posted to the general ledger by debiting the receivables control account and crediting the sales account. The same information will also be posted to the customer's individual personal accounts by debiting the customers accounts in the personal ledger.

5.10 The sales return daybook

- The sales return day book is used to record credit notes sent to customers for goods returned by customers. Alternatively, the credit notes sent may be recorded in the sales day book as negative amounts to reduce the value of sales invoices.
- The sales return daybooks summaries are posted to the general ledger by debiting the sales returns day book and crediting the receivables control account. The individual customers account concerned in the personal ledger should also be credited with the value of the credit note to show the reduction in the amount owing.

5.11 Control accounts

- A control account is an account in the general ledger in which a record is kept of the total value of similar but individual items. Control accounts are chiefly used for trade receivables and payables.
- A receivables control account is an account in which records are kept of transactions involving all receivables in total and receipts from customers in total.
- A payables control account is an account in which records are kept of transactions involving all payables in total and payments in total made to suppliers.

Example

On examining the books Azimenye Ltd, you ascertain that on 1 October 2012 the receivables ledger balances were K8024 debit and K57 credit, and the payables ledger balances on the same date K6235 credit and K105 debit.

For the year ended 30 September 2013 the following particulars are available:

	K
Sales	63728
Purchases	39974
Cash from trade accounts receivable	55212
Cash to trade accounts payable	37307
Discount received	1475
Discount allowed	2338
Returns inwards	1002
Returns outwards	535
Bad debts written off	326
Cash received in respect of debit balances in the payables ledger	105

Contra settlement between payables and receivables	434
Allowances to customers on goods damaged in transit	212

On 30 September 2013 there were no credit balances in the receivables ledger except those outstanding on 1 October 2012, and no debit balances in the payables ledger.
You are required to write up the following accounts recording the above transactions bringing down the balances as on 30 September 2013.
(a) Receivables control account
(b) Payables control account

Receivables control account

	K		K
Balance B/d	8024	Balance B/d	57
Sales	63728	cash	55212
		Discount allowed	2338
		Returns inwards	1002
		Bad debts	326
		Contra settlement	434
		Allowance on goods damaged	212
Balance c/d	57	balance c/d	12228
Total	**71809**	total	**71809**

Payables control account

	K		K
Balance B/d	105	Balance B/d	6235
Cash	37307	purchases	39974
Discount received	1475	cash	105
Returns outwards	535		
Contra settlement	434		
Balance c/d	6458		
Total	**46314**	total	**46**

SUMMARY OF THE CHAPTER

This chapter introduced books of prime entry (also known as books of original entry, day books or journals) *excluding* cash books which will be handled in the next chapter. The usefulness of the books was explained. The relationship with ledgers and control accounts were clarified.

END OF CHAPTER QUESTIONS

Q1 Day books terminology

Give other terms that are used to name day books.

Q2 Importance of day books

State the main reasons for having day books in an accounting system.

CHAPTER 6 THE CASH BOOK

6.0 LEARNING OBJECTIVES

The objective of this chapter is to introduce to the students the Cash Book as one of the books of original entry. Therefore by end of this topic, the students will be expected to understand the cash book, its uses, the need for bank reconciliations and how these are prepared.

6.1 CASH BOOKS

6.1.1 Drawing up a Cash Book

The cash book consists of the cash account and bank account put together in one book. In the cash book, the debit column for cash is put next to the debit column for bank. The credit column for cash is put next to the credit column for bank. This enables the business to record all money received and paid out on a particular date on the same page.

The bank column contains details of the payments made by cheque and direct transfers from the bank account and of money received and paid into the bank. The bank will have its own record of the account in its books. From time to time, or on request from the business, the bank sends a copy of the account in its books to the business known as a bank statement, which the business uses to check against the bank columns in its cash book to ensure that there are no errors.

6.1.2 Cash paid into the bank

When customers pay their accounts in cash and, later, a part of the cash is paid into the bank, the receipt of the cash is debited to the cash column on the date received, the credit entry being in the customer's personal account.

The cash banked has the effect of (i) decreasing the asset cash; therefore, credit the asset cash account represented by the cash column in the cash book, and (ii) increasing the asset of bank; therefore debit the asset bank account, which is represented by the bank column in the cash book.

When the whole of the cash received is banked immediately the receipt is entered directly into the bank column.

When the business requires cash, it may withdraw the cash from the bank. The effect is (i) asset bank is decreased; the action being crediting the bank account that is the bank column in the cash book and (ii) the asset of cash is increased; the action being debiting the asset account; that is the cash column in the cash book.

6.1.3 The use of folio column

When many books are being used, mentioning the other account in which the transaction is to be found, may not be enough information to find the other account quickly. Therefore a folio column is introduced to facilitate quicker finding of the other account. In each account and in each book being used, a folio column is added, shown on the left of the money columns. The name of the other book and the number of the page in the other book where the other part of the double entry was made is stated against each and every entry in this column. To ensure that the double entry is completed the folio column should only be filled when the double entry has been completed.

Using one book as a means of entering transactions into the accounts, so as to perform or complete the double entry is called posting. The advantage of using folio entries is that they speed up the process of finding the other side of the double entry. If an entry has not been filled in, it may indicate that the double entry has not yet been made. Looking through the entry lines in the folio columns to ensure that they have all been filled helps detect such errors quickly.

6.2 Cash discounts

In order to induce customers to pay their accounts quickly, a business may accept a smaller sum in full settlement if payment is made within a certain period of time. The amount of the reduction of the sum to be paid is known as cash discount.
The rate of the cash discount is shown as a percentage. The percentage allowed, and the period within which payment is to be made, are quoted on all sales documents by the seller. Cash discounts always appear in the profit and loss part of the Trading and Profit and Loss account. They are not part of the cost of goods sold, nor are they a deduction from selling price.

Discounts column in cash book

The discount s allowed account and the discounts received account are maintained in the general ledger along with other revenue and expense accounts. To avoid too much reference to the General ledger, extra columns for discount are used in the cash book. Each side of the cash book will have an extra column added in which the amounts of discounts are entered. Discounts received are entered in the discounts column on the credit side of the cash book, and discounts allowed in the discounts column on the debit side of the cash book.

Example

Enter the following transactions for the month of May 2013 in the cash book, balance off the cash book and show the discount accounts in the general ledger

May 1 balance brought down from April:	K
Cash	29
Bank	654
Accounts receivables accounts:	
B Konda	120
M Kaka	280
D Songa	40
Accounts payables accounts:	
U Banda	60
A Kande	440
R Seka	100
2 B Konda pays us by cheque, having deducted 2.5% cash discount K3	117
8 we pay R Seka his account by cheque, deducting 5% cash discount K5	95
11 we withdrew K100 from the bank for business use	100
16 M Kaka pays us his account by cheque less 2.5% discount K7	273
25 we paid office expenses in cash	92
28 D Songa pays us in cash after deducting a discount of K2	38
29 we pay U Banda by cheque less 5% discount K3	57
30 we pay A Kande by cheque less 2.5% discount K11	429

Cash book

Date	Item	Folio	Discount	Cash	Bank	date	Item	Folio	Discount	Cash	Bank
			K	K	K				K	K	
May											
1	Bal b/d			29	654	8	R. Seka	PL5	5		95
2	B. Konda	SL1	3		117	11	Cash	C			100
11	Bank	C		100		25	Office Exp	GL2		92	
16	M. Kaka	SL2	7		273	29	U. Banda	PL3	3		57
28	D. Songa	SL3	2	38		30	A. Kande	PL4	11		429
						31	Balances	c/d		75	363
			12	167	1044				19	167	1044
June											
1	Balances			75	363						

Sales ledger

B Konda

Balance b/d	K120	Bank	K117
		Discount	3

M Kaka

Balance b/d	K280	Bank	K273
		Discount	7

D Songa

Balance b/d	K40	Cash	K38
		Discount	2

Purchase ledger

U Banda

Bank	K57	balance b/d	K60
Discount	3		

R Seka

Bank	K95	balance b/d	K100
Discount	5		

A Kande

Bank	K429	balance b/d	K440
Discount	11		

General ledger

Office expenses

Cash	K92		

Discount received

		Total for the month	K19

Discount allowed

Total for the month	K12		

Exercise

Enter the following in the three–column cash book of an office supply shop, balance–off the cash book at the end of the month and show the discount accounts in the general ledger

2013

June 1 balance brought forward; cash K420, bank K4940

1 the following paid us by cheque, in each case deducting a discount of 5% S Braga K820, L Pine K320 G Hodd K440 M Rae K1040

2 cash sales paid directly into the bank K740

3 paid rent by cash K340

4 we paid the following accounts by cheque in each case deducting 2.5% cash discount M Peters K360 G Graham K960 F Bell K400

8 withdrew cash from the bank for business use K400

10 cash sales K260

12 B Age paid us their account of K280 by cheque less a discount of K4

14 paid wages by cash K540

16 we paid the following accounts by cheque R Todd K310 less K15 discount F Dury K412 less K12 discount.

20 bought fixtures by cheque K4320

24 bought lorry by cheque K14300

29 received K324 cheque from A Line

30 cash sales K 980

30 bought stationery paying by cash K56

6.3 The bank reconciliation statements

(a) Completing entries in the cash book

Funds paid into and out of the bank are entered into the bank columns of the cash book. The bank will also keep record of the flow of funds into and out of the business bank account.

At any one time, it is unlikely that the balance in the business cash book and the balance shown by the Bank records will be same. This is the case for the following reasons:

1. Items may have been paid into or out of the bank account that have not been recorded in the cash book.
2. There may be items entered into the cash book that have not yet been entered in the bank's re cords of the account. These are called **Timing Differences**

The cash book entries need to be compared to the record held by the bank. Banks usually send "bank statements" to their customers which can be used for this comparison which is referred to as reconciliation.

Dr **CASH BOOK (Bank columns only)** **Cr**

2013		K	2013		K
Mar 1	Balance b/d	2500	Mar 6	M Kennedy	650
15	James Brown	1000	25	Joseph	1800
24	K Phillip	1500			

BANK STATEMENT

		Withdrawals	Deposits	Balance
2013		K	K	K
Mar 1	Balance b/d			2500
7	M Kennedy	650		1850
15	Deposit		1000	2850
24	Deposit		1500	4350
27	Joseph	1800		2550
31	Bank transfer- Booth		500	3050
31	Bank charges		200	2850

In this case, the balances in the cash book and in the bank statement are not the same.

The balance on the cash book might be different from that on the bank statement due to the following reasons
-Unpresented cheques will cause the balances to be different
-Bank lodgments' not yet credited to the business's bank account will cause the two balances to be different.

(b) Procedure for preparing bank reconciliations

"The cash book and the bank statement will rarely agree at given date.
The following procedures should be followed to ensure that the reconciliation between them is performed correctly:

1. Identify the cash book balance and the bank balance on the date to which you wish to reconcile.
2. ''**Add up the cash book** "for the period since the last reconciliation and identify and note any errors found.
3. Examine the bank statement for the same period and identify those "**items which appear on the bank statement but which have not been entered in the cash book**.
    i. Standing orders
    ii. Direct debits
    iii. Bank charges
    iv. Dividend receipts from investments
    v. Interest received
4. Identify all the reconciling items due to "**timing differences**

ADJUSTED CASH BOOK BALANCE	K	K
Cash book balance brought down		XX
Add: correction of understatement	X	
Receipts not entered in cash book	X	
		XX
Less: Corrections of overstatements	X	
Payments/charges not entered in cash book	X	
		(XX)
Corrected cash book balance		**XX**

Bank reconciliation

(c) Timing and frequency of the bank reconciliations

The following factors determine the frequency of performing bank reconciliations:-

7 where **Frequency and volume of transactions** – The likelihood of error is greater there are more transactions

8 **Other controls** – If there are very few other checks on cash, the greater the need for a bank reconciliation.

9 **Cash flows** – If the company has to keep a very close watch on its cash position, then the reconciliation should be performed as often as the information on cash balance is required.

10 **Number of bank accounts** – The more the bank accounts are operated, the more difficult it becomes to perform regular reconciliation.

(a) Reconciliation on computerised systems

There is no difference between reconciliations of a manual cash book and reconciliation of a computerised cash book.

(b) Computer controls over cash

The computer will have "programmed controls" built in to prevent or detect many of the errors that can be made in a manual system.

- **Casting** – computers are programmed to add correctly

- **Updating from ledgers** - The bank account will be updated from the sales ledger, purchase ledger and any relevant ledger.

- **Combined computer and manual cash books**

Some organizations will maintain a manual cash book in addition to computerised cash book.

Example – bank reconciliations

Sarah prepares a bank reconciliation statement for her business bank account at the end of each month. At 31 May 2013 her ledger balance was K2,759 (credit) and her bank statement showed that she had funds of K131 at the bank. She has the following information:

(i) The bank debited Sarah's account with charges of K129 during May. Sarah has not recorded the charges.

(ii) Sarah arranged for K2,500 to be transferred from her personal bank account into the business bank account. The bank made the transfer on 30 May, but Sarah has not made any entry for it in her records.

(iii) On 22 May Sarah withdrew K100 cash which she did not record.

(iv) Cheque number 543987 which Sarah issued to a supplier appears on the bank statement as k650. Sarah incorrectly recorded the cheque as K560.

(v) On 31 May, Sarah lodged K457. This amount appears on the bank statement dated 3 June.

(vi) Sarah was advised by the bank that she earned K52 interest for the period in May that her account was in credit. Sarah recorded this in May, but the bank did not credit her account until June.

(vii) Three of the cheques issued in May, with a total value of K942, were not debited on the bank statement until after 31 May.

(viii) A cheque for K276, issued to a supplier was cancelled, but Sarah has not recorded the cancellation of the cheque.

Required:

(a) Show the bank account in Sarah's general ledger, including any adjusting entries required due to the information in (i) to (viii) above.

(b) Prepare a reconciliation of the bank statement balance to the corrected balance on the bank account in Sarah's general ledger.

(c) Indicate how the bank balance will be reported in Sarah's final accounts, and the value to be reported.

Solution

(a) Bank Account

	K		K
Transfer from personal account	2500	Balance B/d	2759
Cheque cancelled	276	Bank charges	129
		Drawings	100
		Understated cheque	90
Balance C/d	302		
	3078		3078

(b) Bank reconciliation statement

	K
Balance as per bank statement	131
Add outstanding lodgements (k457 + k52)	509
Less unpresented cheques	(942)
Balance as per bank account	(302)

(c) The bank balance will be reported as an overdraft under Current Liabilities in the Statement of Financial Position. The amount to be reported will be K302.

SUMMARY OF THE CHAPTER

This chapter introduced the cash book as one of the books of prime entry (also known as books of original entry, day books or journals). The usefulness of this book was explained and how bank reconciliation statements are prepared were illustrated in appropriate detail.

END OF CHAPTER QUESTIONS

Q1 Bank reconciliations terminology

Explain the following terms as they relate to Bank Reconciliations.

a. *Deposits in transit*
b. *Outstanding cheques*
c. *Bank charges*
d. *Non-sufficient fund cheques (NSF cheques)*

Q2 Question: Bank Reconciliations

Company A's bank statement dated 31 December 2013 shows a balance of K24,594.72. The company's cash records on the same date show a balance of K23,196.79. The following additional information is available:

1. *Cheques which had been issued by the company to its customers are still outstanding as follows:*

No. 846 issued on Nov 29	*K320.00*
No. 875 issued on Dec 26	*49.21*
No. 878 issued on Dec 29	*275.00*
No. 881 issued on Dec 31	*186.50*

2. *A deposit of K400.00 made on 31 December does not appear on bank statement.*
3. *An NSF cheque of K850 was returned by the bank with the bank statement.*
4. *The bank charged K50 as service fee.*
5. *Interest income earned on the company's average cash balance at bank was K1,250.*
6. *The bank collected a note receivable on behalf of the company. Amount received by the bank on the note was K550. This includes K50 interest income. The bank charged a collection fee of K10.*

7. *A deposit of K430 was incorrectly entered as K340 in the company's cash record**s.***

Required:

Prepare a bank reconciliation statement using the above information.

CHAPTER 7 CHARTS OF ACCOUNTS AND CODING OF ACCOUNTS

7.0 LEARNING OBJECTIVES

The objective of this chapter is to explain the importance of charting and coding of accounts in processing of financial transactions. The accounting code and different types of codes including sequence**,** block**,** significant digit**,** and hierarchical faceted are also explained. Finally, code supplier and customer accounts and aspects of coding general ledger accounts are handled.

7.1 CODING DATA

CODES

It is necessary to take a look at the importance of coding in transaction processing because coding is at the centre of transaction processing and the integrity of the information obtained from it. Codes are used because they can identify items more precisely and concisely than written descriptions, as such they help to classify items into groups for recording data.

A **code** is defined as a system of symbols designed to be applied to a classified set of items to give a brief accurate reference, facilitating entry, collection and analysis

Coding saves time in copying out data because codes are shorter than longhand descriptions. In view of this, and to save storage space, computer systems make use of coded data

7.2 Coding in the accounts receivable ledger

The accounts receivable ledger consists of individual accounts for each credit customer. Each customer is allocated an account and identified by a unique code number. If there were two customers with the same name, with a unique code, these would be distinguished. In addition to the customer account number other examples of codes in a sales system can incorporate the following important information:

- Sale invoice numbers

  A sequential coding of invoices ensures completeness and helps elimination of errors such as missing invoices, or goods not being invoiced

- Product or service code numbers

  In addition to customer identification number, a code can incorporate product identification. For example customer John may be buying more than one type of product form the company such as home theatres and television sets. Separate identification of the products will enable the transaction to be correctly posted not just in the accounts receivable ledger but also in all relevant accounts in the general ledger.

There are many coding systems (or combinations of them) that may be used when designing codes to offer the flexibility that the company needs and are described below.

7.3 Sequence codes

Sequence codes make no attempt to classify the item to be coded. It simply puts the next available number in a rising sequence. New items can only be inserted at the end of the list and therefore the codes for similar items may be very different.

7.4 Block codes

Block codes provide a different sequence for each different group of items. For example for a particular company, customers may be divided up according to area:

South	Code numbers 10000 - 19999
North	Code numbers 20000 – 29999
East	Code numbers 30000 – 39999
West	Code numbers 40000 – 49999

Within each block coding for customers is then sequential.

7.5 Significant digit codes

Significant digit codes incorporate some digits which are part of the description of the item being coded.

For example:

4000	Electric light bulbs
4025	25 watts
4040	40 watts
4060	60 watts
4100	100 watts

7.6 Hierarchical codes

4	Business
4 2	Finance
4 2 1	Cost accounting
4 2 1.4	Standard costing
4 2 1.4 7	Variance analysis
4 2 1.4 7 2	Fixed overhead variance

7.7 Faceted codes

Faceted codes are made up of a number of sections each section of the code representing a different feature of the item. A good example may be found in a clothing factory where a code might be based on the following facets.

Garment type	Customer type	Colour	Size	Style

If SU stood for suit, M for male, B for blue, a garment might be given the code SU M B 36 15. On the other hand, ND F W 14 22 might represent a woman's white night dress size 14, style 22. One of the greatest advantages of this system is the type of item can be recognized from the code.

Faceted codes can also be entirely numerical.

7.8 Coding in the general (nominal) ledger

A nominal ledger consists of a large number of coded accounts. Part of a nominal ledger might, for example, be as follows:

Account code	**Account name**
100200	Plant and machinery (cost)
100300	Motor vehicles (cost)
300000	Total receivables
400000	Total payables
500130	Wages and salaries
500140	Rent and rates
500150	Advertising expenses
500160	Bank charges
500170	Motor expenses
500180	Telephone expenses
600000	Sales
700000	Cash

A business chooses its own codes for the nominal ledger. The codes given above have been taken from a sample in a manual.

SUMMARY OF THE CHAPTER

This chapter introduced a number of key aspects of charts of accounts and coding to the students. This is a noteworthy area in accounting practice since various accounting systems take a number of coding formats and charts of accounts are varied.

END OF CHAPTER QUESTIONS

Q1 **Coding**

Give an example of coding that may be used in the general (nominal) ledger.

CHAPTER 8 THE ACCOUNTING EQUATION

8.0 LEARNING OBJECTIVES

The objective of this chapter is to introduce to the students the concept of the Accounting Equation. The students will therefore appreciate that the whole financial accounting is premised on this simple idea.

8.1 The Accounting Equation

By adding up what the accounting records say belongs to a business and deducting what they say the business owes, one can identify what a business is worth according to those accounting records. The whole financial accounting is based on this very simple idea and is known as the accounting equation.

It is explained by saying that if a business is to be set up and start trading, it will need resources. If these are entirely supplied by the owner of the business, it can be shown as:

Resources supplied by the owner = Resources in the business, or

Capital = Assets

Usually, however, people other than the owner will have supplied some of the assets. Liabilities is the name given to the amounts owing by the business. The equation therefore now changes to:

Capital = Assets – Liabilities

This is the most common way in which the accounting equation is expressed. It can be seen that the two sides of the equation will have the same totals. This is because we are dealing with the same thing from two different points of view – the value of the owners' investment in the business and the value of what is owed by the owners.

8.2 Alternative presentation

With the form of accounting equation given in the section above, one can no longer see at a glance what value is presented by the resources in the business. You can see this more clearly if you switch assets and capital around to produce the alternative form of the accounting equation:

Assets = Capital + Liabilities

This can then be replaced with words describing the resources of the business:

Resources: what they are = Resources : who supplied them
(Assets) (Capital + Liabilities

8.3 Equality of the accounting equation

It is a fact that no matter how one present the accounting equation, the totals of both sides will *always* equal each other, and that will *always* be true no matter how many transactions there may be. The actual assets, liabilities and capital may change, but the total of those assets will always equal to capital +liabilities. The ultimate conclusion of business transaction will therefore be explained by the effect on statement of financial position totals.

Capital is often called **equity** or net worth. It comprises funds invested in the business by the owner plus any profits retained for use in the business less any share of profits paid out of the business to the owner.

8.4 Dual aspect

As stated, there are two aspects to accounting, one represented by the assets of the business and the other by the claims against them. The concept states that these two aspects are always equal to each other. Double entry is the name given to the method of recording transactions under the dual aspect concept.

8.4 What else would affect capital?

The accounting equation is expressed in a financial statement called the **statement of financial position.** The statement shows the financial position of an organization at a point in time. It presents a snapshot of the organization at the date for which it is prepared. There are many transactions that affect the statement. Examples are:

(a) The introduction of capital
(b) The purchase of an asset by cheque
(c) The purchase of an asset and the incurring of a liability
(d) The sale of an asset on credit
(e) The sale of an asset for immediate payment
(f) The payment of a liability

SUMMARY OF THE CHAPTER

This chapter introduced the accounting equation and the dual aspect concept. Alternative form of presenting the equation was also explained.

END OF CHAPTER QUESTION

Consider various transactions and names of accounts that are to be debited and those that are to be credited. Appreciate the effect these transactions have on the accounting equation and capital of a business.

CHAPTER 9 DOUBLE ENTRY BOOK KEEPING

9.0 LEARNING OBJECTIVES

By the end of this chapter, students will be able to record the entries in books of accounts using the double entry book-keeping.

9.1 The double entry system for assets, liabilities and capital

Double entry book keeping is the system of accounting which reflects the fact that:

- Every financial transaction affects the entity in two ways and gives rise to two accounting entries, one a debit entry and the other a credit entry.
- The total value of the debit entries is therefore always equal at any time to the total value of credit entries.

9.2 The accounts for double entry

Each account should be shown on a separate page in the accounting books. The double entry system divides each page into two halves. The left side of each page is called the debit side while the right hand side of the page is called the credit side. The title of each account is written a cross the top of the account at the centre.

i.e.

Title of the account

Left hand side DEBIT side	Right hand side CREDIT side

These are commonly called T – accounts.
As observed in the previous chapter, transactions increase or decrease assets, liabilities or capital. Thus in terms of assets, liabilities and capital:

- To increase an asset we make a debit entry.
- To decrease an asset we make a credit entry.
- To increase a liability/capital account we make a credit entry.
- To decrease a liability/capital account we make a debit entry.

Capital account

Decrease (-)	Increase (+)

Asset account

Increase (+)	Decrease (-)

Liability account

Decrease (-)	Increase (+)

Worked examples

Enter the following transactions using the double entry book keeping system

1) The owner starts the business with K10, 000 in cash on 1 August 2013.

Effect of the transaction	**action**
Increases the asset cash	debit the cash account
Increases the capital	credit the capital account

Cash account

2013	
Aug 1 capital K10, 000	

Capital

	2013
	Aug 1 cash K10000

The double entry is completed by a cross reference to the title of the other account in which the double entry is completed. I.e. capital will appear as a narrative in the cash account and cash will appear as a narrative in the capital account.

2) A van bought for K 4500 cash on 2 August 2013.

Effect of the transaction	**action**
Increase the asset of van	debit the van account
Decrease the asset of cash	credit the cash account

Van account

2013	
Aug 2 cash K4500	

cash account

	2013
	Aug 2 van K4500

3) Fixtures (e.g. shelves) are bought on credit from shoptters for K1250 on 3 August 2013.

Effect of transaction **action**
Increase the asset of fixtures debit fixtures account
Increase the liability of shop fitters credit shop fitters account

Fixtures account		shop fitters account	
2013			2013
Aug 3 shop fitters K 1250			Aug 3 fixtures K1250

4) Paid the amount owing to shop fitters in cash on 17 August 2013.

Effects of transaction **action**
Decrease the liability to shop
Fitters debit the shop fitters account
Decrease the asset of cash credit the cash account

9.3 The asset of inventory

Inventory movements

- Increase in inventory

Increases in inventory may be due to the following causes:
(a) The purchase of additional goods
(b) The return into the business of goods previously sold.
To distinguish the two aspects of the increase of inventory of goods, two accounts are opened:
(i)A purchase account in which purchases of goods are recorded
(ii) A returns inwards account in which goods being returned into the business are recorded (this is also called a sales return account)
So for increases in inventory, we need to choose which of these accounts to use to record the debit entry of the transaction

- Decrease in inventory

Decreases in inventory can be due to the following causes
(a) The sale of goods
(b) Goods previously bought by the business now being returned to the supplier
In order to distinguish the two aspects of the decreases in inventory, two accounts are opened:
(i)A sales account to record the value of goods sold
(ii) A return outwards account in which goods returned to suppliers are recorded. (This is also called a purchase returns account).

So for decreases in inventory, we need to choose which of these two accounts to use to record the credit side of the transaction.

Examples

i. purchase of stock on credit

On 1 August 2013, goods costing K165 were bought on credit from D Henry. The dual effects of this transaction are:

(1) Asset of inventory increased; therefore the action is to debit the purchases account.

(2) Liabilities increased; hence the payable's account (D Henry) should be credited.

The entries will be as follows

Purchases account

Debit	
Aug 1 D Henry K165	

D Henry account

	credit
	Aug 1 purchase K165

(b) Purchase of stock for cash

On 2 August 2013, goods costing K310 are bought, cash being paid for them immediately at the time of purchase

In this case the dual effects are:

(1) asset of inventory is increased therefore the purchases account is debited
(2) asset of cash is decreased, hence the cash account should be credited

The entries will be as follows:

Purchases account

Debit	
Aug 2 cash K310	

cash account

	credit
	Aug 2 purchases K310

(c) Sale of inventory on credit

On 3 August 2013, goods were sold on credit for K375 to Mr. Jere.
The dual effects of this transaction are:

(1) An asset receivables increases, therefore the receivables account (Jere) is debited

(2) The asset of inventory decreases; hence the sales account is credited.

The entries are as follows:

Jere account (receivable)

Debit	
Aug 3 sales K375	

sales account

	credit
	Aug 3 Jere K375

(d) Sale of stock for cash

On 4 August 2013, goods are sold for K55, cash being received immediately at the time of sale.

The dual effects of the transaction here are as follows:

(1) the asset cash is increased therefore we debit the cash account

(2) the asset of inventory is reduced , hence the sales account is credited

The entries are as follows:

Cash account

Debit	
Aug 4 sales K55	

sales account

	credit
	cash K55

e) Returns inwards

On August 5th 2013, goods which had been previously sold to Mr. Lowe for K29 are now returned to the business.

Effect of the transaction	Action
1. Asset of stock increase	Debit returns inwards account.
2. Decrease in asset (debtors)	Credit debtors (Lowe) account.

The entries are as follows:

Returns inwards

Debit	Credit
Aug 5th Lowe K29	

Lowe

	Aug returns inwards K29

Om 6th August 2013, goods previously bought for K96 are returned by the business to Mr Lungu.

Effect of transaction	Action
1. The liability creditors decrease.	Debit creditors account.
2. An asset of stock is decreased.	Credit returns outwards account.

Lungu

Debit	
Aug 6th Returns outwards K96	

Returns inwards

	Credit
	Aug Lungu K96

9.4 Double entry for expenses and revenue

Example

a) Rent of K20 is paid in cash.
Here the dual effect is as follows:
   i. The total of the expenses of rent is increased. Expenses entries are shown as debits; therefore the action is to debit the rent account with K200.
   ii. The asset of cash is decreased. This means the cash must be credited with K200 to show the decrease of the asset.

Summary: Debit Rent account with K200.
Credit Cash account with K200.

b) Motor expenses of K355 are paid by cheque.
The dual effect is as follows:
   i. The total for motor expenses paid is increased, hence the action required is to debit the motor expenses account with K355.
   ii. The asset cash in the bank is decreased. This means that the bank account must be credited with K355 to show the decrease of the asset.

Summary: Debit Motor expenses account.
Credit Bank account.

c) K60 cash is received for commission earned by the business.
The dual effect is as follows:
   i. The asset cash is increased; hence a debit entry of K60 is made on the cash account to increase the asset.
   ii. The revenue account, commission received is increased. Revenue is shown by a credit entry; hence the commission received account is credited with K60.

Summary: Debit Cash account with K60.
Credit Commission received with K60.

9.5 Drawings

- Sometimes the owners take cash out of the business for their private use. This is known as drawings.
- Any money taken out of a business will reduce capital. Drawings should be treated as expenses of a business.
- An increase in drawings is a debit entry in the drawings account with the corresponding credit being an asset account such as cash or bank.

NB: In theory, the debit entry should be made in the capital account since drawings decrease capital, However to prevent the capital account becoming full of small transactions, drawings are not entered in the capital account, instead a drawings account is opened.

Example:
On 25th August the owner takes K50 cash out of the business for his own use.
The dual effect of the transaction is as follows:

1) Capital is decreased; hence the drawings account is debited.
2) Cash is decreased and the cash account is credited.

i.e.

Drawings

Cash K 50	

Cash

	Drawings K 50

Exercise1

Prepare the T accounts for the following transactions for the month of June

July	1	started in business with K5000 in the bank and K1000 cash
	2	bought stationery by cheque K75
	3	bought goods on credit from smart K2100
	4	sold goods for cash K340
	5	paid insurance by cash K290
	7	bought a computer on credit from M Jere K700
	8	paid expenses by cheque K32
	10	sold goods on credit to Mr. Mbewe K630
	11	returned goods to smart K550
	14	paid wages by cash K210
	17	paid rent by cheque K225
	20	received a cheque for K400 form Mr Mbewe.
	21	paid Mr. Jere by cheque K700
	23	bought stationery on credit form stationery Ltd K125
	24	paid stationery Ltd by cheque K120

9.6 Balancing off accounts and preparing a trial balance

At the end of the accounting period, all the accounts of the business must be balanced off and the balances from the accounts should be picked up and a trial balance should be prepared.

Balancing off accounts

When balancing the accounts, the following steps should be followed:

(i) Add up both sides of the accounts to find out their totals
(ii) Deduct the smaller total from the larger total to find the balance
(iii)Enter the balance on the side with the smallest total to balance off the two sides of the account. This is called **a balance carried down.**
(iv)Enter the totals on both sides of the accounts which should be equal to balance off the accounts.
(v) Enter the balancing figure which is on the smallest total below the totals on the opposite side. This is called a balance brought down

Example1.

Sales account

	K		K
Balance carried down	753		
		Cash	310

		receivables	123
		cash	320
Total	**753**		**753**
		Balance brought down	753

Example 2

M. Jere account (receivable)

	K		K
Sales	234	cash	234
Sales	125	cash	125
Sales	300	balance carried down	300
Total	**659**		**659**
Balance brought down	300		

9.7 Preparing a trial balance

A trial balance is a list of balances extracted from the accounts. All the debit balances are shown on one column and credit balances on the other column. If the double entry for the transactions has been done properly, the total of all the debit balances must be equal to the total of all the credit balances .Where this is not the case then it means that errors may have been made when recording the transactions.

(a) Total debit entries = Total credit entries.
Under the double entry bookkeeping:
- For each debit entry there is a corresponding credit entry.
- For each credit entry there is a corresponding debit entry.

Therefore all the items recorded in all the accounts on the debit side should equal, in total, to all the items recorded on the credit side of the accounts.

In order to check that for each debit entry there is a credit entry, a trial balance is prepared. This is a list of account balances arranged according to whether they are debit balances or credit balances.

The trial balance always has the date of the last day of the accounting period to which it relates.
It is normal to prepare a trial balance at the end of an accounting period before preparing an income statement and statement of financial position (balance sheet). An **income statement** shows what profit has been earned in a period. A **statement of financial position (balance sheet)** shows what assets and liabilities of a business are at the end of the period.

(b) Trial balances and errors

The fact that the trial balance **'balances'**, does not necessarily mean that all the entries i accounts are correct. There are certain types of errors that will not affect the balancing o a trial balance.
Errors that would be revealed by a trial balance are; addition errors, using one figure for debit entry and another for the credit entry, and entering only one side of a transaction.

(c) Closing inventory

Inventory at the end of a period is not usually found in an account in the ledger. It is found from stock records and physical stocktaking. Since it is not generally found in th ledger, it does not generally appear in a trial balance. However, opening inventory is ofte recorded in a ledger account, so that the inventory balance at the start of a period, would be included in the trial balance prepared at the end of that period.

Example

Enter up the necessary accounts for the month of may from the following transactions relating to a small firm, then balance off the accounts and extract a trial balance as at 31 May 2013

May 1 started business with capital in cash of K800 and K2200 in the bank.
2 bought goods on credit form the following, J Mwase K610, P Gondwe K213, NThindwa K524
4 sold goods on credit to S Chipeta K340, G Lungu K720
6 paid rent by cash K180
9 S Chipeta paid us his account by cheque k340
12 we paid the following by cheque J Mwase K530, P Gondwe K213
15 paid carriage by cash K38
18 bought goods on credit from K Manda K291, D Soko K940
21 sold goods on credit F Bonongwe K810
31 paid rent by cheque K 230

Capital account

	K		K
Balance carried down	3000		
		Cash	800
		Bank	2200
Total	**3000**		**3000**
		Balance brought down	3000

Cash account

	K		K
Capital	800	rent	180
		Carriage	38
		Balance carried down	582
Total	**800**		**800**
Balance brought down	582		

Bank account

	K		K
Capital	2200	J Mwase	530
S Chipeta	340	P Gondwe	213
		Rent	230
		Balance carried down	1567
Total	**2540**		**2540**
Balance brought down	1567		

Rent account

	K		K
Cash	180	balance carried down	410
Bank	230		
Total	**410**		**410**
Balance brought down	410		

Carriage account

	K		K
Cash	**38**	balance carried down	**38**
Balance brought down	38		

Sales account

	K		K
		S Chipeta	340
		G Lungu	720
		F Bonongwe	810
Balance carried down	1870		
Total	**1870**		**1870**
		Balance brought down	1870

S Chipeta

	K		K
Sales	**340**	bank	**340**

G Lungu

	K		K
Sales	**720**	balance carried down	**720**
Balance brought down	720		

F Bonongwe

	K		K
Sales	**810**	balance carried down	**810**
Balance brought down	810		

Purchases account

	K		K
J Mwase	610	balance carried down	2578
P Gondwe	213		
NThindwa	524		
K Manda	291		
D Soko	940		
Total	**2578**		**2578**
Balance brought down	2578		

J Mwase

	K		K
Bank	530	Purchases	610
Balance carried down	80		
Total	**610**		**610**
		Balance brought down	80

P Gondwe

	K		K
Bank	**213**	Purchases	**213**

N Thindwa

	K		K
Balance carried down	**524**	Purchases	**524**
		Balance brought down	524

K Manda

	K		K
Balance carried down	**291**	purchases	**291**
		Balance brought down	291

D Soko

	K		K
Balance carried down	**940**	purchases	**940**
		Balance brought down	940

Trial balance as at 31 May 2013

Account	**Debit**	**Credit**
	K	K
Capital		3000
Cash	582	
Bank	1567	
Rent	410	
Carriage	38	
Sales		1870
Receivables		
G Lungu	720	
F Bonongwe	810	
Purchases	2578	
Payables		
J Mwase		80
N Thindwa		524
K Manda		291
D Soko		940
Total	**6705**	**6705**

SUMMARY OF THE CHAPTER

This chapter tackled aspects of double entry of bookkeeping. Accounting treatment of various elements (including inventory, expenses and revenue) were illustrated. The mechanics of preparing trial balance through this system were also dealt with.

END OF CHAPTER QUESTION

Q1 **Double entry system for financial transactions**

It is known that for the purpose of the accounting equation approach, all the accounts are classified into the following ***five*** *types: assets, liabilities, income/revenues, expenses, or capital gains/losses.*

Required:
Explain how the double entry rules operate through these types of accounts

CHAPTER 10 BALANCING OF ACCOUNTS AND PREPARING A TRIAL BALANCE

10.0 LEARNING OBJECTIVES

By the end of this chapter, students will be able to prepare ledger balances, clearly showing the balances carried down and brought down as appropriate, define and understand the nature of a trial balance and understand the nature and impact of errors and closing inventory on the trial balance, and how these are dealt with.

10.1 Balancing off accounts

Balancing the accounts is done in five stages as follows:

(vi) Add up both sides of the accounts to find out their totals (do not write any thing in the account yet)
(vii) Deduct the smaller total from the larger total to find the balance
(viii) Now enter the balance on the side with the smaller total. The totals will now be equal.
(ix) Enter the totals on both sides of the accounts level with each other.
(x) Now enter the balance on the line below the totals on the opposite side to the balance shown above the totals.

The balance above the totals is described as the **balance carried down (balance c/d)**

The balance below the totals is described as the **balance brought down (balance b/d)**

When the total of the debit side originally exceeded the credit side, the balance is known as a debit balance whereas when the total of the credit side originally exceeded the debit side, the balance is known as a credit balance.

Accounts for creditors and debtors

When balancing the accounts for creditors and debtors there will be two situations, (i) where the account has been fully paid and (ii) where the account has not been paid for in full

1. Where the account has been paid in full

The following example shows how to balance the account when it has been fully paid up
On January 5, 2010 Chisale bought goods from Chibwe Enterprise for K2, 500 and on January 10 he bought further goods from Chibwe Enterprise for K5, 000
On January 16 Chisale paid Chibwe Enterprise the invoice for K2, 500 and the invoice for K5, 000 was paid on 24 January 2010.

In the books of Chibwe Enterprise these will appear as follows:

		Chisale			
Date	Details	Amount	Date	Details	Amount
2010		MK	2010		MK
Jan 5	Sales	2,500	Jan 16	Bank	2,500
Jan 10	Sales	5,000	Jan 24	Bank	5,000
		7,500			7,500
			"Closed off"		

In this situation the account is said to be **closed off.**

2. Where the account is not fully paid for.
In this case one or more invoices are outstanding as in the following example.
In the same month of January 2010 Chibwe Enterprise sold goods to Mayamiko and received a cheque as follows.

January 3 Sales K3, 500
January 8 Sales K2, 300
January 15 Sales K4, 000
January 20 Cheque K5, 800
January 27 Sales K3, 200

The account is recorded as follows:

		Mayamiko			
Date	Details	Amount	Date	Details	Amount
2010		MK	2010		MK
Jan 3	Sales	3,500	Jan 20	Bank	5,800
Jan 8	Sales	2,300	Jan 31	Balance c/d	7,200
Jan 15	Sales	4,000			
Jan 27	Sales	3,200			
		13,000			13,000
Feb 1	Balance b/d	7,200			

The examples above are for accounts for debtors. A similar approach would be followed in respect of creditors, but the balances would be on the opposite sides.

10.2 Preparing a trial balance

A trial balance is a list of balances extracted from the accounts. All the debit balances are shown in one column and credit balances in the next column. If the double entry for the transactions has been done properly, the total of all the debit balances must be equal to the total of all the credit balances..Where this is not the case, it means that errors may have been made when recording the transactions.

Total debit entries = Total credit entries.

Under the double entry bookkeeping:

- For each debit entry there is a corresponding credit entry.
- For each credit entry there is a corresponding debit entry.

Therefore all the items recorded in all the accounts on the debit side should equal, in total, to all the items recorded on the credit side of the accounts.

Total debit balances = total credit balances

The trial balance always has the date of the last day of the accounting period to which it relates.

It is normal to prepare a trial balance at the end of an accounting period before preparing an income statement and statement of financial position (balance sheet). An **income statement** shows what profit has been earned in a period. A **statement of financial position (balance sheet)** shows what assets and liabilities of a business are at the end of the period.

Using the example from the previous chapter, we now balance the accounts and extract a trial balance.

		Cash			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 1	Capital	10,000	Jul 5	Insurance	2,900
Jul 4	Sales	3,400	Jul 14	Wages	2,100
			Jul 31	Balance c/d	8,400
		13,400			13,400
Aug 1	Balance b/d	8,400			

Income account and purchases and expenses are not carried forward????

		Bank			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 1	Capital	50,000	Jul 2	Stationery	750
Jul 20	Mbewe	4,000	Jul 8	Gen. expenses	320
			Jul 17	Rent	2,250
			Jul 21	Jeke	7,000
			Jul 30	Maye Stationers	1,250
			Jul 31	Balance c/d	42,430
		54,000			54,000
		42,430			

		Capital			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 31	Balance c/d	60,000	Jul 1	Bank	50,000
				Cash	10,000
		60,000			60,000
			Aug 1	Balance b/d	60,000

		Stationery			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 2	Bank	750	Jul 31	Balance c/d	2,000
Jul 23	Maye Stationers	1,250			
		2,000			2,000
Aug 1	Balance b/d	2,000			

		Kondwani			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 11	Returns	5,500	Jul 3	Purchases	21,000
Jul 31	Balance c/d	15,500			
		21,000			21,000
			Aug 1	Balance b/d	15,500

		Purchases			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 3	Kondwani	21,000	Jul 31	Balance c/d	21,000
Aug 1	Balance b/d	21,000			

		Sales			
Date	Details	Amount	Date	Details	Amount
2008		MK	2009		MK
Jul 31	Balance c/d	9,700	Jul 4	Cash	3,400
			Jul 10	Mbewe	6,300
		9,700			9,700
			Aug 1	Balance b/d	9,700

		Insurance			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 5	Cash	2,900	Jul 31	Balance c/d	2,900
Aug 1	Balance b/d	2,900			

		Computer			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 7	M Jeke	7,000	Jul 31	Balance c/d	7,000
Aug 1	Balance b/d	7,000			

		M Jeke			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 21	Bank	7,000	Jul 7	Computer	7,000
				"closed off"	

		General expenses			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 8	Bank	320	Jul 31	Balance c/d	320
Aug 1	Balance b/d	320			

		Mbewe			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 10	Sales	6,300	Jul 20	Bank	4,000
			31	Balance c/d	2,300
		6,300			6,300
Aug 1	Balance b/d	2,300			

		Returns outwards			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 31	Balance c/d	5,500	Jul 11	Kondwani	5,500
			Aug 1	Balance b/d	5,500

		Wages			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 14	Cash	2,100	Jul 31	Balance c/d	2,100
Aug 1	Balance c/d	2,100			

		Rent			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 17	Bank	2,250	Jul 31	Balance c/d	2,250
Aug 1	Balance b/d	2,250			

		Maye Stationers Ltd			
Date	Details	Amount	Date	Details	Amount
2009		MK	2009		MK
Jul 30	Bank	1,250	Jul 23	Stationery	1,250
				"Closed off"	

Trial balance as at 31 July 2009		
	DR	CR
	MK	MK
Cash	8,400	
Bank	42,430	
Capital		60,000
Stationery	2,000	
Kondwani		15,500
Purchases	21,000	
Sales		9,700
Insurance	2,900	
Computer	7,000	
General expenses	320	
Mbewe	2,300	
Returns outwards		5,500
Wages	2,100	
Rent	2,250	
	90,700	90,700

10.3 Trial balance and errors

The fact that the trial balance **'balances'**, does not necessarily mean that all the entries in accounts are correct. There are certain types of error that will not affect the balancing of a trial balance.

Errors that would be revealed by a trial balance are; addition errors, using one figure for a debit entry and another for the credit entry, and entering only one side of a transaction.

Closing inventory

Inventory at the end of a period is not usually found in an account in the ledger. It is found from stock records and physical stocktaking. Since it is not generally found in the ledger, it does not generally appear in a trial balance. However, opening inventory is often recorded in a ledger account, so that the inventory balance at the start of a period would be included in the trial balance prepared at the end of that period.

SUMMARY OF THE CHAPTER

This chapter illustrated the five steps towards the balancing of ledger accounts and justified the frequency of balancing of ledger accounts. It also illustrated how ledger balances are derived clearly showing the balances carried down and brought down as appropriate. Then, the nature of a trial balance was explained and how the adjustments to errors and closing inventories are dealt with were explained.

END OF CHAPTER QUESTIONS

Q1 Balancing off accounts and extraction of the trial balance

Enter up the necessary accounts for the month of May from the following transactions relating to a small firm, then balance off the accounts and extract a trial balance as at 31 May 2013

May 1	Started business with capital in cash K8, 000 and K22, 000 at the bank.
May 2	Bought goods on credit from the following: J Mwandama K6, 100, P Gomani K2, 130, N Thindwa K5, 240
May 4	Sold goods on credit to S Chisale K3, 400, G Lungumadzi K7, 200
May 6	Paid rent by cash K1, 800
May 9	S Chisale paid his account by cheque K3, 400
May 12	We paid the following by cheque J Mwandama K5, 300, P Gomani K2, 130
May 15	Paid carriage in cash K380
May 18	Bought goods on credit from K Mandala K2, 910, D Sokosa K9, 400
May 21	Sold goods on credit F Bonongwe K8, 100
May 31	Paid rent by cheque K2, 300

CHAPTER 11 BAD DEBTS AND ALLOWANCES FOR DOUBTFUL DEBTS

LEARNING OBJECTIVES

This section will cover some adjustments that must be made to the accounts in the form of: bad debts and allowances for doubtful debts

11.1BAD DEBTS AND PROVISION FOR DOUBTFUL DEBTS (Uncollectable accounts Receivable): Bad debts arise from credit sales. Customers who buy goods on credit may fail to pay perhaps due to dishonesty, bankruptcy or death. For one reason or another, a business may decide that a debt is uncollectable. Bad debts are a business risk. They are therefore accounted for as normal business expenses. They must be charged to the Income Statement as an expense when calculating profit.

11.2 WRITING OFF UNCOLLECTABLE ACCOUNTS RECEIVABLES:

When a sale is made, the invoiced amount is shown in the trading account and the gross profit earned is shown in the account. Subsequent failure to collect the debt is a separate matter which is reported in the Income Statement as bad debts written off.

ILLUSTRATION

(I) ABC Traders sold goods to John worth K 3000.00 on 29th June 20xx

Account Entry 1	Debit John (Debtor)	K 3000	
	Credit Sales		K 3000

These two entries will subsequently go into the trial balance and be taken to the trading account.

(ii) At the end of the accounting period it ascertained that John will pay not his debt of K 3000

Accounting Entry:	Debit Bad Debts Account	K 3000	
	Credit John		K 3000

When posted the account of John as a debtor will balance off.
The value of John as a debtor becomes zero. The bad debts account reduces the profit that would have been reported during that period.

11.3 BAD DEBTS WRITTEN OFF AND SUBSQUENTLY PAID

Sometimes a debtor who was written off may pay. In such a case the amount received should be recorded as additional income in the Income Statement of the period in which the payment is received. The entries to affect this would be: -

(i)	Cash Received	K 3000	
	John		K 3000
	Recording the receipt of cash asset		
(ii)	John	K 3000	
	Bad debts Recovered		K 3000
	Introducing the Bad Debt recovered Account		
(iii)	Bad Debts recovered Account	K 3000	

Income Statement K 3000
Transferring the amount previously written off to the current Income Statement.

11.4 ALLLOWANCES FOR DOUBTFUL DEBTS

The previous section has assumed that the bad debtor John was a known customer. In most business situations the identities of uncollectable amounts is not known until after some period. When a business expects uncollectable debts but does not yet know which specific debts will be bad, it can make a provision for doubtful debts. A provision for doubtful debts provide for future bad debts as required by the prudence concept.

Determining the size of the Provision

A provision for bad and doubtful debts may be estimated through: -

- **Past experience:** Experience will show how many debtors default payment after a certain period
- **Aging:** A process of aging will show how many debtors remain past the credit period.
- **Percentage of outstanding debtors:** Like experience, businesses have established percentages of defaulting debtors in their respective areas of trade.

(a) Making the Provision

When a provision is made for the first time the initial amount of the provision is charged as an expense in the Income Statement.

ILLUSTRATION

ABC Traders have decided that it will maintain a provision for bad debts of 2% of its outstanding debtors. If this amounts to K 500,0000 the entries would be: -

Debit Income Statement K 500,000
Credit Provision for Doubtful Debts K 500,000
To create a Provision

In the Income Statement the provision of K 500,000 will appear as an expense reducing profit. In the balance Sheet the whole provision will be deducted from debtors.

(b) Increasing the Provision

When a provision already exists but is to be increased, the amount of the increase in the provision is charged in the Income Statement as an expense.

ILLUSTRATION

ABC Traders have decided to increase the provision to K 520,000
Debit Income Statement K 20,000
Credit Provision for Doubtful Debts K 20,000
To increase the provision.

In the Income Statement only K 20,000 would be charged as an expense for the period. In the Balance Sheet K 520,000 (the whole amount) should be deducted from total amount of receivables.

(c) Reducing the Provision

When a provision already exists but there is need to reduce it, the amount of the reduction should be credited to the Income Statement and debited to the Provision Account.

ILLUSTRATION

ABC Traders have decided that that the provision for doubtful debts should be reduced to K 510,000 this year

Entry: Debit Provision for Doubtful debt K 10,000

Credit Income Statement K 10,000

To reduce the Provision. In the Income Statement only K 10,000 will be credited. In the Balance Sheet the whole amount of the revised provision of K 510,000 should be deducted from the total debtors.

SUMMARY

A business cannot avoid losses arising from bad debts: -

- Bad debts should be written off as soon as they are known.
- If a debtor was written off, but subsequently pays his or her debt, the amount received must be added to the Income Statement of the period in which cash was received.
- When the specific debt is not yet known a provision for the general debts must be made through a charge to the Income Statement.
- Changes in the provision will be effected through debiting or crediting the Income Statement with the difference i.e. debiting to increase or crediting to decrease the provision.
- The adjusted provision should be deducted from total accounts receivable in the balance sheet to give a realistic estimate of the net realizable value of the receivables.

SUMMARY OF THE CHAPTER

This chapter illustrated the nature and purpose of the allowance for doubtful debts including how the allowance may be estimated, the accounting entries necessary to recognize the allowance, how the allowance may be increased or decreased and the impact of cash discounts on accounts receivable.

END OF CHAPTER QUESTIONS

Q1 A business has always made an allowance for doubtful debts at a rate of 5% of trade receivables. On 01st January 2013 the allowance for this, brought forward from the previous year, was K260,000.

During the year to 31st December 2013 the bad debts written off amounted to K540,000. On 31st December 2013 the remaining trade receivables totaled K6,200,000 and the usual allowance for doubtful debts should be made.

You are to show:

(a) The Bad Debts Account for the year ended 31 December 2013.

(b) The Allowance for Doubtful Debts Account for the year.
(c) Extract from Income Statement for the year.
(d) The relevant extract from the Statement of Financial Position as at 31st December 2013.

Q2 Discuss why an accountant only need to create an expense for the difference between provisions (allowances) for two years..

CHAPTER 12 DEPRECIATION OF NON – CURRENT ASSETS

12.0 LEARNING OBJECTIVES

This chapter aims at explaining the principle of depreciation of non-current assets. Determining the cost of property, plant and equipment, explaining the nature and purpose of depreciation **and** the different methods of depreciation and their possible effect on income, accounting for the acquisition, disposition and depreciation of non – current assets, describing the reporting of depreciation in the financial statements, and explaining the nature of wasting assets and the different methods of accounting for their depletion are the areas covered.

12.1Classification of non – current assets

Non – Current assets can be grouped into Real Property which includes land and anything attached to it. Personal Property which includes everything else that can be owned other than real property. These are things such as plant, equipment, furniture, motor vehicles, machinery, patents and copyrights.
Non – current assets can also be grouped as tangible and intangible assets. That is those with physical form such as machinery and equipment and intangible assets being those without physical substance like patents, copyrights, leases, franchises, trademarks and goodwill. These are said to be long term because they are expected to bring future economic benefit and have legal status that allow them to be classified as property (except for goodwill).

Long term investments such as Government bonds are shown in the balance sheet under the heading of investments.

Non – depreciable and depreciable assets: Land is non – depreciable because it does not lose its capability to serve its purpose.
Property, plant and equipment are depreciable assets because they wear and tear due to use or as time pass on.

Amortisation is the process of depreciating intangible assets such as patent.
Depletion is the process of depreciating wasting assets such as mines, oil and gas wells, fisheries and timber plots.

12.2The cost of non – current assets

Non – Current Assets may be purchased for cash or on account. The amount at which Non – Current Assets should be recorded in the books of accounts is the total initial outlay needed to put them in use . This includes: -

- Purchase price
- Transportation charges
- Installation costs
- Interest charges
- Any other costs incurred up to the point of placing the asset in service.

Transactions involving the purchase of non – current assets may be recorded by debiting the appropriate asset account and crediting the bank account or appropriate liability account such as Accounts payable, notes payable or mortgage payable. Improvements to property, plant and machinery add value and the total cost of such improvements should be added by debiting the asset.

12.2.1 Depreciation of non – current assets

As is the case with all adjustments in the accounts the main task in attempting to determine net income or loss on a periodic basis is to allocate revenue to the period in which it is earned and to assign expenses to the periods that have benefited from the outlays.
Non – current assets frequently last for many years and accordingly benefit a number of periods. The process of determining and recording the depreciations of most long - term assets is carried out in an effort to assign their cost to the periods that they benefit or serve.
Depreciation is therefore a process of cost allocation and not asset valuation. The net amount of an asset i.e. Cost less depreciation are simply the portions of the original costs which have not yet been allocated to expense. It does not represent current values. It is therefore important to remember that the statement of Financial position does not reflect the current values of a business.

12.3 CAUSES OF DEPRECIATION

Most non – current assets lose their usefulness over time. Depreciation is the allocation of the cost of the long – term assets over future periods expected to benefit from its use. The two major types of depreciation are: -

Physical depreciation: This refers to the loss of usefulness of an asset because of : -

(i) **Deterioration** from age and wear and tear. It is generally continuous though not necessarily uniform from period to period.

(ii) **Erosion, rust, rot and decay:** Assets exposed to the elements may wear out at a fairly regular rate than those that are protected. The speed of deterioration is however related to the extent to which they are used.

Functional Depreciation: This refers to the loss of usefulness because of inadequacy or obsolescence.

(i) **Obsolescence** is the process of becoming out of date. Technological development is bringing new and better and more efficient machines and equipments replacing old ones very fast.

(ii) **Inadequacy:** The growth of a business may bring about a need for bigger machines and equipments

- **Time:** Amortisation is based on the length of time an asset has been used e.g. a lease is based on time, patents are also based on length of time.
- **Extraction:** Depletion is a result of extracting raw materials such as oil, minerals e,t,c.

Information for calculating depreciation
There are many and different ways of calculating depreciation for non – current assets but in all cases the following information is essential: -

1. The cost of the asset
2. The estimated salvage value or scrap value.
3. Estimated economic life of the asset.
4. The rate of depreciation.

All the four items listed above are estimates subject to changes in environmental and personal factors. For instance the salvage value of an asset can not be realistically estimated because of time. It may be many years to come before the asset is disposed. The economic life is influenced by many factors such as usage, or technological developments. The rate of depreciation is dependent upon usage and the environment under which the asset is being used. To sum up therefore it is evident that all the information necessary to calculate the amount of depreciation is subjective.

12.4 METHODS OF CALCULATING DEPRECIATION

The most commonly used methods of calculating depreciation are: -

1. Straight – line method
2. Declining – balance method
3. Sum – of – the – years – digits method
4. Units – of – output method.

Straight – Line Method
This method seeks to allocate the cost of the asset to the estimated economic life in equal amounts. Taking into consideration scrap value, dividing the cost by the number of years as follows: -

$$\frac{\text{COST} - \text{SCRAP VALUE}}{\text{NUMBER OF YEARS}}$$

Straight – Line method is most commonly used. It is easy to calculate

Declining – balance method
This method seeks to allocate larger amounts of depreciation to early years and less as the asset grows older. A rate is calculated using the following formula: -

$$\text{Rate} = (1 - n\sqrt{\ } s \div c) \times 100$$

Where n = number of years of estimated life
s = estimated salvage value
c = original cost

This rate is applied to the declining balance of the cost over the years.

Example
Dandwe manufacturers Ltd purchased a machine on January 1st 20X3 for K 23,000,000. It is estimated to last for four years during which time it will produce 100,000 units of output as follows: -

YEAR 1	50,000 Units
YEAR 2	10,000 Units
YEAR 3	10,000 Units
YEAR 4	30,000 Units

The machine is expected to be sold for K 3,000,000 at the end of year 4. Calculate annual depreciation for four years using: -

(i) Straight – Line – Method
(ii) Declining – Balance – Method

Solution
Straight – Line - Method

$$\frac{K\,23 - k3}{4} = 5$$

Annual depreciation = K5 million.

Declining – Method

$$R = \left(1 - n\sqrt{\frac{s}{C}}\right) X\ 100$$

$$= \left(1 - 4\sqrt{\frac{3}{23}}\right) X\ 100$$

$$= 39,9\%$$

YEAR 1	23X 39.9% = 9477	9.2
YEAR2	(23 – 9.2) = 13.8X39,9	5.5
YEAR 3	(13.8 – 5.5) = 8.3X 39.9	3.3
YEAR 4	(8.3 – 3.3) = 5X39.9	2.0
		20.0
	COST	23.0

NET BOOK VALUE = 23 – 20 = 3.0 Million
The salvage value under Straight – Line method and the net book value under the declining – balance method are not same.

Sum – of – the - years – digits - method
Unlike the declining – balance – Method Sum – Of – The - Year – Digits – Method involves reducing the rate of depreciation steadily by using the – sum – of – the – digits as denominator. For example if the asset is estimated to last for four years the denominator for each year will be 4+ 3 + 2 + 1 = 10 or

$$S = N\frac{(n+1)}{2} = 4\frac{(4+1)}{2} = 4\,(2.5) = 10$$

Using the example in Dandwe Manufacturing Company, depreciation for the machine over its four year life would be as follows: -

YEAR	COST MILLION	RATE	ANNUAL DEPRECIATION	CUMULATIVE
1	K 23	4/10	9.2	9.2
2	K 23	3/10	6.9	16.1
3	K 23	2/10	4.6	20.7
4	K 23	1/10	2.3	23.0

Units of – Output or Units – of – Production or Machine – Hour – Method

These methods allocate the cost to the unit of output in a given period or allocate to an hour of production.

12.5 CHOOSING A DEPRECIATION METHOD

There is no depreciation method that is better than the other. All methods have different characteristics which may be preferred by business operators. For instance : Straight – Line – Method is easy to calculate and understand. It allocates equal amounts to all years of the assets economic life.
Declining – Balance – Method is more difficult to calculate. It depreciates an asset more during its early years than later years.
Sum – of – the – digit – Method allocate more depreciation to early years.

12.6 ACCOUNTING FOR DEPRECIATION

T he aim of accounting for depreciation is to allocate and reflect the cost of a non – current asset in the general profit and determining process in the business.
Depreciation is usually calculated at the end of an accounting period along with other necessary adjusting entries.
An expense account may be opened for each asset but it is common to have a summary of assets with related accumulated depreciation account.
In the normal course of events the only entries made in the accumulated depreciation account are those made at the end of each period to record the depreciation for the period ended.

Double Entry

Once the amount of depreciation for an asset has been established for the period the following entries are made: -

1. Debit the comprehensive income statement with the amount of depreciation for the year Credit the accumulated provision for depreciation account
2. The accumulated balance in the accumulated account will then be used to arrive at the book value of the asset at the end of each accounting period.
3. The asset account remains unchanged unless there have been any disposals or additions. It will be closed once the asset is fully depreciated or disposed.

Example

Using the information in Dandwe Manufacturing Company the accounts using Straight – Line – Method would be as follows; -

MACHINE ACCOUNT

ACCUMULATED PROVISION FOR DEPRECIATION ACCOUNT

YEAR	MONTH				YEAR	MONTH			
1	DEC.	31	Balance c/d	K 5 million	1	DEC	31	Income Statement	K 5 Million
2	DEC.	31	Balance c/d	K 10 Million	2	JAN	1	Balance b/d	K 5 Million
				______________	2	DEC	31	Income Statement	K 5 Million

K 10 Million

K 10 Million

3 DEC. 31 Balance c/d K 15 Million 3 JAN 1 Balance b/d

K 10 Million

DEC 31 Income Statement

K 5 Million

K 15 Million

K 15 Million

4 DEC. 31 Balance c/d K 20 Million 4 JAN 1 Balance b/d

K 15 Million

DEC. 31 Income Statement

K 5 Million

K 20 Million

K 20 Million

5 JAN 1 Balance b/d

K 20 Million

By comparing the balance in the Machine Account with any credit balance in the accumulated depreciation account the business can tell the book value of its assets at the end of each period.

CHANGES IN NON – CURRENT ASSET

Asset of a business may increase through purchase of new ones or revaluation of the existing ones. In such cases depreciation is going to be based on the new values as shown in the asset account.

DISPOSITION OF NON – CURRENT ASSETS

Long term assets may be disposed of in any one of the following ways: -

1. It may be discarded or retired
2. It may be sold
3. It may be exchanged or traded in for an asset of similar kind.

When an asset is to be disposed the following steps must be taken: -

1. Identify the value of the asset as recorded in the asset account (Historical Cost)
2. Credit the asset account and debit a disposal account with the historical cost of the asset
   .Debit: Disposal Account
   Credit: Asset Account
3. Identify the accumulated depreciation of the asset to the date of disposal.
4. Debit the Accumulated depreciation account and credit the disposal account with the amount.
   Debit: Accumulated Provision for Depreciation
   Credit: Disposal Account
5. Debit a cash account and credit the disposal account.
   Debit: Cash Account
   Credit: Disposal Account with the cash received on disposal end result.

In Point 2 : The asset account will be cleared of the asset cost having transferred the amount to the disposal account.

Point 4: The depreciation amount associated with the disposed asset is transferred to the disposal account to determine the book value of the asset.

Point 5: In the disposal account the difference between historic cost (Debit) and accumulated depreciation plus cash received will be profit or loss on the disposal of the asset.

Illustration

The following information relate to the activities of ABC Manufacturer L~~td~~ during the year ending 31st December 20X3 : -

1. On 16th March, weighing scales with an original cost of K 100,000 and K 75,000 accumulated depreciations respectively were discarded.
2. On 5th May, a machine costing K 300,000 was purchased, depreciation is at the rate of 10% (Full year's depreciation) for the year of purchase.
3. One machine costing K 300,000 which had been bought 3 years ago was sold for K 225,000. A second similar machine which was bought at K 300,000 was sold for K 175,000, depreciation for both machines was 10%.

Required:

Draw journal entries to show the disposal of these assets

Solution

Journal Entries

		Dr	Cr
1.	Accumulated depreciation	K 75,000	
	Loss on discarded asset	K 25,000	
	Weighing scales		K 100,000
	To record the disposal of an asset at no value.		
2.	Statement of Comprehensive Income	K 30,000	
	Accumulated depreciation		K 30,000
	To record depreciation charge for the year of purchase		
3(a)	Bank	K 225,000	
	Accumulated depreciation	K 90,000	
	Disposal of office equipment		K 300,000
	Gain as sale of asset at a profit		K 15,000
	To record the sale of an asset at a profit		
3 (b)	Bank	K 175,000	
	Accumulated depreciation	90,000	
	Loss on sale of asset	35,000	
	Machine account		K 300,000
	To record the sale of an asset at a loss.		

12.7 TRADE – IN OR EXCHANGE OF NON – CURRENT ASSETS

If an asset is traded – in on purchase of another, a trade – in allowance may be granted. The value agreed upon by the buyer and seller is known as fair market value. The trade – in allowance may be equal to, greater, or less than the undepreciated cost of the asset. The allowance, however does not reflect fair market values of assets so that losses and gains arising from trade – in allowances may not be an accurate measurement of a situation

Types of trade - ins

(a) In a transaction which involves trading – in similar assets losses are recognized but not gains i.e following the concept of conservatism (prudence).

Example

A delivery truck bought 3 years ago costing k 56,000.00 is being traded for another similar one. Accumulated depreciation on the old truck is K 48,000.00 and the fair market value of the new one is K 70,000.00. K12,000.00 has been granted as trade – in allowance.

Solution – similar asset

- Book value of the old truck= K 56,000 – 48,000= K 80,000
- Cash paid for the new truck= K 70,000 – 12,000= K 58,000
- Gain on trade – in = K 12,000 – 8,000= K 4,000

For accounting purposes the depreciable amount of the new truck is the sum of the undepreciated cost of the old truck and the cash paid for the new truck i.e. (K 8,000 + 58,000 = K 66,000)

Journal entries for this transaction would be as follows: -

Delivery equipment (New Truck)	K 66,000	
Accumulated depreciation old delivery truck	K 48,000	
Delivery truck (old)		K 56,000
Bank		K 58,000

To record the purchase of a new truck on trade – in basis.

Note that the gain on trade – in of K 4,000 has not been recognized.

Loss on trade – in

If the fair market value of the asset had been K 65,000 instead of K 70,000 the trade – in value of the old asset would have been K 7,000 instead of K 8,000 and a loss of K I,000 would have been recognized as follows: -

Delivery equipment (new truck)	K 65,000	
Accumulated depreciation (old truck)	K 48,000	
Loss on exchange of truck	K 1,000	
Delivery equipment (old truck)		K 56,000
Bank		K 58,000

To record the purchase of a new truck on trade – in basis.

(a) In a transaction involving a dissimilar asset any gain or loss resulting from the transaction should be recognized and recorded in the accounts.

Example

A threshing machine costing K 250,000.00 charged to the office equipment account, had K 50,000 accumulated depreciation credited to the accumulated depreciation account for two years. At the end of that period the machine was traded – in on new cash register costing

K 575,000. The trade – in allowance was K 170,000 and the balance of K 405,000 was paid in cash.

Solution

The entries for this transaction would be : -

Office equipment (cash register)	K 575,000	
Accumulated depreciation	K 100,000	
Office equipment (threshing machine)		K 250,000
Bank		K 405,000
Gain on exchange of office equipment		K 20,000

To record the purchase of a new cash register on exchange.

Had the trade – in allowance been less than the undepreciated cost of the threshing machine the difference would have been reported as a loss on exchange of office equipment.

12.8 WASTING ASSETS

A wasting asset is any real property which is acquired for the purpose of removing or extracting the valuable natural resource on or in the property. Examples of wasting assets are wood lots, mines, oil wells, or any property out of which the valuable product is expected to be eventually removed or exhausted.

Depletion

The consumption and exhaustion of wasting assets is called depletion. Information necessary for computation is: -

Cost of the asset

Estimated quantity of deposits or resources

Unit cost of the deposits

Depletion expenses would be : -

COST ÷Estimated Quantity OF Output x Unit Cost

12.9 SUMMARY

1. Depreciation is the process of allocating the cost of a non – current asset to unit of output.
2. It is a measure of the wear and tear of a non – current asset through usage and passage of time.
3. Depreciation is subjective because it is influenced by changing and different conditions under which the asset may be used.
4. It is a non – cash expense hence it does not provides funds for replacement of assets although it is generally referred to as a provision for depreciation.
5. Non – current assets are recorded at cost in the books of accounts. Any changes in these amounts are reflected through an accumulated depreciation account.
6. There are many methods of depreciation but commonly used are the Straight – line method and the reducing – balance method.
7. As asset is fully depreciated when the recorded depreciation equal to the cost of the asset. Since depreciation is based on the estimated useful life, an asset may still be in use after it has been fully depreciated .
8. Depreciation affects profit measurement because the annual depreciation is charged as an expense in the statement of comprehensive income.
9. At the end of its useful life the asset may be scrapped without residual value, sold or traded – in for another similar or dissimilar asset. In such cases a loss or gain on disposal may be made and charged to the Income Statement.

END OF CHAPTER QUESTIONS

Q1 A company, which makes up its accounts annually to 31st December, provides for depreciation of its machinery at the rate of 10 percent per annum on diminishing balance system. On 31st December 2013, the machinery consisted of three items purchased as under:

	K
On 1 January 2011 Machine A	*Cost 3,000,000*
On 1 April 2012 Machine B	*Cost 2,000,000*
On 1 July 2013 Machine C	*Cost 1,000,000*

Required:
Provide calculations showing the depreciation provision for the year 2013

Q2 Explain how the unit of output method is used in estimating depreciation amounts. Give an example of its use.

CHAPTER 13 ACRUALS AND PREPAYMENTS

13.0 LEARNING OBJECTIVES

By the end of this chapter, you should be able to:

i. Define the terms accruals and prepayments
ii. Explain why we include accruals and prepayments in the financial statements

13.1ACRUALS AND PREPAYMENTS

The accruals basis of accounting consists of recording revenue in the period in which it is earned and recording expenses in the period in which they are incurred. The receipt or disbursement of cash in the same period may or may not be involved. Revenue is generally recognized when services are performed or goods are provided, and is considered to be earned when in exchange for something of value is received or legal claim is made.

Expenses should be recognized when goods or services are consumed. The accruals basis of accounting involves the period – by – period matching of revenue with expenses that caused or aided in producing that revenue. In keeping business records, accountants must think in terms of time intervals and must be sure that the revenues and expenses are accounted for in the proper accounting period.

PREPAID EXPENSES

A prepaid expense is an item that was purchased and considered to be an asset when acquired but which will be consumed or used up in the near future and thus become an expense.

Purchase of various sorts of supplies and payments for utilities and insurance are good examples of prepaid expenses. At the end of the period, the portions of such assets that have expired or have been consumed must be determined and entries made by debiting the proper expense accounts and crediting the proper prepaid expense accounts.

ILLUSTRATION

ABC Traders purchased office supplies for K 7,500 and a three year fire insurance policy for K 3,000

The entry would be: -

Debit Office Supplies	K 7,500	
Debit Prepaid Insurance	K 3,000	
Cash		K 10,500

To record the purchase of Office Supplies and Insurance

At the end of accounting period a physical count indicated that there was K 1,250 worth of office supplies on hand. The insurance policy covering the current year has been (K 3,000/3) K 1,000.

Entries for prepaid expenses are as follows: -

Office Supplies Expenses	K 6,250	
Office Supplies		K 6,250
To record office supplies used		
Insurance Expense	K 1,000	
Prepaid Insurance		K 1,000
To record expired insurance for the year.		

The value of accruals and prepayments for items which relate to a period of time is found by apportioning the cost of the item on time basis. Unless the period of time covered by these payments coincides exactly with the accounting period, adjustments are needed to take account of the assets created where payments are made in advance, and the liability which arises when benefits are paid for in arrears.

PREPAYMENT EXAMPLE

ABC Traders LTD makes up its accounts to 31^{st} December. The company made up the following cash payments in respect of rates: -

YEAR	MONTH	PAYMENT
20X0	OCTOBER	K 9,000
20X1	APRIL	K 10,000
20X1	OCTOBER	K 10,000

The prepayments for rates relate to the six months period starting the month in which they are paid.

Required:

Prepare a rates account for the year 20x1

SOLUTION

RATES ACCOUNT

(1) Jan 20x1	b/d	4,500	31.12.20x1	C/d	5,000
April	Cash	10,000	Income Statement		19,500
October	Cash	10,000			
		24,500			24,500
(2) Balance	b/d	5,000			

(i) The balance brought down at the start of year is half of payment of K 9,000 made in October 20x0 covering three months to March.

(ii) The balance of K 5,000 carried down at the end of year 20x1 is an asset since it is payment in advance for the first three months of 20x2.

EXAMPLE

Kamphunga LTD makes up his accounts to December 31. The following payments were made in respect of electricity.

YEAR	MONTH	PAYMENT
20X0	OCTOBER	K 40,000
20X1	JANUARY	K 60,000
20X1	APRIL	K 63,000
20X1	JULY	K 40,000
20X1	OCTOBER	K 50,000
20X2	JANUARY	K 75,000

The payments are for electricity consumed during the three months immediately prior to the months in which they are made.

Required

Record the above transactions in the Company's electricity account for 20x1 and 20x2

Solution

ELECTRICITY ACCOUNT

20X1			1.1.20x1	Balance c/d	K 60,000
January	Cash	60,000			
April	Cash	63,000			
July	Cash	40,000			
October	Cash	50,000			
31.12.20x1	Balance c/d	75,000	31.12.20x1	Income Statement	K 228,000
		K 288,000			K 288,000
20x2					
January	Cash	75,000	1.1.20x1	Balance b/d	75,000

(1)The credit balance of K 60,000 brought down would have been a liability at 31st December 20x0 shown in the balance sheet. It relates to electricity consumed in the last three months of 20x0 payments for it was made in January 20x1.

13.2 ACCRUED INCOME

The accrued basis concept of accounting states that revenue is recognized in the accounting period in which it is earned and expenses are recognized in the accounting period in which they are incurred. Accrued income is income earned but not received during an accounting period i.e. amount owed or where a business receives income other than sales revenue it may have earned some income.

For Example

Accrued interest may be interest payable or interest receivable. Accrued rent may be rent payable or rent receivable. One is an expense the other is revenue.

13.3 OTHER CONSIDERATIONS

The combined effect of the realization and matching concepts plus the accruals basis concept provide some assurance that income is accurately measured.

Under the accruals basis concept

(I) Expenses may be paid for in advance (prepayments) or in arrears (accrued).

(II) Similarly revenue may be received in advance or be accrued.

(III) Debit closing balances in an expense account represent an outstanding balance of a prepayment. It is an asset shown as a current asset in the balance sheet.

(IV) Credit closing balances in an expense account represent an outstanding balance in amount owing. It is a liability and appears as a current liability in the balance sheet.

SUMMARY OF THE CHAPTER

This chapter illustrated the nature and purpose of Prepayments and accruals.(This should be beefed up)

END OF CHAPTER QUESTIONS

Q1 Indicate the placement of prepayments in the current assets sequence.

Q2 Indicate the placement of accruals in the current liabilities sequence.

Q3 During the year ended 28th February 2014, Ndazizwa bought some packaging materials for K2,200,000 and there were materials in hand at the year-end of K400,000
Required:
Prepare the packaging materials account for Ndazizwa for the year ended 28th February 2014 and explain how the balance on account will be treated in the Statement of Financial Position.

CHAPTER 14: STATEMENT OF PROFIT OR LOSS

Learning Outcomes:

By the end of this chapter, you should be able to:

i. Explain the importance of the statement of profit or loss
ii. Prepare the statement of profit or loss with all the adjustments

14.1 Introduction to Financial Statements

You learnt in chapter one that accounting is a process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. This process is shown in figure 1. By now you have looked at the first five stages shown in the figure. The communication aspect that has been mentioned in this definition is the same as stage six in the figure. This is the last step in the definition of accounting. It refers to the preparation and presentation of financial statements. Financial statements ensure that the economic information is communicated to users in an effective manner.

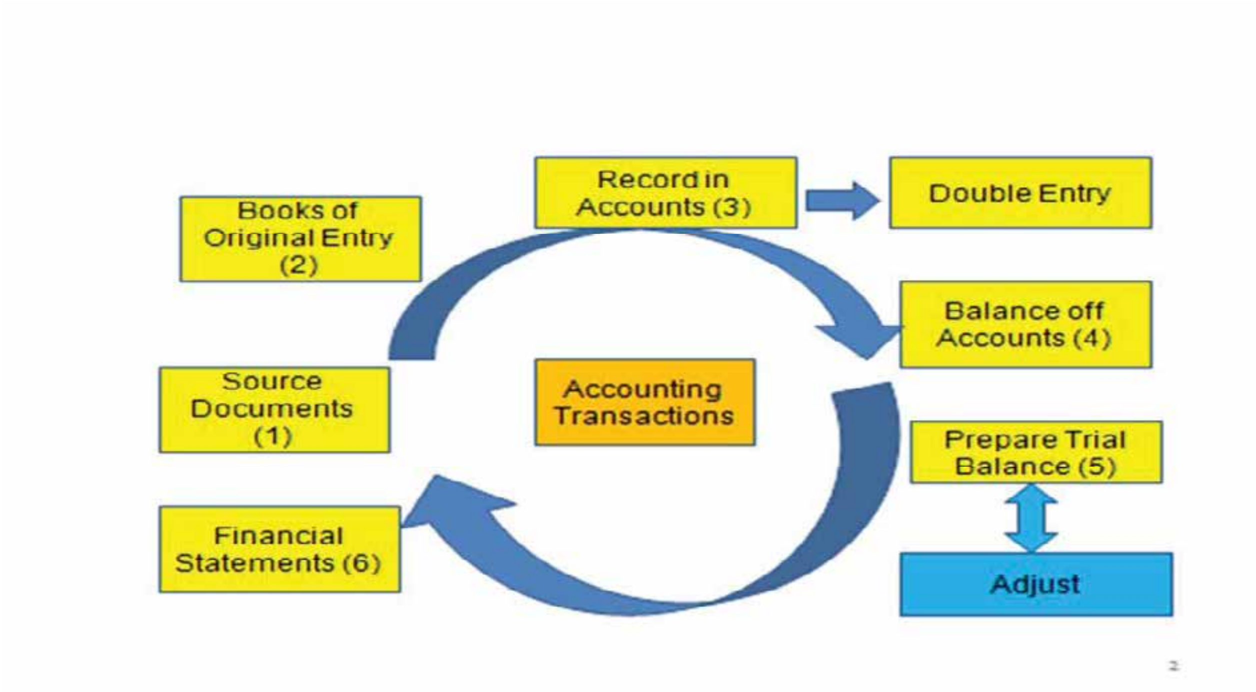


Figure 14.1: The Accounting Process

The statement of income or loss is one of the components of financial statements which we should prepare and present to the users of accounting or economic information.

14.2 Purpose of Statement of Income or Loss

Businesses are set up for the sole reason of making profits. It is important for the owners of businesses to check whether they are making profits or not. The statement of income or loss is prepared in order to assess if the business is making profits or losses in a given period. This is referred to as financial performance of a business. This statement is prepared for a period and not as at any particular point in time.

14.3 Statement of Income or Loss Format

The statement of income or loss has two components:

- Trading account
- Profit and loss account

14.3.1 Trading Account

This section focuses on the revenue from the sale of goods and the cost of the goods which have been sold. The difference between the sales figure (revenue) and the cost of goods is called gross profit. Gross profit is an indicator of the initial profit earned by a business. If the cost of goods sold is greater than the sales figure, the outcome will be a gross loss. Normally, businesses should have gross profits. The profits will enable the organisations to cover non-trading expenses.

The cost of goods sold is made up of opening inventories and purchases made in the period less closing inventories. Closing inventories, which are unsold inventories during a period, are not included in the cost of goods sold because they have not been sold. Closing inventories will become opening inventories in the following year. They will be part of the cost of goods sold in the period in which they will be sold.

Example 1

Atate made sales of K1,000,000 for the period ended 31 December 2012. Opening inventories amounted to K20,000, purchases K500,000 and closing inventories K80,000. You are required to prepare a trading account for the period ended 31 December 2013.

Solution

Atate

Trading account for the year ended 31 December 2012

	K	K
Sales		1,000,000
Opening inventories	20,000	
Add : Purchases	500,000	
Less : Closing inventories	(80,000)	
Cost of goods sold		(440,000)
Gross profit		560,000

Please note that opening inventories and purchases represent the cost of goods available for sale. Closing inventories then removed to establish the cost of goods sold.

14.3.2 Profit and Loss Account

Once the gross profit has been calculated in the trading account, the next step is to consider all the expenses not related to the trading activities. The net profit is calculated in this section. The net profit is the difference between gross profit and the other expenses. This figure is very important when assessing the financial performance of a business.

Expenses to be included in the preparation of the profit and loss account would have been included in the trial balance as shown in figure 1. So these expenses will be isolated from the trial balance prepared for the period.

Example 2

Continuing from example 1, Atate had the following expenses in the year ended 31 December 2012:

General expenses	K40,000
Lighting expenses	K80,000
Rent	K190,000

You are required to prepare a profit and loss account for Atate for year ended 31 December 2012.

Solution

Atate

Profit and loss account for the year ended 31 December 2012

	K	K
Gross profit		560,000
General expenses	40,000	
Lighting expenses	80,000	
Rent	190,000	
Total expenses		(310,000)
Net profit		250,000

A complete income statement for Atate for the period ended 31 December 2013 will be as follows:

Atate

Statement of Income or Loss for the year ended 31 December 2013

	K	K
Sales		1,000,000
Opening inventories	20,000	
Add : Purchases	500,000	
Less : Closing inventories	(80,000)	
Cost of goods sold		(440,000)
Gross profit		560,000
General expenses	40,000	
Lighting expenses	80,000	
Rent	190,000	
Total expenses		(310,000)
Net profit		250,000

14.4 Other Issues

14.4.1 Net Profit for the Year

Net profit belongs to the owners of the businesses. Therefore, the net profit increases capital. However, the capital figure will not be increased to show an increase in capital. You should only increase the capital figure when the owners of the business have injected additional capital in the business. The relationship between capital and net profit will become clear when we will be looking at the other component of financial statements, the statement of financial position.

14.4.2 Returns

In chapter 5, you covered returns inwards (sales returns) and returns outwards (purchases returns) day books. Returns inwards reduce the sales figure in the trading account. Returns outwards are subtracted from the purchases figure. Returns inwards and outwards are also recorded in the trial balance for the period.

Example 3

The following is an extract of the trial balance of Atate as at 31 December 2013.

	Dr	Cr
	K	K
Sales		1,000,000
Purchases	500,000	
Returns inwards	90,000	
Returns outwards		60,000

You are required to prepare a trading account for the period ended 31 December 2013.

Solution

Atate
Trading account for the year ended 31 December 2013

	K	K
Sales		1,000,000
Less: Returns inwards		(90,000)
		910,000
Purchases	500,000	
Less : Returns outwards	(60,000)	
Cost of goods sold		(440,000)
Gross profit		470,000

14.4.3 Carriage

When businesses have purchased inventory, they need to transport the inventories to the business premises. In the course of doing this, the businesses incur costs. These costs are called carriage inwards. In the trading account, carriage inwards is added to purchases.

As part of a marketing strategy, businesses may deliver goods to customers. In this case the business incurs costs. These costs are called carriage outwards. Carriage outwards are recorded as expenses in the profit and loss account.

14.4.4 Accruals and Prepayments

In chapter 13 you looked at how to account for accruals and prepayments. Accruals increase the respective expense items while prepayments reduce the respective expenses. This ensures that all the period expenses should be recorded as expenses in that period.

14.4.5 Depreciation

You have learnt that depreciation is an expense. As such depreciation charge for the period should be recorded as an expense in the profit and loss account.

14.4.6 Allowances for Receivables and Irrecoverable Debts

You will recall that irrecoverable debts (bad debts) are treated as expenses in the profit and loss account. Increases in the allowance for receivables (provision for doubtful debts) are recorded as expenses in the profit and loss account. On the other hand, decreases in the allowance for receivables are treated as income and so are added to gross profit in the profit and loss account.

14.5 Comprehensive example

The following balances were extracted in the books of Atate Hawkers as at 31 December 2013.

	K
Loan from Financial Solutions Ltd	5,000
Capital as at 1 January 2013	25,955
Drawings	8,420
Cash at bank	3,115
Cash in hand	295
Trade receivables	12,300
Trade payables	9,370
Inventory as at 31 December 2012	23,910

Inventory as at 31 December 2013	47,475
Motor vehicle at cost	4,100
Office equipment	6,250
Sales	130,900
Purchases	92,100
Returns inwards	550
Carriage inwards	215
Returns outwards	307
Carriage outwards	309
Motor expenses	1,630
Rent paid	3,320
Rent payable	350
Telephone expenses	405
Wages and salaries	12,810
Insurance	492
Office expenses	1,377
Sundry expenses	284

The statement of income or loss will be presented as follows:

Atate Hawkers

Statement of Income or Loss for the year ending 31 December 2013

	K	K	K
Sales			130,900
Less returns inwards			(550)
			130,350
Opening inventory		23,910	
Add purchases	92,100		
Add carriage inwards	215		
	92,315		
Less returns outwards	(307)		
		92,008	
		115,918	
Less closing inventory		(47,475)	
Cost of sales			(68,443)
Gross profit			61,907
Less other operating expenses			
Carriage outwards		309	
Motor expenses		1,630	
Rent		3,320	
Telephone expenses		405	
Wages and salaries		12,810	
Insurance		492	

Office expenses	1,377	
Sundry expenses	284	
Total expenses		(20,627)
Net operating profit		**41,280**

Note that other figures have not been used in the preparation of the statement of income or loss. These figures will be used when we will be looking at the statement of financial position.

14.5 Chapter Summary

In this chapter you have looked at the purpose and preparation of the statement of income or loss. You have learnt that you need to make adjustments in order to establish a proper income statement. Some of the adjustments include allowances for receivables and irrecoverable debts, depreciation, accruals and depreciation.

Exam Based Question

HKJ Trading is in a business of trading in various merchandise. The trial balance for the year ended 30 November 2013 is as follows:

	Dr	Cr
	K	K
Sales		820,000
Return inwards	25,000	
Purchases	465,000	
Carriage inwards	15,000	
Carriage outwards	40,000	
Salary and wages	60,000	
Return outwards		30,000
Insurance costs	20,000	
Advertisements	60,000	
Rates	10,000	
Rent	35,000	
Capital		500,000
Opening inventories	80,000	
Motor van (cost)	400,000	
Motor van (accumulated depreciation)		120,000
Furniture and fittings (cost)	300,000	
Furniture and fittings (accumulated depreciation)		100,000
Receivables	180,000	
Drawings	40,000	
Bank		50,000

Payables		120,000
Discount allowed	10,000	
	1,740,000	1,740,000

Additional information:

(1) Closing inventories as at 30 November 2013 were K90,000

(2) Depreciation charges

Motor van	20% on reducing balance method
Equipment	10% on straight line method

(3) Accrued insurance for the year K6,000

(4) Prepaid rent for the year was K5,000

(5) Provision for doubtful debts has been set at 3% of the receivables

Required:

Prepare the Statement of Income or Loss for HJK Trading for the year ended 30 November 2013.

(Adapted from PAEC FA4 Exam December 2009)

CHAPTER 15: STATEMENT OF FINANCIAL POSITION

Learning Outcomes:

By the end of this chapter, you should be able to:

i. Prepare a statement of financial position

15.1 Purpose of the Statement of Financial Position

You will recall that the last step in the accounting process is the production of financial statements. A statement of financial position is one of the components of financial statements which should be prepared as one way of communicating financial information. The statement of financial position shows the position of a business at any particular point in time. Financial position is presented in terms of the business's assets, liabilities and capital.

15.2 Format of a Statement of Financial Position

The statement of financial position contains assets, liabilities and capital of a business.

Assets

Assets represent resources which are owned by the business. When preparing the statement of financial position, assets are grouped into two:

- Non-current assets and;
- Current assets

Non-current assets

Non-current assets are assets which are expected to be used by the organization for a long period of time in the course of generating revenue or income for the business. The business will benefit through the use of these assets for a long period of time. The intention of the business is to use the assets and not necessarily reselling them. Land, buildings, fixtures, plant and machinery are the examples of non-current assets.

You should remember that non-current assets are generally depreciated. However, there are other non-current assets which are not depreciated. An example of such assets is land. Depreciation has been covered in chapter 12.

Current assets

Current assets are assets that are held only for a short time and are certainly going to change their form within twelve months of the date of the statement of financial position. These assets are not depreciated. Examples of current assets are inventories, trade receivables, cash at bank and cash in hand.

Current assets are presented in the statement of financial position according to their liquidity. Liquidity means the easiness of current assets when they are being converted into cash. So we start with those current assets that are furthest away from being converted into cash and finish with the cash itself.

The order of presenting current assets will be as follows:

i. Inventory
ii. Accounts receivable
iii. Cash at bank
iv. Cash in hand

Liabilities

Liabilities represent obligations which the business expects to settle. Liabilities are also classified into two:

- Current liabilities
- Non-current liabilities

Current liabilities

Current liabilities are obligations that must be paid within a year from the end of the previous accounting period. Examples of current liabilities are accounts payables and bank overdrafts.

Non-current (long-term) liabilities

Non-current (long-term) liabilities are obligations that will be paid in a period of more than one year from the end of the previous accounting period. They include loan notes/debentures and bank loans

Capital

Capital represents money and other resources put into the business by the owner. The net profit for the year increases capital. On the other hand, drawings (amounts withdrawn by the owner from the business for personal use), reduce capital. When preparing the statement of financial position, assets are equal to capital plus liabilities. You will recall that this is the accounting equation.

15.3 Example

The following balances were extracted from the books of Atate Hawkers as at 31 December 2013.

	K
Loan from Financial Solutions Ltd	5,000
Capital as at 1 January 2013	25,955
Drawings	8,420
Cash at bank	3,115
Cash in hand	295
Trade receivables	12,300
Trade payables	9,370
Inventory as at 31 December 2012	23,910
Inventory as at 31 December 2013	47,475
Motor vehicle at cost	4,100
Office equipment	6,250
Sales	130,900
Purchases	92,100
Returns inwards	550
Carriage inwards	215
Returns outwards	307
Carriage outwards	309
Motor expenses	1,630
Rent paid	3,320
Rent payable	350
Telephone expenses	405
Wages and salaries	12,810
Insurance	492
Office expenses	1,377
Sundry expenses	284

The statement of financial position of Atate Hawkers will be as follows:

Atate Hawkers
Statement of financial position as at 31 December 2013

	K	K
Non- current assets		
Motor vehicles		4,100
Office equipment		6,250
		10,350
Current assets		
Inventory	47,475	
Trade receivables	12,300	
Cash at bank	3,115	
Cash in hand	295	
		63,185
Total assets		73,535
Capital and Reserves		
Capital at 1 January 2003		25,955
Add net profit for the year		41,280
		67,235
Less drawings		(8,420)
		58,815
Long term liabilities		
Loan from Blue Co Ltd		5,000
Current liabilities		
Trade payables	9,370	
Other payables-rent	350	
		9,720
Total capital and Liabilities		73,535

15.4 Chapter Summary

This chapter has focused on the preparation of the statement of financial position. You have leant that the purpose of this statement is to show the financial position of a business as at any particular point in time in terms of assets, liabilities and capital.

Exam Based Question

HKJ Trading is in a business of trading in various merchandise. The trial balance for the year ended 30 November 2013 is as follows:

	Dr	Cr
	K	K
Sales		820,000
Return inwards	25,000	
Purchases	465,000	
Carriage inwards	15,000	
Carriage outwards	40,000	
Salary and wages	60,000	
Return outwards		30,000
Insurance costs	20,000	
Advertisements	60,000	
Rates	10,000	
Rent	35,000	
Capital		500,000
Opening inventories	80,000	
Motor van (cost)	400,000	
Motor van (accumulated depreciation)		120,000
Furniture and fittings (cost)	300,000	
Furniture and fittings (accumulated depreciation)		100,000
Receivables	180,000	
Drawings	40,000	
Bank		50,000
Payables		120,000
Discount allowed	10,000	
	1,740,000	1,740,000

Additional information:

(1) Closing inventories as at 30 November 2013 were K90,000

(2) Depreciation charges

Motor van	20% on reducing balance method
Equipment	10% on straight line method

(3) Accrued insurance for the year K6,000

(4) Prepaid rent for the year was K5,000

(5) Provision for doubtful debts has been set at 3% of the receivables

Required:

Prepare the statement of financial position for HJK Trading as at 30 November 2013.

(Adapted from PAEC FA4 Exam December 2009)

CHAPTER 16: CLOSING INVENTORY VALUATION

Learning Outcomes:

By the end of this chapter, you should be able to:

i. Explain the methods of valuing inventory
ii. Explain the advantages and disadvantages of inventory valuation methods
iii. Value inventory
iv. Explain the inventory taking methods

16.1 Inventory valuation

You noted in chapter 14 that calculation of cost of goods sold in the trading account takes into account of opening and closing inventories. In this chapter, you will learn how to value inventories.

Valuation of inventories is important for the following reasons:

- It enables businesses to establish the value of closing inventories
- Values attached to inventories form a basis for setting selling prices
- It facilitates the calculation of cost of sales and profits

You can see that inventory valuation is important when preparing financial statements as the above reasons affect either the income statement or the statement of financial position.

Historical costs are generally used in the valuation of inventories. Historical costs are the costs which were incurred to produce or purchase inventories. The main ways of determining the historical cost of inventory are:

i. First In First Out (FIFO) method
ii. Average Cost (AVCO) method

16.1.1 First In First Out (FIFO)

This method assumes that the first components of inventory to be brought into stock are the first ones to be sold out or issued out to production in the case of a manufacturing business.

The FIFO method is logical in the sense that it portrays what should happen in practice; goods acquired first should be used first. The method is very easy to use. It is also recommended by International Accounting Standard (IAS 2) *Inventories*.

However, the assumption that the inventories which have been acquired should be used first might not hold true if the goods have been mixed up in a warehouse or store room.

Example 1

A business has kept the following record for its inventory for the month of January 2013:

2 January	Bought 100 units at K50 each
7 January	Bought 70 units at K55 each
14 January	Sold 120 units
22 January	Sold 30 units

Required:

Calculate value of inventory left in the business at the end of the month and the cost of goods sold during the period.

Solution

Application of the FIFO method is illustrated in Table 16.1

Table 1 : FIFO Method

Date	Description	Units bought	Units sold	Balance (Units)	Balance (K)
2 Jan	Purchases	100 @ K50 each	100	100	5,000
7th Jan	Purchases	70 @ K55 each	70	170	100 units @ K50 each = 5,000 70 units @ K55 each = 3,850 Total =5,850
14th Jan	Sales		120 (100 units @ K50 each and 20 units @ K55 each)	50	50 units @ K55 each = **2,750**
22nd Jan	Sales		30 units @ K55 each	20	20 units @ K55 each = **1,100**

You will notice from the table that items bought on 2nd January were sold first, and then those bought on 7th January and so on. This means that the 120 units sold on 14th January were drawn as follows : 100 units from the items bought on 2nd January and 20 units from the items which were bought on 7th January .The 30 units sold on 22nd January were taken from the remaining 50 units bought on 7th January. At the end of the month, there are 20 units from the lot which was purchased on the 7th January.

Cost of goods sold will be calculated as follows:

100 units at K50 each = K5,000 plus 50 units at K55 each = K2,750.
So total cost of sales will amount to K7,750.

16.1.2 Average Cost (AVCO)

The AVCO method involves valuing items of inventory sold or issued to production at the average cost of all inventories in stock. This means that a new average cost will be calculated whenever additional items of inventories have been acquired or produced.

Unlike the FIFO method which assumes that goods acquired first will also be used first, the AVCO method implies that this assumption might not work. You have learnt that goods acquired on different times may be mixed up. In this case, it is difficult to identify the goods which were bought first. The use of average costs will be ideal in this scenario. This method is recommended by the IAS 2.

On the other hand, the use of the AVCO method is tedious as the business is required to calculate a new average cost upon receipt of additional inventories.

Example 2

We will use the same figures in example 1. You are required to calculate the value of closing inventory.

Solution
The average cost of inventory on 2nd January will be K50 per unit. However, following the acquisition of 70 units on 7th January, we are required to calculate another average cost for the 170 units. The calculation of average costs is shown in Table 16.2.

Date	Description	Units bought	Units sold	Average cost	Balance (Units)	Balance (K)
2 Jan	Purchases	100 @ K50 each	100	50*	100	5,000
7th Jan	Purchases	70 @ K55 each	70	52**	170	8,850
14th Jan	Sales		120	52	50	2,600
22nd Jan	Sales		30	52	20	1040

*(K5,000/100)
** {(100 x K50) + (70 x K55))/170}

Therefore the 120 units sold will be valued at K52 each. Total cost of sales will be 120 x 52= K6,240. The average cost of the remaining 50 units will be: K2,600. This will be the cost of remaining two units since no additional inventory has been brought in. The cost of inventory at the end of the month will be 20 units x 52 = 1,040 as shown in the above table.

16.2 Comparison of FIFO and AVCO methods

Table 16.3: Comparison of FIFO and AVCO methods

	Method	**Cost of sales (K)**	**Closing inventory (K)**
1	FIFO	7,750	1,100
2	AVCO	6,250	1,040

You can see that each method gives a different value of inventory and cost of sales. This means that the profit figures reported by each method will also be different. It is important for businesses to apply the method which they will adopt consistently. This is in line with the consistency concept..

16.3 Inventory Taking

Inventory taking is the process of verifying the quantity balances of the entire range of items held in stock.

It is vital to take into account of security issues when conducting an inventory taking exercise. These may include ensuring that inventories are located in a secure building (location), not allowing unauthorized persons not allowed access and proper custody of store keys.

Inventory taking is important because:

i. It enables businesses to verify accuracy of stock records
ii. It provides support for the value of stock in the statement of financial position.
iii. It may assist in the identification of fraud, theft or loss and other weaknesses in the management of inventory.

16.4 Inventory Taking Methods

There are two major methods of inventory taking. These are:

i. Periodic
ii. Perpetual (Continuous)

16.4.1 Periodic Method

Under this method, inventory taking exercise takes place at the end of a given period. This can be at the end of the year or any other point in time. Thorough preparation is needed; programme drawn up and agreed with all concerned parties, stocktaking sheets prepared and duties communicated to all concerned parties

16.4.2 Perpetual (Continuous) Method

Inventory taking is conducted continuously throughout the year. The procedures for this method are similar to periodic inventory taking except that:

i. There is no need to close down stores while inventory taking
ii. Normal posting of receipts and issues on the inventory records can continue without interruption
iii. Inventory taking is done by few specially appointed, experienced and trained staff completely independent of stores staff

16.5 Chapter Summary

This chapter was about the inventory valuation. You have learnt that you can use the First In First Out (FIFO) and the Weighted Average method (AVCO) to value inventories. You have also learnt that inventory taking is a very important exercise in inventory management.

Exam Based Question

The inventory movement for VJ hardware which sells roofing tiles was as follows for the month of October 2010:

1 Oct Opening Inventories	2,000 units @ K300
4 Oct Purchased	1,000 units @ K320
7 Oct Sold	2,500 units @ K600
10 Oct Purchased	3,000 units @ K300
15 Oct Purchased	1,000 units @ K320
20 Oct Sold	2,000 units @ K600
25 Oct Purchased	1,500 units @ K330
30 Oct Sold	2,000 units @ K600

Required:

Compute the value of the closing inventories using both the First-in-First-Out (FIFO) and Average Cost methods of inventory valuation. **18 Marks**

(PAEC FA4 Exam, November 2011)

CHAPTER 17: ERRORS AND THEIR CORRECTION

Learning Outcomes:

By the end of this chapter, you should be able to:

i. Explain the types of errors
ii. Correct errors
iii. Prepare suspense accounts

17.1 Introduction

Human beings are prone to making mistakes and errors in everything they do. The area of accounting is no exception. Individuals who are responsible for providing financial information may make mistakes and errors. This may be due lack of accounting knowledge, negligence, fraud or even mere failure to follow laid down procedures. The implication of mistakes and errors is that the financial information which will be provided in a form of financial statements may not give a true state of affairs. You should remember that accounting information forms a basis of decision-making and so provision of distorted and misleading information will affect the decisions which will be made. In this case, it is imperative that accounting errors and mistakes should be corrected.

17.2 Types of errors

There are two types of errors in accounting:

i. Errors that do not affect the trial balance
ii. Errors that affect the trial balance

17.2.1 Errors That Do Not Affect the Balancing of the Trial Balance

In chapter 10 you learnt that once the accounts have been balanced off, the next step is to prepare a trial balance. Remember that a trial balance is a list of account balances. The idea behind the trial balance is that the totals in the debit column should be equal to the totals in the credit column. We can assume that once the totals have agreed, then there are no errors. However, under certain circumstances, the trial balance may agree even though we have made some errors. These are the errors which do not affect the trial balance; the totals still agree. The errors are as follows:

(a) **Errors of Omission**

This is where a transaction is completely omitted from the books.

Example:

The purchase of goods for resale from Chisomo Kampeni for K50, 000 on invoice number 11256 was not entered in the purchases day book. This transaction would not be posted to the purchases ledger, but when a trial balance is extracted it would still balance.

The error should be corrected by entering the transaction in the books. The journal entries are as follows:

DATE	DESCRIPTION	DEBIT	CREDIT
	Purchases Chisomo Kampeni *Being correction of transaction previously omitted*	50,000	 50,000

(b) **Errors of Commission**

This type of error arises where the correct amount is entered, but in the wrong account.

Example

Purchase of goods from J Cham'bwinja for K65, 000 entered in the account J Chambwinda. The error should be corrected as follows:

DATE	DESCRIPTION	DEBIT	CREDIT
	J. Chambinda J. Cham'bwinja *Being correction of transaction entered in wrong account*	65,000	 65,000

(c) **Errors of Principle**

This type of error occurs when the **correct amount** is entered in the **wrong class of account**.

Example

An acquisition of a second-hand motor vehicle for K950, 000 is debited to motor expenses account. This error will be corrected by debiting the motor vehicle account and crediting the motor expenses account.

(d) **Compensating Errors**
This is where errors cancel each other out i.e. a debit entry cancelling out a credit entry. For example, the amounts transferred from the cash book to the salaries account and motor expenses have been overstated and understated by K35, 000 respectively. The trial balance will still balance. To correct this error we should debit the motor expenses account by K35,000 and credit the salaries account by K35,000 as well.

(e) **Errors of Original Entry**
An error of original entry occurs where the original amount is incorrect, yet the double entry is correctly done using this incorrect amount. In this case, the equality of the trial balance will still be maintained. For example, a cheque in settlement of an electricity bill for K5, 560 is entered in the books as K8, 560. In this case, both the expense account and the cash book will be understated by K3,000 but the trial balance will still balance. To correct this error we should debit the electricity account by K3,000 and credit the cash book by a similar amount.

(f) **Complete reversal of the entries**
With this type of error the correct amounts and accounts are used, but each item is entered on the wrong side of the accounts. For example, a receipt of cash of K2, 500 from a customer is entered on the credit side of the cash book and on the debit side of the customer's account.

Correcting this type of errors involves two stages namely: reversing the entries and then entering the amounts on the correct sides of the two accounts. In terms of reversing the entries, we should debit the cash book by K2,500 and credit the customer's account by K2,500. The incorrect entries have now been reversed. We should then debit the cash book by K2,500 and credit the customer's account by K2,500. The second set of entries implies that the correct entries have now been made in the two accounts. You will notice that in total the cash book has been debited by K5,000 while the customer's account has been credited by a similar amount. In other ways, we just need to double the initial amount and make sure that the amount has been entered on the correct sides of the accounts.

(g) **Transposition errors**
This is where a wrong sequence of the individual characters within a number is entered.

Example

K856 entered as K586 in the general expenses account and cash book. The transposition must be in both the debit and credit entries. Correcting this error involves adding K270 to K586 so that the figure which has been recorded in both accounts should be K856 i.e. debiting the general expenses account and crediting the cash book by K270.

17.2.2 Errors that Affect the Balancing of the Trial Balance

The totals on the two sides of the trial balance should be equal. However, sometimes the totals might not be equal. This may be due to the following reasons:

a) Errors in double entry book keeping. For instance a transaction being recorded in only one account or a transaction may be recorded in one account as one figure and in another account as a different figure. These errors are corrected following double entry principles as they are made within double entry.

b) Errors in drawing out and adding up a trial balance. For example, a debit balance in an account may be taken to the trial balance as a credit balance, or an account balance may be transposed as it is being taken to the trial balance. You should remember that the trial balance is not part of double entry system and so such errors are corrected through the double entry rules. Just revise the trial balance by recording the amounts on the correct sides of the trial balance or enter the correct amount. The trial balance total will now be equal.

17.2.2.1 Correction of Errors Affect the Balancing of the Trial Balance

When we have errors which affect the balancing of the trial balance, the totals fail to agree. In this case the difference is entered in the suspense account. This is the account which temporarily holds the difference in the trial balance and may also be used to record items where the bookkeeper is not certain where the entries should be recorded. Balances in the suspense account should not be kept permanently. We should establish the causes of the errors and then clear the balances in the suspense account. Figure 17.1 shows an extract of the trial balance with an entry for the suspense account.

Figure 1: Extract Trial Balance

	Dr	Cr
	MK	MK
Sub-totals	99,500	100,000
Suspense	500	
Totals	100,000	100,000

Example:

The trial balance of Giant did not agree because the debit balances totalled K12,000 whereas the credit balances totalled K8,700. An investigation was conducted. The causes, the following errors were discovered:

a) A sale of K2,200 was debited to Smith instead of Simon
b) A sale for K4,200 was correctly entered in the sales account but was not debited to Jones' personal account
c) A purchase of K7,500 was correctly entered in the nominal account but was omitted from the personal account.

Prepare journal entries to show the correction of the above errors and hence prepare the suspense account to clear the Trial balance difference.

Solution:

In this example, the totals of the trial balance are not equal. This means that we need to insert a line for suspense account and K3,300 will be entered on the credit side. The trial balance will balance temporarily.

Error a:

This error does not affect the trial balance agreement. The double entry is complete although the transaction was recorded on the correct side of a wrong account. This will be corrected by Debiting Simon A/c and Crediting Smith A/c with K2,200.

Error (b)

The second error affects the trial balance agreement. This transaction has been entered once in the books of accounts and so the double entry is not complete. This is a case of single entry. There is need to enter the transaction in the account of Jones. We will do this by making a debit entry in Jones' account. A corresponding entry will be made in the Suspense account.

You should note that this transaction was to be recorded in the sales and Jones accounts. Since the entry in the sales account was made, the correction will involve Jones' account and the Suspense account and not the sales account again. This will then be Debit Jones A/c and Credit Suspense A/c with K4,200

Error (c)

The third error affects the trial balance just as (b) above. This is also as a result of single entry as the purchase was only recorded in the purchases account and not in the account of the Supplier. Correction will therefore be as follows: Debit Suspense and Credit Trade Payable with K7,500.

Below are the journal entries showing the correction of the above three errors.

DATE	DESCRIPTION	DEBIT	CREDIT
a)	Simon	2,200	
	Smith		2,200
b)	Jones	4,200	
	Suspense		4,200
c)	Suspense	7,500	
	Trade payables		7,500

Here now is how the suspense account will look like. We have been informed that the credit side of the trial balance has a shortfall of K3,300. This K3,300 is transferred to the credit side of the suspense account. If the shortfall were on the debit side the balance would also appear on the debit side of the suspense account.

Suspense Account

Trade payables	7,500	Difference per Trial Balance	3,300
		Jones	4,200
	7,500		7,500

At the moment the two sides of the suspense account have now agreed. This means that the causes of the difference in the trial balance have all been discovered and corrected. Otherwise, if the two sides of the suspense account do not agree, even after some errors being discovered and corrected, the implication is that there is need for further investigations.

17.3. Chapter Summary

In this chapter you have been introduced to accounting errors. You have learnt that there are two types of errors. These are the errors which do not affect the balancing of the trial balance and the errors which affect the balancing of the trial balance. Correction of errors which affect the balancing of the trial balance calls for the use of the suspense account.

Exam Based Question

A student pursuing the Certificate in Financial Accounting (CIFA) course was recruited on a temporary basis to assist in reducing the workload in the accounting department of Shopleft Retail Shop. The student was asked to correct the following errors from the transactions for the month of July 2008.

(1) Credit purchases from J Bhana amounting to K24,000 were recorded correctly in personal account but in purchases account it was recorded as K42,000.

(2) A cash discount of K15,000 from a supplier was recorded as a credit to suppliers account and as a debit to the discount received account.

(3) Cash sales amounting to K40,000 were completely omitted from the accounting records.

(4) Goods returned by cash customers amounting to K12,000 were recorded in the debtors control account.

(5) Purchase of computers for resale amounting to K70,000 were recorded as fixed assets.

(6) Rent paid amounting to K30,000 was debited to both the rent and cash book accounts.

(7) The cash book was credited with an amount of salaries paid amounting to K65,000 but no corresponding entry was made in the salaries account.

(8) The Accountant forgot to charge depreciation for a piece of office equipment. The cost of this equipment was K240,000 and its residual value was K20,000. The company policy is to depreciate equipment using the sum of digit method and the economic life is estimated at 4 years. The asset has two years of its useful economic life remaining as at the end of the financial year.

Required:

i. Briefly describe **five** types of errors which do not affect the correctness of the trial balance. **10 Marks**

ii. From the information given above from (1) to (7), prepare journal entries **without** narratives to correct the errors identified. **7 Marks**

(PAEC FA4 Exam, November 2008)

CHAPTER 18: CONTROL ACCOUNTS

Learning Outcomes:

By the end of this chapter, you should be able to:

i. Explain the importance of control accounts
ii. Draw up a receivables control account
iii. Draw up a payables control account

18.1 Introduction

To ensure financial soundness of a business, managers of the business must put in place measures to ensure that the business's assets and resources are controlled. Such measures are known as internal controls. It is imperative that that every system of transactions undertaken in the business has internal controls to ensure that the information reported by such system is true and fair.

To ensure the appropriateness of accounting records, **control** accounts are prepared for a particular system (say a purchase system). The control accounts record the same information that is recorded in the sales ledger (for a sales system) or the purchase ledger (for a purchase system) and at the end the information in the control is compared to that in the ledger concerned. This is done to check the arithmetical accuracy as well as proper entries in the records.

A control account is an account in the general ledger which keeps a record of a total number of similar individual items. For large entities, the control account forms part of the double entry system.

18.2 The Receivables/ Sales Ledger Control Account

This is an account which keeps a record of all trade receivables in total. A business can have numerous trade receivables and each of them will have his/her account in the sales ledger. One special account will be needed to control the entries in all the trade receivables accounts, that is, the receivables control account.

The amount that is transferred to the receivables control account is the total in the sales day book. Remember that the total in the sales day book is transferred to the sales account in the general ledger. If control accounts are being used, this total has to be transferred to the receivables control account as well.

Any item that is recorded in one or more receivables' accounts in the sales ledger is also recorded in total in the receivables control account. It is important to know on which side of the control account, entries will be made. For instance, the following items will have to be totaled and entered in the receivables control account on the debit side:

i. Total of credit sales from the sales day book
ii. Total of customers' dishonoured cheques and refunds made to customers
iii. Total of any interests charged on overdue accounts of customers.

The following items will have to be totaled and entered in the receivables control account on the credit side:
i. Total of cash /cheques received from customers
ii. Total of cash discounts allowed to customers
iii. Total of sales returns made by customers
iv. Total of debts that have been written off as irrecoverable.

18.3 Trade Payables/Purchases Control Account

This is an account which keeps a record of all trade payables in total. A business can have numerous trade payables and each of them will have his/her account in the purchases ledger. One special account will be needed to control the entries in all the trade payables' accounts, that is, the payables/purchases ledger control account.

The amount that is transferred to the payables control account is the total in the purchases day book. Remember also that the total in the purchases day book is transferred to the purchases account in the general ledger. If control accounts are being used, this total has to be transferred to the payables control account as well.

Any item that is recorded in one or more payables' accounts in the purchases ledger is also recorded in total in the payables control account. For instance, the following items will have to be totaled and entered in the payables control account on the debit side:

- Total of cash/cheques paid to suppliers
- Total of purchases returns made to suppliers
- Total of any discounts received from suppliers.

The following items will have to be totaled and entered in the receivables control account on the credit side:
- Total of credit purchases from suppliers
- Total of any interests charged by suppliers on overdue accounts

18.4 Contra Entries

In a situation where one person/entity becomes both a customer and a supplier, for the purposes of control accounts, the balances in the two ledgers, that is the sales and purchases ledger, are off set to come up with one balance in the control account. The double entries required for the set offs are:

Dr   Payables Control account
Cr   Receivables Control account

With the amount involved.

Example 1

The following are the opening ledger balances and totals for the month of January 2012

Opening balances

	Debit	Credit
	MK	MK
Receivables ledger (MK)	46,217	
Payables ledger (MK)		23,993

Totals for the month to 31 January 2012

	MK
Purchases	76,474
Sales	126,024
Purchases returns	2,154
Receivables accounts settled by contra accounts with payables	455
Irrecoverable debts written off	1,253
Discounts and allowances to customers	746
Cash received from customers	120,464
Cash discounts received	1,942
Cash paid to suppliers	70,476
Cash paid to customers (Refunds)	52

Required:

i. Prepare receivables ledger control account

ii. Prepare payables ledger control account

Solution

Receivables control account will be drawn up as shown below :

Receivables Control

Balance b/f	46,217	Contra	455
Sales	126,024	Discounts allowed	746
Refunds	52	Irrecoverable debts	1,253
		Cash	120,464
		Balance c/d	49,375
	172,293		172,293

Using the above information, we can also prepare a payables control account.

Payables Control

Returns	2,154	Bal b/d	23,993
Contra	455	Purchases	76,474
Discount received	1,942		
Payments	70,476		
Balance c/d	25,440		
	100,467		100,467

18.5 Importance of Control Accounts

You have learnt how the receivables and payables control accounts are maintained. But why do we need to prepare control accounts? Control accounts are important for the following reasons:

a) Provide a check on the accuracy of entries made in the personal accounts in the sales and purchases ledger.
b) Assist in location of errors
c) Provide an internal check where there is segregation of duties
d) Assist in extracting closing receivables, and payables ledger balances for use in the trial balance and statement of financial position.

18.6 Control Account Reconciliation and the Ledger

At the end of a specified period, the balance on the control account must be checked and compared with the sum of the balances from the individual accounts in the sales or purchases ledger. In normal circumstances, the two totals must agree. However, if the balances do not agree, we should reconcile the two balances to ensure that all errors are discovered and any fraud, if any, is detected.

When reconciling the control account balance to the sum of balances of the accounts in the ledger, the following procedures should be followed:

i. Update the control account. This is achieved by bringing into the control account any item which has not been included in it but is supposed to be included; as well as removing from the control account any item which has been included in it but it is not supposed to be included. The end result is that the control account will have a new closing balance.

ii. Adjust the updated control account balance with any errors or omissions that have been made in the individual accounts in the ledger.

If all errors and omissions have been discovered and dealt with accordingly, the final amount arrived at after the second stage above must be equal to the sum of the balances in the accounts in the ledger. This is illustrated below:

i. Reconciliation of the Receivables Control Account with the Sales Ledger

	K
Updated balance in the Receivables control account	X
Add:	
Items to be credited but have not been credited	
in the sales ledger accounts, e.g. irrecoverable debts	X
	X
Less:	
Items to be debited but have not been debited	
in the sales ledger accounts, e.g. correction of under cast of sales	(X)
Balance from sum of trade receivables accounts	X

ii. Reconciliation of the Payables Control Account with the Purchases Ledger

	K
Updated balance in the Payables control account	X
Add:	
Items to be debited but have not been debited in ledger accounts	X
	X
Less:	
Items to be credited but have not been credited in ledger accounts	(X)
Balance from sum of Trade payables accounts	X

Chapter Summary

In this chapter you have learnt that businesses prepare control accounts as part of internal controls. You have looked at the purposes of control accounts and how the receivables and payables control accounts are prepared. You have also learnt why periodic reconciliations between control accounts and ledger accounts are important. This ensures that causes of differences have been identified. Once this is done they can now be rectified.

End of Chapter Questions

1. Explain the purposes of control accounts.
2. Explain how the following items are reflected in the receivables and payables control accounts :

   Receipts from customers
   Payments to suppliers
   Discount allowed
   Discount received
   Dishonoured cheques
   Returns inwards and outwards

Exam Based Question

The following transactions relate to receivables and payables controls for G Motors for the month of September 2010:

		K
Balance b/f	- Receivables	140,000
	- Payables	90,000
Credit sales		600,000
Cash sales		180,000
Credit purchases		400,000

Cash purchases	50,000
Returns inwards from customers	10,000
Carriage inward for purchases	40,000
Interest on receivable	4,000
Bad debts	12,000
Provision for doubtful debts	16,000
Contra account (purchases)	25,000
Return outward to credit supplier	14,000
Cash from receivables	380,000
Payment to credit suppliers	250,000
Discount allowed to credit customers	17,000
Discount received from credit suppliers	10,000
Returns inward from credit customers	11,000
Dishonoured cheque from a credit customer	8,000

Required:

(a) Prepare the receivables and payables control accounts for the month of September 2010. **17 Marks**

(b) Outline **three** items which may result in differences between the amount of payables in ledger accounts and that on the supplier's statement. **3 Marks**

(PAEC FA4 Exam ,November 2011)

CHAPTER 19: BANK RECONCILIATION

Learning Outcomes

By the end of this chapter, you should be able to:

i. Explain the purpose of reconciliation between the bank ledger and the corresponding bank statement
ii. Identify errors and omissions in the bank ledger account and in the bank statement
iii. Identify timing differences
iv. Make the correcting entries in the bank ledger account
v. Prepare the reconciliation between the bank statement balance and the corrected bank ledger account

19.1 Introduction

In chapter 6 you looked at how to prepare a cash book. You will recall the cash books columns for cash and bank transactions. The bank columns are for all the transactions which go through an entity's bank account. In this case, the transactions which have been recorded in the bank columns of the cash book should be the same as the bank records for the business, which are being maintained by the bank. The records prepared by the bank will be in a form of a **bank statement**. However, there are times when the two sets of records are different. This calls for the preparation of a bank reconciliation statement.

19.2 Bank Statement and Cash Book Balances

Any transaction the business undertakes with the bank is recorded by both the business and the bank. One would expect that that the balance in the cash book of the business must be equal to that in the bank's books because the records of the two parties are the same. However, this is unlikely to be the case for the following reasons:

i. Bank Charges:
Banks charge for the services they offer to their customers and these charges are directly recorded (debited) into the customer's account. The balance shown by the bank will therefore be different from that of the cash book of the business because the cash book will not record this charge made by the bank.

ii. **Bank Interest:**
Just as bank charges, a bank may give interest to the customers directly through the bank accounts or may charge interest on overdraft balances directly. This may bring about the differences in the balances reported by the two entities.

iii. **Standing Orders:**
These are orders customers give the bank to make regular payments at stated dates to persons or companies. The bank simply obeys the command and the payment is only reflected in the books of the bank and not the business' books, hence a cause of the disagreements between the two balances.

iv. **Direct Debits:**
This occurs where an instruction is given to the business' creditors, (not the bank), to obtain the money directly from the business' bank account.

v. **Credit Transfers/Bank Giro Credits:**
These are the amounts that the business' customers pay directly into the business' bank account. The receipt will therefore be recorded in the books of the bank alone hence difference arise between the two balances.

vi. **Unpresented Cheques:**
These are cheques that have been issued by the business to its credotors but have not been presented to the bank to effect payment. This will be recorded in the business' cash book but the bank will not record this payment until the creditors have actually presented the cheques to the bank.

vii. **Outstanding Bank Lodgements:**
These are the amounts or cheques that the business has deposited at the bank but the bank has not yet cleared them. They are also called **uncredited cheques.** These will be recorded by the business in its cash book but the bank will record these only when they are cleared.

viii. **Errors:**
In chapter 18 you noted that accounts personnel are bound to make errors. These errors may be committed when dealing with bank transactions. For example an error may be made when balancing the cash book and so the resulting balance might not be correct. Such an error will not appear in the bank's records. The implication is that there will be a difference between the balance shown by the cash book and that shown by the bank's records. The bank may also make errors by putting thrugh wrong transactions in the business's bank account

ix. **Dishonoured cheques (or R/D cheques).**
These are cheques that the bank has denied to clear for various reasons. These cheques had been recorded initially in the business' books and when the bank denies payment, thay won't be recorded in the bank's records. Until the business reverses the transactions involving those dishonoured cheques, there will be a difference between the balance in the cash book and that in the bank statement.

When the cash book balance and the bank balance are not equal, we need to find out why the balances are not equal. This is achieved through the reconciliation process. The reconciliation process is also a control measure to detect cash fraud.

19.3 Frequency and Purposes of Bank Reconciliation

Bank reconciliation is an accounting procedure for agreeing the balance as per bank statement with the balance as per cash book. It is good practice to reconcile the bank balance with the cashbook balance as frequent as possible say at least once a month. How frequent the bank reconciliation statement may be prepared will depend on the following factors:

i. Frequency and volume of transactions :The likelihood of error is greater where there are more transactions
ii. Other controls: If there are very few other checks on cash, the greater the need for bank reconciliation.
iii. Cash flows: If the company has to keep a very close watch on its cash position, then the reconciliation should be performed as often as the information on cash balance is required.
iv. Number of bank accounts: The more the bank accounts are operated, the more difficult it becomes to perform regular reconciliation.

The bank reconciliation serves the following purposes:

i. Analysing the difference between the cashbook and the bank statement.
ii. Detecting and correcting errors committed by the bank or cash office
iii. Detecting possible misappropriation of funds
iv. Recognising or identifying appropriate expenditures or receipts made directly by the bank.
v. Ensuring that Commercial Bank's claims for reimbursement are not duplicated.

19.4 Bank Reconciliation Process

To reconcile the two balances the following procedures are to be followed:

a) Update the cash book by taking into it some amounts that appear in the bank statement but not appearing in the cash book. If the cash book contained some errors, the update should include correcting such errors. For instance, bank charges will always be recorded in the bank statement and not in the cash book. The updated cash book should therefore include this item.

b) Identify any unpresented cheques. You noted that Unpresented cheques represent any amount shown by the cash book as a payment but has not been reflected as a debit in the bank statement.

c) Identify any outstanding bank lodgements. Bank lodgements are amounts that have been recorded in the cash book as receipts but are not reflected as a credit in the bank statement.

Once the above procedures have been undertaken, we can now prepare the reconciliation statement. The reconciliation statement will be presented as follows:

Bank Reconciliation Statement as at ……………………………….

	K
Updated cash book balance	X
Add unpresented cheques	X
	X
Less bank lodgements	(X)
Balance per Bank Statement	X

Alternatively we can start with the balance as per the bank statement in which case the statement will be as follows:

Balance per bank statement	X
Add Bank lodgements	X
	X
Less Unpresented cheques	(X)
Balance per updated cash book	X

Regardless of the method used, the differences between the cash book balance and the balance on the bank statement will be explained. Let us now look at a practical example.

Example 1

From the following cash book and bank statement, draw up a statement reconciling the two balances:

Cash book

Dec 1. Balance b/d	3,480	Dec 8 A. Dalitso	698
" 7. P.J. Malumbo	176	" 15 R. Matemba	66
" 22. J. Elenda	146	" 28. G. Samalani	230
" 31. K. Wanda	498	" 31. Balance c/d	3,662
" 31. M. Balendo	356		
	4,656		4,656

Bank statement

			Dr	Cr	Balance
Dec	1.	Balance B/f			1,740
"	7.	Cheque		176	1,828

“	11	A. Dalitso	698		1,479
“	20	R. Matemba	66		1,446
“	22	Cheque		146	1,519
“	31	Credit transfer, J. Wadada		108	1,573
“	31	Bank charges	44		1,551

Solution

i. Entries in the cash book and on the bank statement are not recorded on the same side. A debit entry in the cash book would be reflected on the bank statement as a credit entry and the other way round.

ii. Let us spot any amounts appearing in the bank statement which do not appear in the cash book. We will then use these amounts to update the cash book. A credit transfer of K108 from J. Wadada and bank charges of K44 have not been recorded in the cash book and should be included in the cash book. In this way the cash book will be up to date.

Therefore, the updated cash book will be:

Balance b/d	3,662	Bank charges	44
J. Wadada	108	Balance c/d	3,726
	3,770		3,770

iii. We could have re-written the whole cash book but this may be time consuming. For examination purposes it is good to start with the balance which has been brought down (K3,726) as marks are not awarded for the original entries in the cash book.

iv. From the cash book and the bank statement, K330 paid to G. Samalani has not been presented to the bank for payment as at the date the reconciliation is being made. This is an unpresented cheque. Cheques from K. Wanda and M Balendo of K498 and K356 respectively have not been cleared by the bank. As a result they are not reflecting on the business' bank statement. The two cheques are bank lodgements as at 31 December 2012.

Bank Reconciliation Statement as at 31 December 2012

	K	K
Balance as per updated cash book		3,726
Add : Unpresented cheques		330
		4056
Less : Bank lodgements		
K. Wanda	498	
M. Balendo	356	(854)
Balance as per bank statement		3,202

Alternatively the bank reconciliation statement may also be prepared as follows:

Bank Reconciliation Statement as at 31 December 2012

	K	K
Balance as per bank statement		3,202
Add : Bank lodgements		
K. Wanda	498	
M. Balendo	356	854
		4,056
Less : Unpresented cheques		(330)
Balance as per updated cash book		3,726

19.5 Overdrafts

An overdraft occurs when a business or a person draws from the bank more money than the money that it or he has in the bank. In this case, the bank becomes a liability to the business and the business an asset to the bank. We still need to check if the balances in the cash book and on the bank statement are equal. When overdraft balances are involved in the reconciliation processes, the presentation changes as follows in order to take care of the negative balances:

Bank reconciliation statement

	K
Updated cash book overdraft balance	X
Add bank lodgements	X
	X
Less Unpresented cheques	(X)
Overdraft per Bank statement	X

OR

Overdraft per bank Statement	X	
Add Unpresented cheques	X	
	X	
Less: bank lodgements		(X)

You will note that the items in the reconciliation statements are the same. You should be able to reconcile whether a business has an overdraft or not.

19.6 Chapter Summary

In this chapter you have learnt that ideally the balance in the cash book and the balance on the bank statement should be equal. However, sometimes the balances are not equal. In this case you need to prepare a bank reconciliation statement in order to identify the causes of the differences between the two balances. You have noted that it is good practice to prepare the bank reconciliation statements periodically.

End of Chapter Questions

1. Explain the importance of the bank reconciliations.
2. Mention possible factors which may make the cash book balance to be different from the balance on the bank statement.

Exam Based Question

The bank transactions for a sole trader for the month of October 2009 were as follows:

Cash book

		K			CHQ	K
1 Oct	Balance b/f	20,000	2 Oct	Rent	0020	12,000
3 Oct	Cash banked	30,000	4 Oct	J Banda	0021	35,000
9 Oct	N Mota	25,000	7 Oct	Electricity	0022	30,000
10 Oct	Cash banked	40,000	8 Oct	K Mbewe	0023	11,000
13 Oct	Cash banked	50,000	12 Oct	H Sitima	0024	30,000
17 Oct	Cash banked	10,000	15 Oct	Purchases	0025	16,000
27 Oct	N Mota	45,000	18 Oct	City rates	0026	18,000
30 Oct	Cash banked	15,000	20 Oct	K Mbewe	0027	14,000
31 Oct	Balance c/d	38,000	25 Oct	Salaries	0028	80,000
			27 Oct	Kabula Pvt	0029	15,000
			29 Oct	J Banda	0030	12,000
		273,000				273,000

The bank statement as at the 31 October 2009 was as follows:

			Dr	Cr	Balance
			K	K	K
1 Oct	Balance b/f				20,000 Cr
2 Oct	Rent	0020	12,000		8,000 Cr
3 Oct	Cash			30,000	38,000 Cr
4 Oct	J Banda	0021	35,000		3,000 Cr

9 Oct N Mota			25,000	28,000 Cr
10 Oct Electricty	0022	30,000		2,000 Dr
10 Oct K Mbewe	0023	11,000		13,000 Dr
10 Oct Cash			40,000	27,000 Cr
12 Oct Bank charges		4,000		23,000 Cr
13 Oct Cash			50,000	73,000 Cr
15 Oct Credit transfer			20,000	93,000 Cr
15 Oct Purchases	0025	16,000		77,000 Cr
17 Oct Cash			10,000	87,000 Cr
20 Oct Direct debit – Game stores		25,000		62,000 Cr
21 Oct K Mbewe	0027	14,000		48,000 Cr
26 Oct Salaries	0028	80,000		32,000 Dr
27 Oct N Mota			45,000	13,000 Cr
30 Oct J Banda	0030	12,000		1,000 Cr
30 Oct N Mota – Refer to drawer		45,000		44,000 Dr
31 Oct Standing order		10,000		54,000 Dr

Required:

(a) Explain the difference between a bank lodgment and a direct debit. **4 Marks**

(b) Prepare an updated cash book for the sole trader as at 31 October 2009. **7 Marks**

(c) Prepare a bank reconciliation statement for the sole trader as at 31 October 2009 to agree with the balance on the bank statement and with the balance in the updated cash book. **7 Marks**

(PAEC FA4 Exam, December 2009)

CHAPTER 20: COST CATEGORISATION AND CLASSIFICATION

Learning Objectives

By the end of this chapter, you should be able to:

i. Explain the elements of costs
ii. Categories of costs
iii. Identify the elements of the unit cost

20.1 Introduction

We noted in Chapter One that financial accounting and management accounting are different. You will recall that one of the notable differences is that financial accounting is aimed at providing economic information for external users. On the other hand, cost/management accounting provides information for internal use. Therefore, costing/management accounting is there to provide information which will be used by managers within the business, thereby enabling them to make informed decisions.

20.2 The Role of Costing in Organisations

Regardless of type of organisation, size of organisation, or location of organisation, one requirement from management information systems is common to all, namely the cost of particular goods or services provided over a period of time. Cost may be defined as the actual expenditure of money incurred on, or attributable to, a specific thing or activity.

Cost is one of the most fundamental control mechanisms in a management information system. With knowledge of costs, managers are able to:

i. Control actual performance against planned performance and take corrective action if necessary;
ii. Plan next year's costs carefully, making due allowance for inefficiencies and unforeseen events which distorted last year's performance;
iii. Determine a desirable selling price (whether in terms of ticket price in the market or subsidy sought from local or central government), even though that price may not be achievable;
iv. Track the consumption of the organisation's resources to ensure that all employees are carrying out their duties efficiently and honestly;

v. Choose among alternative courses of action

20.3 Cost Classification

Costs may be classified in several ways. Below is one of the common ways of classifying costs:

i. **Direct Materials**
The cost of materials entering into and becoming constituent elements of a product or saleable service and which can be identified separately in product cost.

ii. **Direct labour**
The cost of remuneration for employees' efforts and skills applied directly to a product or saleable service and which can be identified separately in product cost.

iii. **Direct other expenses**
Costs, other than materials and labour, which can be identified in a specific product or saleable service

iv. **Indirect materials**
Materials costs which are not charged directly to a product, for example coolants, cleaning materials.

v. **Indirect labour**
Labour costs which are not charged directly to a product, such as supervision.

vi. **Indirect expenses**
Expenses which are not charged directly to a product e.g. building insurance, water rates, electricity

vii. **Prime cost**
This is the total cost of direct materials, direct labour and direct expenses. The term prime cost is commonly restricted to direct production costs only and, so, does not customarily include direct costs of marketing or research and development

viii. **Conversion costs**
The cost of converting material input into semi-finished or finished products, i.e. additional direct materials, direct wages, direct expenses and absorbed production overheads

ix. **Overhead cost**
The total cost of indirect materials, indirect labour and indirect expenses
You should note that overhead costs may be classified under the main headings of expenditure such as production, administration, selling, distribution, and research.

20.4 Calculation of Unit Cost

A cost unit is a quantitative unit of production or unit of activity in relation to which a cost is measured. It is an item for which an output cost or an activity cost is measured. Using the above elements of costs, we can come up with a structure for establishing the unit cost of a product. The structure is as follows:

	MK
Direct materials	xx
Direct labour	xx
Direct expenses	xx
Prime cost	**xx**
Production overhead	xx
Manufacturing (full factory) cost	**xx**

The total for direct costs (direct materials, direct labour and direct expenses) is called Prime cost. Owners of businesses or management may want to know the full cost of producing a product or offering a service. In this case, the prime costs alone would not be enough. We need to include other indirect costs or overheads which were incurred in the course of producing a product or rendering services. Manufacturing overheads are then added to the prime costs so that we should have the full cost of producing a product or rendering a service. Unlike manufacturing overheads, non- manufacturing overheads like selling and distribution overheads, administrative overheads are not included in the cost of a product. They are treated as period costs and are then charged in the costing income statement as expenses when calculating the business overall profit.

There are several reasons why cost units are measured:

- To establish how much it has cost to produce an item or perform an activity
- To measure the profit or loss on the item
- To value closing inventories of the item
- To compare actual costs of the item with budgeted costs
- To plan future costs, by basing future costs on historical costs
- To decide on a selling price for the item, where the selling price is derived by a **cost-plus** formula
- To monitor changes in costs over time

20.4 Cost behaviour

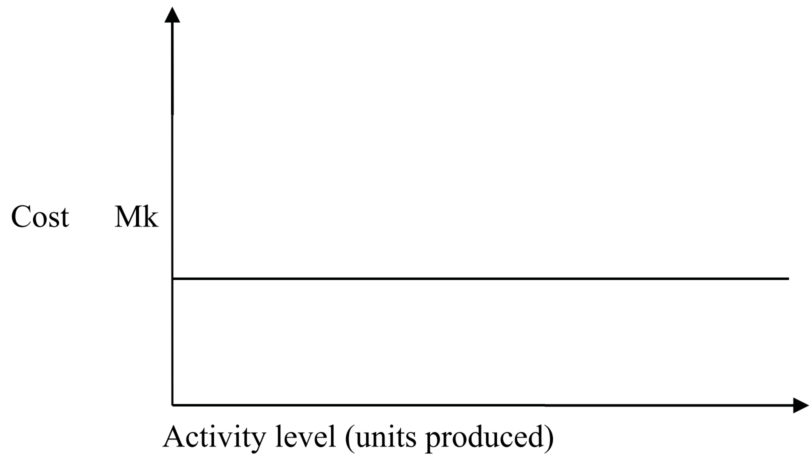
Cost behaviour means the way that a cost changes as the volume of activity or output rises or falls. It is concerned with how costs change with the **level of activity** and **by how much** Many costs can be classified according to their behaviour as follows:

- Fixed costs
- Variable costs
- Semi-variable(and semi-fixed) costs
- Step or Stepped costs

20.4.1 Fixed Costs

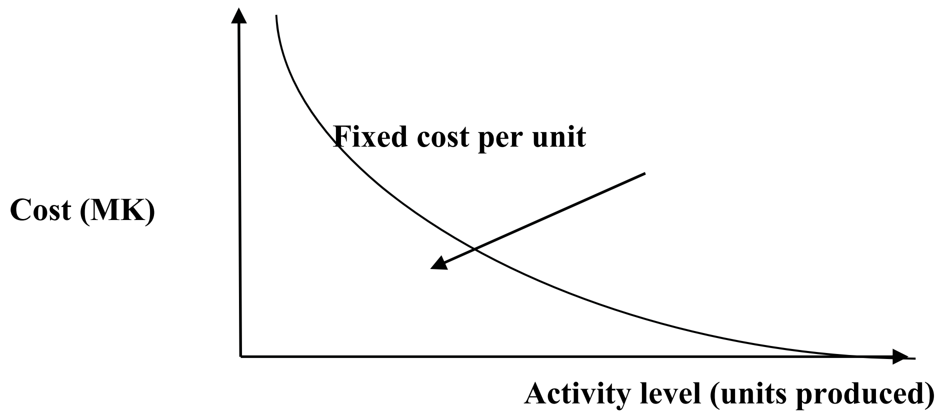
Fixed costs are costs that are not affected in total by the level of activity, but remain the same amount regardless of how much or how little work is done in a period. An example of a fixed cost is factory rent, which is a constant amount each period regardless of how much or how little is manufactured in it. Figure 20.1 shows the graphic presentation of total fixed costs. You can see that as the level of activity changes, the total fixed costs remain the same.

Figure 20.1 Total Fixed Costs



However, the fixed cost per unit is not constant. The fixed cost per unit decreases when there is an increase in the level of activity. On the other hand, if there is a decrease in the level of activity, the fixed cost per unit increases. This has been shown in Figure 20.2.

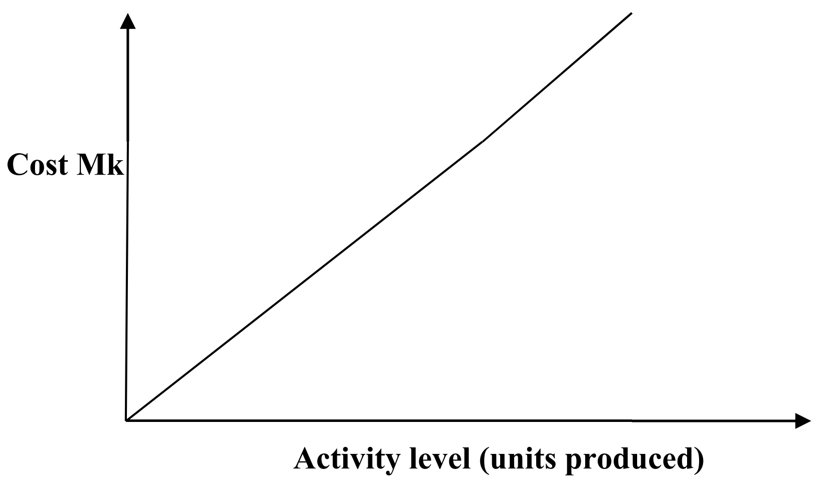
Figure 20.2 Fixed Costs per Unit



20.4.2 Variable Costs

These are costs that change in direct proportion to the level of activity. Total variable costs change as the level of activity increases or decreases as shown in figure 20.3. However, within a reasonable range of activity, the variable cost per unit of output remains much the same. Graphically, the variable cost may be presented as Figure 20.1.

Figure 20.3 : Total Variable costs

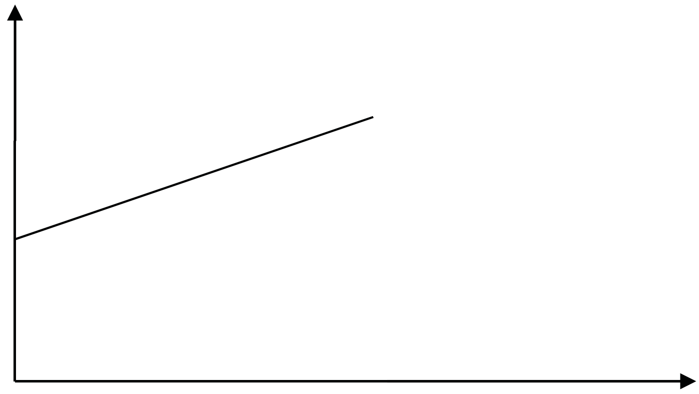


20.4.3 Semi-Variable Costs

Semi-variable costs are those that have both fixed and variable elements. Semi-variable costs will change in total with the increase or decrease in output or level of activity. An example of a semi-variable cost is a telephone bill which consists of a fixed period rental and charges for calls made. This is shown in Figure 20.4.

Figure 20.4: Semi-Variable Costs

Cost Mk



Activity level (no. of phone calls)

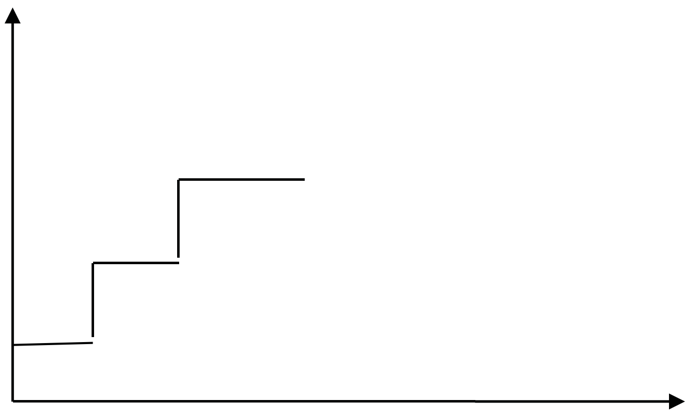
In cost accounting, it is usual **to analyse** semi-variable costs by separating them into their **fixed** and **variable elements**.

20.4.4 Stepped-Fixed Costs

Stepped-fixed costs/step costs are costs that are constant for a range of activity levels, and then change, and are constant again for another range. See Figure 20.5. The key feature of stepped costs is that they are fixed within a limited range of activity, but then go up a step as the activity level rises beyond a certain level.

Figure 20.5: Stepped-Fixed Costs

Cost Mk



Activity level (no. of units produced)

20.5 Application of Fixed and Variable Costs

The distinction between fixed and variable costs may be used:

i. In product costing such as in marginal costing
ii. To help to analyse profitability
iii. To help managers to make decisions about increasing or decreasing activity levels
iv. To estimate future costs (forecasting and budgeting)
v. To estimate what costs should have been (budgetary control) and assessing performance

Semi-variable costs are often divided into their fixed and variable elements. The fixed portion is included in fixed costs for the period and the variable portion within total variable costs.

20.5.1. High-low method

This method estimates fixed and variable costs by comparing the costs of the highest and lowest activity levels and analyzing the difference between them. The procedure is as follows:

i. Take the cost information for the **highest activity** level and for **lowest activity** level from the available data. The assumption is that the total cost line passes through these two points
ii. Since **fixed costs** are **the same** at **both activity levels**, the **difference** in total cost between the highest and lowest activity levels **must be attributable to variable cost entirely**. That is to say, the difference must be **variable cost** of **the number of units of activity** between the **lowest and highest points**.
iii. Now the **variable cost per unit** can be **calculated.** Having done this, the variable cost per unit can be **applied** to either the **low cost** or **high cost data**, to calculate the **fixed costs.**

Example 1

You are given the following information:

High capacity December: 55,000 machine-hours
Cost of electricity: K80,450
Low capacity September: 30,000 machine-hours
Cost of electricity: K64,200

You are required to calculate the variable rate per machine hour using the High-Low method and the fixed costs.

Solution:

Variable rate per machine hour :

(K80,450 – K64,200) ÷ (55,000 machine hours – 30,000 machine hours

Variable rate per machine hour : K16,250 ÷ 25,000 machine hours = K0.65 per machine hour

Fixed Costs:

K80,450 = Fixed costs + Variable costs
K80,450 = Fixed costs + (55,000 machine hours X K0.65 per machine hour)
Fixed costs = K80,450 – K35,750
Fixed costs = K44,700

20.6 Management responsibility levels: Cost centres, profit centres and investment centres

The nature of internal reporting systems will vary according to the way the organisation is structured and the responsibilities that different managers are given.

(a) Responsibility Accounting

Responsibility accounting is a system of providing financial information to management, where the structure of the reporting system is based on identifying individual parts of the business which are the responsibility of a single manager. Responsibility centre is an individual part of a business whose manager has personal responsibility for its performance.

(b) Cost Centre

A cost centre can be defined as a production or service location, function, activity or item of equipment whose costs may be accumulated and attributed to the cost units, such as machining department, assembly department and finishing department in a manufacturing company. Within the accounting system the costs incurred by the cost centre are charged to that centre. The performance of the manager of a cost centre is judged on the extent to which cost targets have been achieved.

(c) Revenue Centre

A revenue centre is a part of the organisation that earns revenue. Its manager is responsible for the revenue earned, but not the costs of the operation. They are generally associated with selling activities, and within a company, the sales team under each regional sales manager, might be treated as a revenue centre. The management information system must, therefore, be capable of tracing all sales revenue earned to the individual revenue centre

(d) Profit Centre

A profit centre is a part of the business for which both costs incurred and the revenues earned are identified. The performance of a profit centre manager is measured in terms of the profit made by the centre. The manager must, therefore, be responsible for both costs and revenues, and in a position to plan and control both, he or she is therefore likely to have a substantial amount of authority. When a business has a profit centre structure, data for revenues and costs must be collected and attributed to the appropriate profit centre. The data is then used to measure profit trends and compare actual profit with target profit.

(e) Investment Centre

An investment centre is a profit centre with additional responsibility for capital investment and possibly for financing, and whose performance is measured by its return on investment.
The managers of investment centres are responsible not just for decisions affecting revenues and costs, but also for investment decisions. Performance is measured in terms of the profit relative to the level of investment. The information system must therefore be capable of providing information on costs revenues and amounts invested.

Chapter Summary

In this chapter you have looked at how costs are classified and how they behave. You have also looked at how one can calculate the unit cost of a product or a service. Finally the chapter touched on the areas of responsibility in cost/ management accounting.

End of Chapter Questions

1. Define the following terms :

    i. Direct Materials
    ii. Direct labour
    iii. Direct other expenses
    iv. Indirect materials
    v. Indirect labour
    vi. Indirect expenses
    vii. Prime cost
    viii. Conversion costs
    ix. Overheads

2. Explain the importance of calculating the unit cost of a product or a service
3. Why is responsibility accounting important in cost/management accounting

CHAPTER 21 COSTING METHODS - JOB AND BATCH COSTING

Learning Objectives

By the end of this chapter, you should be able:

i. Describe job and batch costing
ii. Explain the difference between job and batch costing
iii. Calculate the cost and the price of jobs and batches

21.1 Introduction

In manufacturing organizations, the costing unit might be a batch of output or a specific job carried out for a customer. In such cases, the appropriate costing system would be a batch costing system or a job costing system respectively. These costing systems are usually associated with absorption costing methodology, and the costs calculated for each batch or each job produced are normally a fully absorbed production cost. Under the absorption costing method, the cost of a product includes an element of production or manufacturing overheads. The implication is that the product cost includes all the costs that have been incurred in producing the product. This has been illustrated in Chapter 20 on the calculation of unit costs.

21.2 Job Costing

A job is an individual product designed and produced as a single order for an individual customer. The job will usually be requested by a customer and that customer's individual requirements and specifications considered. Each individual job is a cost unit. Since the job is a unit, the job will have all the cost elements as shown in Chapter 20. These are direct materials, direct labour, direct expenses and manufacturing overheads. Remember that direct labour and manufacturing overheads are part of conversion costs.

The organisation will estimate the costs of the job, add on their required profit margin and quote a price to the customer. If a customer accepts the quotation, the job will proceed in accordance with the time table agreed between customer and supplier.

21.2 Job Cost Cards

All of the actual costs incurred in a job are recorded on a job cost card. The job cost card may travel with the particular job as it moves around the factory, or it may be held centrally by the accounts department and all revenue cost information for that job forwarded to the accounts department.

21.2.1 Direct Materials

When materials are requisitioned for a job, the issue is recorded in the inventory ledger account. They will also be recorded, at their issue price, on the job cost card as they are used as input into that particular job. Materials may be issued at different dates to a particular job, but each issue must be recorded on the job card.

21.2.2 Direct Labour Costs for Jobs

A job card travels with each individual job and hours worked by each grade of labour are logged onto this card. The card is sent to the accounts department and the hours are transferred to the job cost card. The relevant hourly labour rate is then applied to each grade of labour to give a cost for each grade and a total cost for the job.

21.2.3 Direct Expenses

Direct expenses are any expenses that can be directly attributed to that particular job. The cost accountant will record such expenses when incurred and code them in such a way that it is clear to which job or jobs they relate.

21.2.4 Production Overheads and Job Costs

The most common method of allocating overheads to specific cost units is either direct labour hours or machine hours worked on that particular cost unit. Therefore, production overheads will be absorbed into jobs on the basis of the pre-determined overhead absorption rate.

21.2.5 Other Overheads and Job Costs

Any administration, selling and distribution overheads must be included in the job costs to arrive at the total cost for a particular job. When the job is completed an appropriate proportion of administration, selling and distribution overheads will, therefore, be included on the job cost card.

21.2.6 Accounting for Job Costs

The job costs must be recorded in the cost ledger accounts in addition to recording them on the job cost cards. Each job will have its own job ledger account to which the costs incurred are all debited.

A job in progress control account will also be maintained in order to keep track of all the individual job ledger accounts. All of the costs incurred on a job must also be debited to this control account. The balance on the job in progress control account should be equal to the total of all the balances on the individual job ledger accounts.

21.2.7 Job pricing

There will be no set price for each job, because each job is different. A price for the job will have to be quoted to the customer before work begins, therefore the supplier might:

- Estimate a fully absorbed cost for the job; and
- Add a profit mark-up to the cost, to arrive at the price to charge for the work. The profit added on the job is usually a standard percentage of total cost (profit mark-up) or standard percentage of sales price (a profit margin). This is known as Cost-plus pricing.

Example

A furniture shop has won a tender to produce a platform to be installed in an entertainment hall. The following transactions took place:

	K
Cost of timber	45,000
Cost of consumables (nails, glue etc)	13,000
Direct labour	24,000
Salaries for supervisory staff	18,000

The following information is also available:

1. Overheads are absorbed at the rate of 70% of prime costs
2. The shop operates at a markup of 25%

Required:

Prepare the job cost account to determine the price charged for this assignment.

Solution

Job Cost Account

	K	K
Direct costs		
Direct materials		45,000
Direct labour		24,000
Prime costs		69,000
Overheads		
Consumables	13,000	
Salary for supervisors	18,000	
General overheads	48,300	
		79,300
Total costs incurred		148,300
Mark up at 25%		37,075
Job price		185,375

23.3 Batch Costing

Batch costing system is likely to be very similar to a job costing system and indeed a batch is in all respects a job. A batch is a group of identical, but separately identifiable products that are all made together

23.3.1 Accounting for Batches

Each batch is very similar to a job. Accounting for batches is exactly the same way as in job costing the costs of that batch will be gathered together on some kind of a batch cost card. These costs will be the materials input into the batch, the labour worked on the batch, any direct expenses of the batch and the batch's share of overheads.

A unit cost of the product batch differs from a job in that a batch is made up of a number of identical products or cost units. To find the cost of each product in the batch, the total cost of the batch must be divided by the number of products in that batch.

Example

Batch number 0692 has the following inputs:
15 June Material X 20kg at Mk30 per kg
40 hours of grade II labour at Mk6 per hour
16 June Material Y 15kg at Mk10 per kg
60 hours of grade III labour at Mk5 per hour
Production overhead is to be absorbed into the cost of each batch on the basis of labour hours at a rate of Mk0.5 per labour hour.

The number of products produced from batch 0692 was 100.

Calculate the cost of each product from batch 0692.

Item	Quantity	Cost per unit	Total Cost
Material X	20 kgs	K30 per kg	600
Material Y	15 Kgs	K10 per kg	150
Labour Grade II	40 hours	K6 per hour	240
Labour Grade III	60 hours	K5 per hour	300
Overheads	100 hours	K0.50 per hour	50
Grand Total			1,340

Number of units in the batch = 100
Unit cost per item = K1,340/100 units
Unit cost = K134 per unit

23.4 Chapter Summary

In this chapter you learnt how to account for jobs and batches in terms of establishing the costs and prices. A job and a batch are similar to a certain extent. The only difference lies in the fact that a batch is made up of similar jobs and calculating the unit cost of items in the batch involves dividing the batch cost by the number of units in the batch. Note that the price of a job or a batch include a markup on cost which is the profit earned by the business.

End of Chapter Questions

1. Explain the differences between a job and a batch in cost accounting.
2. Outline the cost elements of a batch or a job.

CHAPTER 22: COSTING METHODS - PROCESS COSTING

Learning Objectives:

By the end of this chapter, you should be able to:

i. Explain the features of process costing
ii. Calculate the unit cost of a process
iii. Prepare process accounts
iv. Account for normal loss, abnormal loss in a process

22.1 Features of Process Costing

Process costing is a method of costing used in industries such as brewing, food processing, quarrying, paints, chemical and textiles. In a process, the following features will be evident:

i. Products are produced repetitively over time.
ii. The products in a process are produced in mass but the products are identical
iii. Usually there are two or more consecutive processes, with output from one process being input to the next process and finished output only being produced from the final process.
iv. When processing is continuous, there will be opening inventory in process at the start of any period and closing inventory in process at the end of the period. A problem is then to decide what value to put to part-finished inventory in process. It is usually necessary to make an estimate of the degree of completion of the closing inventory (which is then part finished opening inventory at the start of the next period).
v. There could be losses in process whereby, if 100kg of direct materials are input to a process, the output quantity could be less than 100kg. Losses could be a natural part of the production process, occurring because of evaporation or chemical change or natural wastage.
vi. There could be more than one product produced from a common input, for example petrol, diesel, tar and so on, in an oil refinery. These products may be significant in their own right or a by-product of the process.

22.2 Process Accounts

We need to prepare process accounts. The typical costs of a process are direct materials, direct labour and production overheads absorbed into the cost of the process. Note that these elements are the same as those of a job or a batch. Remember that the total of the labour costs and the overhead costs tend to be known as costs of conversion.

22.2.1 Unit Costs in Process Costing

The cost per unit of finished output is calculated by dividing the expected process costs by the expected number of units of output. Process costs consist of direct materials, direct labour and production overheads. When processing goes through several successive processes, the output from one process becomes an input direct material cost to the next process. The total costs therefore build up as the output goes through each successive processing stage.

22.2.2 Losses in Processes

In a process we have inputs which will be transformed into output or finished goods. In an ideal scenario, inputs will be equal to outputs. However, in many processes, some losses in process are inevitable. When losses occur, the problem arises as to how they should be accounted for.

One approach is to value each unit as the average cost of each unit of input, so that the cost of the finished output per unit would be the same as the cost of the loss per unit. The loss would then be written off as an expense in the income statement.

The second approach is to say that if losses are a regular and expected aspect of the processing, it is sensible to calculate a cost per unit based on the expected output from the process with the knowledge that the losses are unavoidable.

In process costing the second approach is taken whereby the cost per unit of output is calculated after allowing for "normal losses". A distinction is made between normal loss and unexpected loss or "abnormal loss". Abnormal loss is given a cost which is charged to the income statement as an expense.

Normal Loss is the expected amount of loss in a process. It is the level of loss or waste that management would expect to incur under normal operating conditions. Abnormal Loss is the amount by which actual loss exceeds the expected or normal loss in a process. It may also be described as the amount by which actual production is less than normal production. Normal production is the quantity of input units of materials less normal loss.

i. **Normal Loss**

Normal loss is not given a cost. If units of normal loss have no scrap value, their value or cost is nil. When units of normal loss have a scrap value, the value of this loss is its scrap value, which is set off against the cost of the process. This is to say that, the cost of finished output is reduced by the scrap value of the normal loss. If normal loss has a scrap value, we should debit the normal loss account with the scrap amount and credit the process account with a similar amount. In this way, the costs to be borne by good output will be reduced.

ii. Abnormal Loss

The abnormal loss is given a value. The cost of a unit of abnormal loss is the same as a cost of one unit of good output from the process. The cost of abnormal loss is charged against profit in the period it occurs.

The cost of good output and abnormal loss is found by dividing the cost of production by the expected quantity of output. In the cost accounts, abnormal loss is accounted for by:

Debiting: **Abnormal loss account**

Crediting: **Process account**

With the cost of the abnormal loss

Then:

Debiting: Income statement

Crediting: Abnormal loss account

If abnormal loss with a scrap value, the scrap value of abnormal loss is set off against the amount to be written off to the profit and loss account by debiting the normal loss (scrap) account and crediting the abnormal loss account with the scrap value of the abnormal loss units. The balance on the abnormal loss is written off to the Income statement.

Example

Mwanza Refinery produces juice from malambe fruits. The following information relates to the process 2 for the month of September 2013.

Input from process 1	4,000 litres	K16,000
Added materials		9,000
Labour costs		12,000
Overheads		10,000

The output from the process was 3,400 litres

There were no closing inventories

Normal loss for the period was expected to be 10% of input materials from process 1.

Scrap materials are to be sold at 50 tambala per unit.

Required:

(a) Prepare process 2 Account for the month of September 2013.

(b) Prepare the abnormal loss account.

Solution

Dr Process 2 Account Cr

	Units	K		Units	K
Input from Proc. 1	4,000	16,000	Output	3,400	44, 200
Materials		9,000	Normal loss	400	200
Labour costs		12,000	Abnormal loss	200	2,600
Overheads		10,000			
	4,000	47,000		4,000	47,000

$$\text{Unit cost} = \frac{\text{Costs anticipated} - \text{scrap value}}{\text{Expected output units}}$$

Expected output = Input materials – normal loss
= 4000 – 400
= 3600

$$\frac{47{,}000 - 200}{3{,}600} \quad \text{K13/ unit}$$

(b) Preparation of abnormal gain or loss account

Abnormal Loss

	K		K
Process account	2,600	Cash from scrap	100
		Income Statement	2,500
	2,600		2,600

22.3 Chapter Summary

In this chapter you have learnt the main features of process costing and how to prepare process accounts. Remember that preparation of process accounts involves calculating the unit cost so that process costs should be passed on to units of good output and abnormal loss. Note that units of normal loss are not allocated any costs. When normal loss has a scrap value, this will reduce the cost which will be borne by good output and abnormal loss.

End of Chapter Questions

1. Explain the distinguishing features of process costing.
2. Outline the accounting treatment of normal loss and abnormal loss with scrap value in process accounts.

Exam Based Question

Masese Brewery is a company that produces opaque beer called Masese Special. This product passes through three stages in its production; fermentation, distilling and bottling. Results for the distilling stage for the month of September 2009 were as follows:

		K
Transfer from fermentation	4,000 litres	14,400
Added in materials		16,000
Labour costs		20,000

Overheads are absorbed at 90% of labour costs
Normal loss was set at 10% of inputs

At the end of the month 3,800 litres were transferred to the bottling stage.

There was no opening or closing work-in-progress

Required:

(a) Compute the cost of producing 1 litre of Masese special up to the distilling stage, basing on the above data. **6 Marks**

(b) Prepare the distilling process for the month of September 2009. **8 Marks**

(c) Mention **three** situations which could cause a process to experience abnormal loss. **3 Marks**

(TOTAL: 20 MARKS)

(PAEC FA4 Exam , November 2009)

ANSWERS TO END OF CHAPTER QUESTIONS

Chapter 1

Answer 1
Text Section 1.4

Answer 2

Qualities of good accounting information

*Any **five** of:*

Relevance and purpose
Timeliness
Accuracy
Completeness
Communicated to the right person
Reliability
Comparability
Materiality
Appropriate channel of communication.

Note: Students should be able to explain in detail each of the given characteristic.

Answer 3

See text.

Chapter 2

Answer 1

See text.

Chapter 3

1.2 *Answer 1*

1.3 An accounting equation example

Suppose a business reports MK2.5 million in total assets. The total of its liabilities, plus the capital invested by its owners, plus its retained profit, adds up to MK2.5 million. Otherwise, its books would be out of balance, which means there are bookkeeping errors.

Continuing with this example, suppose that the total amount of the liabilities of the business is MK1.0 million. This means that the total amount of owners' equity in the business is MK1.5 million, which equals total assets less total liabilities. The total owners' equity may be traceable to capital invested by the owners in the business as well as profit retained in the business. The total of these two sources of owners' equity is MK1.5 million.

The financial condition of the business in this example is summarized in the following accounting equation (in millions):

MK2.5 assets = MK1.0 liabilities + MK1.5 owners' equity

Looking at the accounting equation, one can see why the statement of financial condition is called the balance sheet; the equal sign means the two sides balance.

Note: This explains the dual aspect of accounting entries

Chapter 4

Answer 1

A transaction an event that take place in a business arrangement which will have a twofold effect on the statement of financial position bringing forth a change to the statement.

Answer 2

Pay As You Earn
Employees contributions to pension fund
Salary advances

Chapter 5

Answer 1

Books of original entry or books of prime entry

Answer 2

These are important because they are the books in which credit sales, purchases, and returns inwards and outwards of goods are first recorded. The details are then posted from them to the ledger accounts.

Chapter 6

1.4 *Answer 1*

a. *Deposits in transit*
These are deposits that are in the cash per books but not in the cash per bank statement. The reason is that there is delay between when the cash gets recorded on the books and when the bank records the deposit. Deposits in transit are determined by comparing the deposits listed on the books with the deposits listed on the bank statement.

b. *Outstanding checks*
These are checks that have been deducted from the cash per the books but not the cash per the bank statement. The reason is that there is a delay between when the check gets recorded on the books and when the bank records the check. Outstanding checks are determined by comparing the check disbursements on the books with the checks listed on the bank statement.

c. *Bank charges*
An expense for bank services that is listed on the bank statement but is not recorded on the company's books.

d. *Non-sufficient fund cheques (NSF cheques)*
A customer payment by cheque that has been recorded as a deposit on the books but was not collectible because of insufficient funds in the account of the customer.

Other terms are:

Service charges *which may have been deducted by the ban. Such charges are usually not known to the company before the issuance of bank statement.*

Interest income: If any interest income has been earned by the company on its bank account, it is not usually entered in company's account before issuance of bank statement.

1.5 *Answer 2*

Company A
Bank Reconciliation
31 December, 2013

Balance as per Bank, Dec 31	*K24,594.72*
Add: Deposit in Transit	*400.00*
	K24,994.72
Less: Outstanding Cheques:	

No. 846 issued on Nov 29	*K320.00*	
No. 875 issued on Dec 26	*49.21*	
No. 878 issued on Dec 29	*275.00*	
No. 881 issued on Dec 31	*186.50*	
		830.71
Adjusted Bank Balance		***K24,164.01***
Balance as per Books, Dec 31		***K23,196.79***
Add:		
Interest Income from Bank	*K1,237.22*	
Note Receivable Collected by Bank	*500.00*	
Interest Income from Note Receivable	*50.00*	
Deposit Understated	*90.00*	
		1,877.22
		K25,074.01
Less:		
NSF Cheque	*850.00*	
Bank Service Fee	*50.00*	
Bank Collection Fee	*10.00*	
		910.00
Adjusted Book Balance		***K24,164.01***

Note: The reconciliation can start with balance as per Bank Statement and then reconcile towards obtaining an adjusted Cash Book balance or Balance per Cash Book (as adjusted) and reconcile towards getting a Balance per Bank Statement.

Chapter 7

Answer

A nominal ledger consists of a large number of coded accounts. Part of a nominal ledger might, for example, be as follows:

Account code	Account name
100200	*Plant and machinery (cost)*
100300	*Motor vehicles (cost)*
300000	*Total receivables*
400000	*Total payables*
500130	*Wages and salaries*
500140	*Rent and rates*
500150	*Advertising expenses*
500160	*Bank charges*
500170	*Motor expenses*
500180	*Telephone expenses*
600000	*Sales*
700000	*Cash*

Chapter 8

Answer

Various types of transactions are expected and their effect on capital are expected to explained.

Chapter 9

Answer 1

Double entry book-keeping

The fundamental rule is that if there is an increase or decrease in one account, there will be equal decrease or increase in another account. There may be equal increases to both accounts, depending on what kind of accounts they are. There may also be equal decreases to both accounts. Accordingly, the following rules of debit and credit in respect to the various categories of accounts can be obtained. The rules may be summarised as below:

1. *Assets Accounts: debit increases in assets and credit decreases in assets*
2. *Capital Account: credit increases in capital and debit decreases in capital*
3. *Liabilities Accounts: credit increases in liabilities and debit decreases in liabilities*
4. *Revenues or Incomes Accounts: credit increases in incomes and gains and debit decreases in incomes and gains*
5. *Expenses or Losses Accounts: debit increases in expenses and losses and credit decreases in expenses and losses*

These five rules help learning about accounting entries.

Note: The trial balance would conveniently periodically be extracted after balancing off relevant accounts.

Chapter 10

Balancing off accounts

Trial balance as at 31st May 2013

1.6 *Answer 1*

Between receivables and bank.

1.7 *Answer 2*

Between payables and bank overdraft.

1.8

1.9

1.10

1.11

1.12 *Answer 3*

1.13 *Ndazizwa Packaging materials account*

1.14 *for the year ended 28th February 2014*

2014	K	2014	K
February 28 Bank	2,200,000	February 28 Inc Statement	1,800,000
		February 28 Inc Statement	400,000
	2,200,000		2,200,000
March 1 Inventory b/d	400,000		

Chapter 6

Answer 1

(a) *Bad debts*

2013		*2013*	
Dec 31 various	*540,000*	*Dec 31 Income Stement*	*540,000*

(b) *Allowance for doubtful debts*

Dec 31 Balance b/d	*310,000*	*Jan 1 Balance b/d*	*260,000*
		Dec 31 Income Statement	*50,000*
	310,000		*310,000*

(c) *Income Statement (extract)*

Bad debts	*540,000*
Allowance for doubtful debts	*50,000*

(d) *Statement of Financial Position*

Trade receivables	*6,200,000*	
Less allowance for doubtful debts	*310,000*	*5,890,000*

Answer 2

During the year, some debts will have been written off as bad. They will include debts from the previous year which last year's provision was intended to cover. If last year's estimate was correct, the accountant could add this year's bad debts to the change in the provision and the total would be the same as the total provision he/she wants to make this year, not just the difference between the two year's provisions (allowance or estimate). Son in effect, the accountant has converted last year's provision into this year's bad debts. All he/she need do now is adjust the balance on the provision for doubtful debts account to make it equal to the provision he/she wants to make against this year's closing trade receivables balance.

Chapter 7

Answer 1

A nominal ledger consists of a large number of coded accounts. Part of a nominal ledger might, for example, be as follows:

Account code	Account name
100200	Plant and machinery (cost)
100300	Motor vehicles (cost)
300000	Total receivables
400000	Total payables
500130	Wages and salaries
500140	Rent and rates
500150	Advertising expenses
500160	Bank charges
500170	Motor expenses
500180	Telephone expenses
600000	Sales
700000	Cash

Chapter 7

Answer 1

	Machines A	Machines B	Machines C
Bought 1 Jan 2011	*3,000,000*		
2011 Depn 10% for 12 months	*300,000*		
	2,700,000		
Bought 1 Apr 2012		*2,000,000*	
2012 Depn 10% x2,700,000	*270,000*		
Depn 10% for 9 months		*150,000*	
	2,430,000	*1,850,000*	
Bought 1 Jul 2013			*1,000,000*
2013 Depn 10% x2,430,000	*243,000*		
Depn 10% x1,850,000		*185,000*	
Depn 10% for 6 months			*50,000*
	2,187,000	*1,665,000*	*950,000*

2013 Total Depreciation Provision 243,000 + 185,000 + 50,000 = 478,00

Answer 2

Unit of output method of depreciation establishes the total units of output expected from the asset. Depreciation, based on cost less salvage value, is then calculated for the period's output over the life of the asset.

An instance of this could be a machine which is expected to be able to produce 10,000 widgets over its useful life. It has cost K6,000.000 with zero expected salvage value. In year 1 a total of 1,500 widgets are produced, and in year 2 the production is 2,500 widgets.

The depreciation per period is calculated as:

$$(Cost - salvage\ value) \times \frac{period's\ production}{Total\ expected\ production}$$

$$Year\ 1 : K6{,}000{,}000 \times \frac{1{,}500}{10{,}000} = K900{,}000\ depreciation$$

$$Year\ 2 : K6{,}000{,}000 \times \frac{2{,}500}{10{,}000} = K1{,}500{,}000\ depreciation$$

Chapter 8

Answer 1

Statement of Comprehensive Income for the Year Ended 31st December 2013

	MK	MK
Revenues		150,000
Less Cost of Sales (COSA)		
Opening Inventories	-	
Add: Purchases	200,000	
	200,000	
Less Closing inventories	80,000	120,000
Gross Profit		30,000
Less Expenses		-
Net profit for the period		30,000

Lister's

Statement of Financial Position as at 31st December 2013

	MK	MK	MK
	Cost	Depn	Net Book Value
Non-Current Assets	600,000	-	600,000
Current Assets			
Inventories	80,000		
Receivables	150,000		

Bank	*240,000*	*470,000*
TotaL Assets		*1,070,000*
Financed by Capital and Liabilities		
Capital		*1,000,000*
Profit for the period		*30,000*
		1,030,000
Payable		*40,000*
Total Equity and Liabilities		*1,070,000*

Answer 2

Revenue expenditure are expenses needed for day-to-day running of the business. It is chargeable in income statement durimg the period it is incurred. Example: petrol for van.

Capital expenditure are amounts a business spends to buy or add value to a non-current asset. This is incurred when a business spends money either to:
buy non-current assets; or
add to the value of an existing non-current asset.
Included in this should be amounts spent on acquiring non-current assets, bringing them into business, legal costs of buying buildings, carriage inwards on machinery bought, and any other cost needed to get a non-current asset ready for use. This will result in increased figures for non-current assets in the statement of financial position. Example: purchase of a van.

Chapter 9

Answer 1(a)

(i)FIFO Closing inventories 20 x MK40,000 = MK800,000

(ii) LIFO	*Received*	*Issued*	*Inventory after each transaction*		
Jan	*10xMK30,000*		*10xMK30,000*		*300,000*
Mar	*10xMK34,000*		*10xMK30,000*	*300,000*	
			10xMK34,000	*340,000*	*640,000*
Apr		*8xMK34,000*	*10xMK30,000*	*300,000*	
			2xMK34,000	*68,000*	
Sep	*20xMK40,000*		*10xMK30,000*	*300,000*	
			2xMK34,000	*68,000*	
			20xMK40,000	*800,000*	*1,168,000*
Dec		*12xMK40,000*	*10xMK30,000*	*300,000*	
			2xMK34,000	*68,000*	
			8xMK40,000	*320,000*	*688,000*

(i)	*AVCO*	*Received*	*Issued*	*Average cost per unit stock held*	*No. of units in stock*	*Total value of stock*

Jan	*10xMK30,000*		*MK30,000*	*10*	*MK300,000*
Mar	*10xMK34,000*		*MK32,000*	*20*	*MK640,000*
Apr		*8*	*MK32,000*	*12*	*MK384,000*
Sept	*20xMK40,000*		*MK37,000*	*32*	*MK1,184,000*
Dec		*12*	*MK37,000*	*20*	*MK740,000*

Answer 1(b)

Trading Account for the year ended 31st December 2013

	FIFO	*LIFO*	*AVCO*	*(All methods)*	
Purchases	*1,440,000*	*1,440,000*	*1,440,000*	*Sales 8xMK46,000*	*MK368,000*
Less Closing inventory	*800,000*	*688,000*	*740,000*	*12xMK56,000*	*MK672,000*
Cost of goods sold	*640,000*	*752,000*	*700,000*	*Total sales =*	*MK1,040,000*
Gross profit (difference)	*400,000*	*288,000*	*340,000*		
	1,040,000	*1,040,000*	*10,40,000*		

Answer 2(a)

In one respect the consistency convention is not applied, as at one year end the inventory may be shown at cost whereas the next year end may see inventory valued at net realizable value. One the other hand, as it is prudent to take the lower of cost or net realizable value, it can be said to be consistently prudent to consistently take the lower figure.

Answer 2(b)

Being prudent can be said to be an advantage. For instance, a shareholder can know that inventories are not overvalued: if they were, it would give them a false picture of their investment.
Someone to whom money is owed, such as a creditor, will know that the inventories in the statement of financial position are realizable at least at that figure.
It is this knowledge that profits are not recorded because of excessive values placed on the inventories that gives outside parties confidence to rely on reported profits.

Chapter 10

Answer 1

Trial balance.

Chapter 10

Answer 1

See text. However, the length of the answer will depend on marks that are allocated to the question. It will be wasteful to write a lot where only a few marks are available.

Answer 2

Item	*If no effect state 'No'*	*Debit side exceeds credit side by*	*Credit side exceeds debit*
(i)	*No*		
(ii)			*MK 3,400,000*
(iii)	*No*		
(iv)		*MK1,500,000*	
(v)			*MK 610,000*
(vi)			*MK 170,000*
(vii)	*No*		

Chapter 11

Answer 1

A debit balance of MK39,500 i.e Sales			*20,500*
			36,000
			18,000
			74,500
	Less: Bank	*30,000*	
	Returns	*5,000*	*35,000*
			39,500

Answer 2

Start by drafting a receivables account.

	Dr		Cr
	USD		USD
Balance b/d			
		Balance c/d	
Balance b/d			

Now fill in the figures that you have starting with opening and closing balances.

Receivables account

	Dr		Cr
	USD		USD
Balance b/d	29,100		
		Balance c/d	38,600
Balance b/d	38,600		

Now think about your sales ledger control account and enter the transactions.

Receivables account

	Dr		Cr
	USD		USD
Balance b/d	29,100	Cash received (381,600+6,800)*	388,400
		Irrecoverable debts	7,200
Credit sales	414,500	Discounts allowed	9,400
		Balance c/d	38,600
	443,600		443,600
Balance b/d	38,600		

** the expenses paid out before the cash was banked reduced the amount banked overall. That means that the amount received from customers will be higher by USD6800.*

Total sales = credit sales USD414,500 (above) + cash sales USD112,900 (from the question) = USD527,400

An alternative answer would include all cash received from customers which means including the cash sales as cash received. As you can see it gives the same overall answer.

Receivables account

	Dr		Cr
	USD		USD
Balance b/d	29,100	Cash received (381,600+6,800+112,900)	501,300
		Irrecoverable debts	7,200
TOTAL sales	527,400	Discounts allowed	9,400
		Balance c/d	38,600
	556,500		556,500
Balance b/d	38,600		

Notice that the only difference in the account in the inclusion of cash sales in cash received and the balancing figure is labelled total sales, credit and cash combined.

Chapter 12

Answer 1

(a) PrEz

Partnership Appropriation Account for the year ended 31st July 2013

	Province	Region	Zone	Total
Interest on capital accounts (at 15%)	*120,000*	*90,000*	*60,000*	*270,000*
Salaries		*500,000*	*300,000*	*800,000*
				1,070,000
Share of balance of profits (3,000,000 less 1,070,000i.e 1,930,000				
3/6; 2/6; 1/6	*965,000*	*643,333*	*321,667*	*1,930,000*
	1,085,000	*1,233,333*	*681,667*	*3,000,000*

(b) (i) Combined PrEz Partners' Capital Accounts after admitting Tayanjana

---

	Province	Region	Zone	Tayanjana
Bal b/d	*1,085,000*	*1,233,333*	*681,667*	
Inventories	*60,000*	*40,000*	*20,000*	
Cash				*120,000*
	1,145,000	*1,273,333*	*701,667*	*120,000*

(ii) The capital accounts amounts are amounts that have been accumulated and shared from the previous partnership. That is the sharing of the total profit of K3 million.

Chapter 14

(a) Income statement for HKJ Trading for the year ending 30 November 2013

	K	K
Sales		820,000
Less: return inwards		(25,000)
		795,000
Less: Cost of goods sold		
Opening inventories	80,000	
Purchases	465,000	
Carriage inwards	15,000	
Return outwards	(30,000)	
Closing inventories	(90,000)	440,000
Gross profit		355,000
Less: Expenses		
Carriage outwards	40,000	
Salary and wages	60,000	
Insurance costs (20,000 + 6,000)	26,000	
Advertisements	60,000	
Rates	10,000	
Rent (35,000 – 5,000)	30,000	
Provision for doubtful debt	5,400	
Discount allowed	10,000	
Depreciation – Motor van	60,000	
– Equipments	30,000	331,400
Net profit		23,600

Chapter 15

(b) Balance sheet for HKJ Trading as at 30 November 2013

	K	K
Noncurrent assets		
Property plant and equipment		390,000
Current assets		
Inventories	90,000	
Receivables	174,600	
Prepayments	5,000	269,600
		659,600
Capital and Liabilities		
Capital		500,000
Profit		23,600
Drawings		(40,000)
		483,600
Liabilities		
Payables	120,000	

Bank	50,000	
Accruals	6,000	176,000
		659,000

Chapter 16

Inventory Valuation

(a) Value of inventories using FIFO & Average Cost

(i) FIFO

Date	Purchases	Issues	Balance c/d
1/10			2,000 @ K300 = 600,000
4/10	1,000 @ K320 = 320,000		1,000 @ K320 = 320,000
7/10		2,500 @K320	500 @ K320 = 160,000
10/10	3,000 @ K300 = 900,000		3,000 @ K300 = 900,000
15/10	1,000 @ K320 = 320,000		1,000 @ K320 = 320,000
20/10		2,000	1,500 @ K300 = 450,000
			1,000 @ K320 = 320,000
25/10	1,500 @ K330 = 495,000		1,500 @ K330 = 495,000
30/10		2,000	500 @ K320 = 160,000
			1,500 @ K330 = 495,000
			2,000 655,000

(ii) Average Cost

Date	Purchases	Issues	Balance Units	Price	Amount
1/10			2,000	300	600,000
4/10	1,000 @ K320 = 320,000		3,000	307	920,000
7/10		2,500	500	307	153,500
10/10	3,000 @ K300 = 900,000		3,500	301	1,053,500
15/10	1,000 @ K320 = 320,000		4,500	305	1,373,500
20/10		2,000	2,500	305	762,500
25/10	1,500 @ K330 = 495,000		4,000	314	1,257,500
30/10		2,000	2,000	314	628000

Chapter 17

(a) Five errors which do not affect trial balance

(i) Error of principle – where an item is entered in the wrong class of account.

(ii) Error of commission – where an item is entered in the wrong personal account.

(iii) Error of omission – where a transaction has not been recorded in the books of accounts.

(iv) Error of original entry – where the original figure is incorrect, yet double entry still has been observed.

(v) Compensating error – where errors cancel out each other.

(vi) Complete reversal error – where the correct amount has been used but each item is shown on the wrong side of the accounts.

(vii) Transposition error – where the wrong sequence of individual characters within a number was entered but the double entry is done correctly.

(b) Journal entries to correct errors

			K	K
(i)	Dr	Suspense Account	18,000	
	Cr	Purchases Account		18,000
(ii)	Dr	Suppliers (Creditors) Account	30,000	
	Cr	Discount received account		30,000
(iii)	Dr	Cash book	40,000	
	Cr	Sales		40,000
(iv)	Dr	Customers control account	12,000	
	Cr	Cash book		12,000
(v)	Dr	Purchases	70,000	
	Cr	Fixed assets account		70,000
(vi)	Dr	Suspense account	60,000	
	Cr	Cash book		60,000
(vii)	Dr	Salaries account	65,000	
	Cr	Suspense account		65,000

Chapter 18

(a) Control accounts

(i) Receivable Control Accounts

Balance b/f	140,000	Bad debts	12,000
Credit sales	600,000	Control a/c	25,000
Interest on receivables	4,000	Cash	380,000
Dishonoured cheque	8,000	Discount	17,000
		Return inwards	11,000
		Balance c/d	307,000
	752,000		752,000
Balance b/d	307,000		

(ii) Payable Control Account

Contra account	25,000	Balance b/f	90,000
Return outwards	14,000	Purchases	400,000
Cash	250,000		
Discount	10,000		
Balance c/d	191,000		
	490,000		490,000
		Balance b/d	191,000

(b) Differences in balances between payables ledger and suppliers statement.

(i) Goods in transit from supplier.
(ii) Payment made which has not yet been received by the supplier.

Goods returned outwards – returns to the supplier.

Chapter 19

Bank lodgments and direct debit

Bank lodgments refer to deposits which have been made on the date when the bank statement has been obtained and therefore not reflected in the statement received. Direct debits refers to transfers which are made by the bank directly from the account to the suppliers (payables).

(b) Updated cash book

Cash book

	K		K
Credit transfer	20,000	Balance b/f	38,000
Balance c/d	102,000	Bank charges	4,000
		Direct debit	25,000
		Returned cheque	45,000
		Standing order	10,000
	122,000		122,000

(c) Bank reconciliation statement

			K
Balance per updated cash book			(102,000)
Add: Unpresented cheques			
H Sitima	0024	30,000	
City rates	0026	18,000	
Kabula Pvt	0029	15,000	63,000
			(39,000)
Less: Bank lodgments			(15,000)
Balance per bank statement			(54,000)

Chapter 22

Cost of producing 1 litre of Masese special

Units		4,000 litres
		K
Cost elements		
Transfer from fermentation		14,400
Added materials		16,000
Labour costs		20,000
Overheads	(90% of labour cost)	18,000
TOTAL		68,400

Unit cost $\frac{\text{Cost expected}}{\text{Expected output}}$

$\frac{68,400}{3,600}$ K19/ litre

Process account

	Units	K		Units	K
Transfers	4,000	14,400	Output	3,400	64,600
Materials		16,000	Normal loss	400	0
Labour costs		20,000	Abnormal loss	200	3,800
Overheads		18,000			
	4,000	68,400		4,000	68,400

PILOT PAPER

FORMAT AND STANDARD OF THE EXAMINATION PAPER

The paper will consist of two sections; section A and section B. **Section A** will be compulsory with one question. The question will be on **preparation of final accounts for various forms of businesses with some adjustments**. This section will carry 40 marks. **Section B** will have **4 questions,** each carrying 20 marks. Candidates will be required to answer **any three** questions from section B.

SECTION A (40 marks)

One compulsory question

Question 1

Mamangidwe Properties is a business that started with capital from the owner, Masa, who deposited K180,000 cash into the business account on 1st September 2013.

The following transactions took place during the month of September:
(1) 1 September purchased land and buildings for K141,000 paying cash.
(2) 3 September arranged for a fire insurance for K36,000, paying K15,000 cash and incurring a liability of K21,000.
(3) 10 September sold part of the land at a price equal to the cost of K11,000, collectible within three months.
(4) 14 September purchased office equipment on credit for K5,400.
(5) 20 September received K1,500 cash as partial collection of the K11,000 account receivable.
(6) 30 September paid K3,000 on accounts payable.

And the following transactions took place during the month of October:
(1) October 1 paid K360 cash for publication of newspaper advertisement for various houses offered for sale.
(2) October 2 earned and collected a commission of K2,250 in cash by selling a residence previously listed by a client.
(3) October 16 newspaper advertisement was purchased at a price of K270, a payment to be made within 30 days.
(4) October 20 a commission of K8,390 was earned by selling a client's residence. The sales agreement provided that the commission would be received in 60 days.
(5) October 31 paid salaries of K7,100 cash to employees for services rendered during October.
(6) October 31 a telephone bill for October amounting to K144 was received. Payment required by November 10.
(7) October 31 withdrawal by owner K1,800 cash for personal use.

Required:

(a) Prepare the Trial Balance for Mamangidwe Properties covering all the transactions that took place in September and October. **14½ Marks**

(b) You have further been given the following information:

(1) The fire insurance with an original cost of K36,000 covers 20 years.

(2) The office equipment with an original cost of K5,400 has a useful life of 10 years after which its residual value will be nil. Assume that the use of equipment in each month is equal.

Required:

Prepare the Income Statement for September and October, after including the adjusting entries relating to October. **5½ Marks**

(c) Draw a Statement of Financial Position as at 31st October 2013.

. **5½ Marks** .

(d) Mgwazo, a competitor of Mamangwidwe Properties, has prepared the following statement of affairs as at 31st October 2012:

Statement of Affairs

		K		K
2012				
October 1	Trade payables	600,000	Office furniture	50,000
	Other payables	50,000	Inventories	200,000
	Capital account		Trade receivables	450,000
	Being excess of		Other receivables	100,000
	assets over liabilities		Cash	150,000
	at this date	300.000		
		950,000		950,000

On 30 September 2013 Mgwazo's trade payables were K450,000 and other payables K70,000. His office furniture was valued at K45,000, inventories K150,000, trade receivables K530,000, other receivables K70,000, and cash was K80,000. His drawings during the period amounted to K45,000.

Required:

(i) Calculate Mgwazo's profit for the year ended 30th September 2013. **10 Marks**

(ii) Explain why it is advisable to estimate values of assets and liabilities at, or shortly after, the end of the year rather than later. **4½ Marks**

[TOTAL : 40 Marks]

SECTION B (60 marks)

Answer any three questions from four available

Question 2

Your organization has provided the following information for the month of November 2013.

	K'000
Purchases Ledger	
Balance at 1 November (cr)	8,900
Cheques paid to suppliers during the month	20,420
Purchases on credit from suppliers during the month	16,850
Sales Ledger	
Balance at 1 November (dr)	11,680
Credit sales during the month	30,980
Cash received from customers during the month	15,740

Required:

(a) Complete the Sales Ledger Control Account and the Purchases Ledger Control Account for the month of November, carrying down the balances at the end of the month.
7 Marks

(b) State, giving brief reasons, where the following two accounts should appear in the ledger control accounts:
(i) return outwards;
(ii)return inwards. **4 Marks**

(c) Explain the main purpose of control accounts. **2 Marks**

(d) Giving examples, name accounting errors which do not affect the trial balance from balancing. **7 Marks**

[TOTAL 20 MARKS]

Question 3

You are given the following information for Paulendo Enterprises:

Cash Book

2013		K'000	2013		K'000
May 1	Balance b/d	320	May 10	Cashflow	110
16	Ferries Limited	160	20	Thamangirani	90
24	Jets Limited	140	28	Couriers Trading	180
31	Coach Trains	470	30	Worldlinkers	200
31	Speedliners	90			

Bank Statement (amounts also in K'000)

2013		Withdrawals	Deposits	Balance
May 1	Balance b/d	-	-	320
12	000111	110	-	-
16	Deposit	-	160	-
23	000112	90	-	-
24	Deposit	-	140	-
28	Direct debit: Couriers Trading	180	-	-
31	Bank giro credit	-	90	-

Required:

(a) Balance off the cash book and explain what the balance means to Paulendo Enterprises.
4 Marks

(b) Show the running balances on the bank statement and state what the balance as at 31st May 2013 means to the bank. **5 Marks**

(c) Prepare a bank reconciliation for Paulendo Enterprises as at 31st May 2013.
5 Marks

(d) A new customer of Paulendo Enterprises, Miss Tafika, runs a fleet of minibuses and trades under the name Zobanguka Runners. Tafika issued a cheque, writing K55,000 in figures on the cheque, but writing it in words as fifty five thousand *five hundred* kwacha.

Required:

(i) Explain what the bank will most likely do with the cheque issued by Tafika. **1 Mark**

(ii) Show the accounting treatment of the cheque in the books of Paulendo Enterprises before and after the action by the bank, assuming that Zobanduka was owing Paulendo Enterprises K55,500. **5 Marks**

[TOTAL 20 MARKS]

Question 4

Set out below is a table giving details of purchases during year 2013 by Zida Zamakono Enterprises. Zida Zamakono Enterprises buys and sells modern farm carts throughout Malawi. It commenced operations on 1 January 2013.

cart

Date	Quantity (Farm carts)	Cost per farm cart
		K
1 January	35,000	5,000
1 April	10,000	6,000
1 July	10,000	6,500
1 September	15,000	8,000

From 1 January to 30 June, 25,000 farm carts were sold at a price of MK12,000 each. In the second half of the year 35,000 farm carts were sold at K16,000 each leaving 10,000 farm carts in stock at 31st December 2013.

Required:

Calculate the gross profit for Zida Zamakono Enterprises and the value of its closing inventory as at 31st December 2013 under **each** of the following inventory valuation methods:

(a) First In First Out (FIFO)
(b) Last In First Out (LIFO)
(c) Average Cost (AVCO).

The average cost should be calculated once at the end of the year. **[TOTAL 20 MARKS]**

Question 5

(a) Explain the difference between a partnership and a private limited company in terms of legal personality and liability for debts. **4 Marks**

(b) Bweleka, Katapila and Kongoza are trading in partnership under the name Ngongole Partnership. You are given the following information for Ngongole Partnership for year ended 30th April 2014:

(1) Net profit after adding back partners' salaries K30,350.
(2) Fixed capital accounts: balances b/fwd: Bweleka K40,000, Katapila K30,000 Kongoza K18,000.
(3) Current accounts: debit balances b/fwd: Bweleka K1,860, Katapila K946, Kongoza K717.
(4) Salaries to be credited: Katapila K2,000; Kongoza K3,500.
(5) Profits to be shared: Bweleka 50%, Katapila 30%, Kongoza 20%
(6) Interest to be charged on capitals: Bweleka K2,000, Katapila K1,500, Kongoza K900.
(7) Interest to be charged on drawings: Bweleka K240, Katapila K180, Kongoza K130.

(8) Drawings: Bweleka K9,200, Katapila K7,100, Kongoza K6,900.

Required:

(i) Prepare the Profit and Loss Appropriation Account for Ngongole Partnership for The year ended 30 April 2014. **6 Marks**

(ii) Prepare the partners' current and capital accounts as at 30 April 2014. **10 Marks**

[TOTAL 20 MARKS]

End of question paper

SUGGESTED SOLUTIONS

SECTION A (40 marks)

Answer 1 (a)

TRIAL BALANCE

	Dr K	Cr
Cash	15,490	
Capital		180,000
Land & Buildings	130,000	
Insurance	36,000	
Accounts receivable	17,890	
Accounts payable		23,814
Office equipment	5,400	
Advertising expenses	630	
Sales Commission		10,640
Telephone expenses	144	
Salary expenses	7,100	
Drawings	1,800	
	214,454	214,454

12½ Marks from workings add 2 for the trial balance above = 14½ Marks

Workings

(i) Cash transactions

	Add	Deduct	
Deposit	180,000		½
Land and buildings		141,000	½
Insurance		15,000	½
Land sale	1,500		½
Creditors		3,000	½
Newspaper advertising		360	½
Commission	2,250		½
Salaries		7,100	½
Drawing		1,800	½
	183,750	168,260	15,490 **1**

(ii) Land and buildings K141,000 – K11,000 **1**

(iii) Accounts receivable

Land 11,000 less 1,500	9,500	**1**
Commission	8,390	½
	17,890	

(iv) Accounts payable

Insurance	21,000	½
Office equipment	5,400	½
Payments made	(3,000)	½
Advertisement	270	½
Telephone	144	½
	23,814	

(v) Advertising 360 + 270 = 630 **1**

(vi) Sales commission 2,250 + 8,390 = 10,640 **1**

(b) INCOME STATEMENT

Mamangidwe Propeties Income Statement for the two months ended October 2013

	K	K
Revenue:		
Sales commissions earned		10,640 ¾
Expenses:		
Advertising expenses	630 ¾	
Salaries	7,100 ¾	

Telephone expenses	144 ¾		
Insurance expense (36,000 / (20x12)) x 2	300 **1**		
Depreciation expense	45 **1**		
Total expenses			(8,219)
Net Income			2,421 ½
			5½ Marks

(c) STATEMENT OF FINANCIAL POSITION

Mamangidwe Properties Statement of Financial Position as at 31st October 2013

	K	K	K
Non-current assets	Cost	Depreciation	Net Book Value
Land & Buildings	130,000	-	130,000 ½
Office equipment	5,400	45	5,355 **1**
			135,355
Current assets			
Accounts receivable	17,890 ½		
Prepaid insurance (238 of 240 months)	35,700 **1**		
Cash	15,490 ½	69,080	
Less: current liabilities			
Accounts payable		23,814 ½	45,266
			180,621

Capital	180,000 ½
Add Net income	2,421 ½
Less Drawings	(1,800) ½
	180,621

or

Assets		
Non current assets		
Land and buildings		130,000 ½
Equipment (5,400 – 45)		5,355 **1**
		135,355
Current assets		
Receivables	17,890 ½	
Prepayments (238 for 240 months)	35,700 **1**	
Cash	15,490 ½	69,080
		204,435
Capital and liabilties		
Capital		180,000 ½
Add Net income		2,421 ½
		182,421
Less Drawings		1,800 ½

		180,621
Current liabilities		
Payables		23,814 ½
		204,435

(d) (i)

Statement of Affairs

2013		K		K	
September	Trade payables	450,000 **1**	Office furniture	45,000	**1**
	Other payables	70,000 **1**	Inventories	150,000	**1**
	Capital account being excess of assets over liabilities at this date	355.000 **1**	Trade receivables	530,000	**1**
			Other receivables	70,000	**1**
			Cash	80,000	**1**
		875,000		875,000	

Calculation of profit	K	
Capital, 30 September 2013	355,000	
Drawings for the year	45,000	**1**
Capital, 1 October 2012	(300,000)	**1**
	100,000	

10 Marks

(ii) *Candidates were expected to be imaginative in their attempts to this question. Time interval and other accounting concepts would have been applied in the discussions.*
No great difficulty should be experienced in estimating values of the assets and liabilities at, or shortly after, the end of the period under review when the work of preparing the statement is undertaken shortly after that date. This is because the necessary material for the valuation will probably be still accessible, and memory on transactions made may still be fresh. The preparation of earlier statements may present more difficulty and the most searching enquiries may have to be made. Needless to say, this method of ascertaining results is most unsatisfactory and the trader should be advised to install double entry bookkeeping without delay.

4 ½ Marks
[TOTAL 40 MARKS]

SECTION B (60 marks)

Answer 2 (a)

Purchases Ledger Control Account ½

	K		K
Bank	20,420 ½	Bank/Cash (November)	8,900 ½
c/d 30 November	5,330 **1**	Suppliers (November)	16,850 ½
	25,750		25,750
		b/d	5,330 ½

Sales Ledger Control Account ½

	K		K
b/d 1 November	11,680 ½	Bank/Cash (November)	15,740 ½
Credit sales (November)	30,980 ½	c/d (November)	26,920 **1**
	42,660		42,660
b/d	26,920 ½		

(b) Return outwards represents an organization returning goods, previously purchased to a supplier. It should appear in the purchases ledger control account as a debit entry. **2**

Return inwards represents an organisation receiving goods back which had previously been sold, because they were faulty or inappropriate for some reason. It should appear in the sales ledger control account as a credit entry. **2**

(c) They represent the total for the detailed individual accounts and they make reconciliation of all the accounts easier and quicker. **2**

(d) Error of original entry	Invoice amount K5,350 recirded wrongly as K535 but double entry observed correctly throughout
Error of principle	K25,000 repairs to motor vehicle recorded in Motor vehicle account
Error of commission	Purchases of K1 m from X credited to Y's account
Error of omission	An entry totally omitted from the books such as K13,500 credit sale to Kim not debited to Kim nor credited to sales account.
Complete reversal of entries	Debit entry credited and credit entry debited
Compensation errors	Cast error of equal amount on both the debit and corresponding entry
Transposition error	Individual characters in a figure put in wrong Sequence but double entry correctly observed. K71,600 recorded as K61,700.

1 Mark each item, total 7

[TOTAL 20 MARKS]

Answer 3 (a) Paulendo Enterprises:

Cash Book

2013	K'000			K'000	
May 1 Balance b/d	320		May 10 Cashflow	110	
16 Ferries Limited	160		20 Thamangirani	90	
24 Jets Limited	140		28 Couriers Trading	180	
31 Coach Trains	470		30 Worldlinkers	200	
31 Speedliners	90		31 Balance c/d	600	**1½**
	1,180			1,180	
June 1 Balance b/d	600	½			

This means that Paulendo has K600,000 of cash resources in the company. **2**

(b) Bank Statement – Balances (K'000)

2013			
May 1	Balance b/d		320
12	Less 110	½	210
16	Add 160	½	370
23	Less 90	½	280
24	Add 140	½	420
28	Less 180	½	240
31	Add 90	½	330

The balance of K330,000 implies that the bank is keeping this amount for its customer, Paulendo **1**. The amount is like a liability to the bank and is payable to the customer on demand **1**.

(a) Bank reconciliation as at 31 May 2013

	K'000	
Balance as per cash book	600	**1**
Add unpresented cheque	200	**1**
	800	½
Less Bank lodgement not on statement	(470)	**1**
Balance per bank statement	330	**1**

½ Mark for format/presentation

(b) (i)The cheque will be dishonoured by the bank/referred to the drawer. **1**

(ii)

Zobanduka

	K			K	
2013 Balance b/d	55,500	½	2006 Bank	55,000	½
			Balance c/d	500	½
	55,500			55,500	

Bank

	K			K
2013 Paulendo	55,500	½		

BUSINESS ACCOUNTING (FA4)

CERTIFICATE IN FINANCIAL ACCOUNTING

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