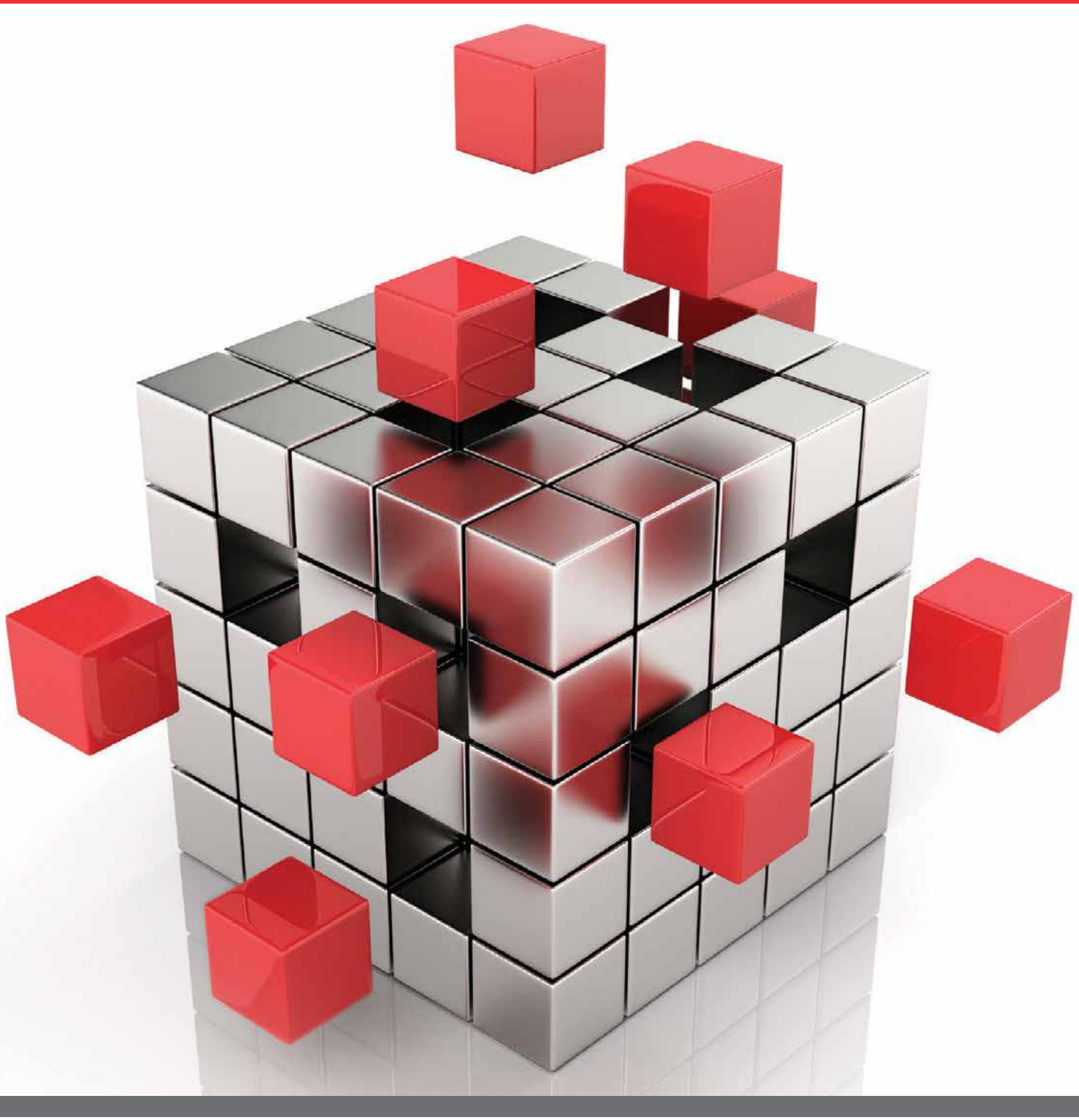
ACCOUNTING FRAMEWORK(P1)

KNOWLEDGE LEVEL



ICAM THE INSTITUTE OF CHARTERED ACCOUNTANTS IN MALAWI

Copyright © The Institute of Chartered Accountants in Malawi – 2014

The Institute of Chartered Accountants in Malawi
P.O. Box 1 Blantyre
E-mail: icam@icam.mw
www.icam.mw

ISBN: 978-99908-0-425-6

All rights reserved. No part of this book may be reproduced or transmitted in any form or by any means-graphic, electronic or mechanical including photocopying, recording, taping or information storage and retrieval systems-without the written permission of the copyright holder.

Design
PRISM Consultants
prismmw@gmail.com

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 MANUAL

The manual has been developed in order to provide resources that will help the Institute's students attain the needed skills. The manual has been developed in such a way that even those who would like to study on their own can do that. 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.

NOT FOR SALE

ACCOUNTING FRAMEWORK

Aims of the module

i. To develop the student's understanding of the fundamental principles and concepts of accounting.
ii. To develop the student's ability to apply accounting principles in various practical accounting environments in line with regulatory and statutory frameworks.
iii. To develop the student's ability to prepare, analyze and interpret financial statements.

Objectives

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

i. Prepare financial statements for a variety of organizations within the regulatory framework.
ii. Analyze the performance of a business using financial statements through ratio analysis.
iii. Prepare basic consolidated financial statements for simple group accounts

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 (%)
Maintaining financial records and adjustments to accounting records and financial statements	25
Accounting and reporting concepts	10
Accounting and reporting for various business organisations	50
Consolidated financial statements	15
Total	100

Learning Outcomes

1 Introduction to accounting

In the assessment candidates may be required to:-

1.1 *Accounting and the accounting process*

(a) Define accounting
(b) Define financial reporting – recording, analyzing and summarizing financial data

1.2 *Qualitative characteristics of accounting information*

(a) Define, understand and apply qualitative characteristics: relevance, faithful representation, comparability, verifiability, timeliness and understandability.

1.3 *Users of accounting information and their requirements*

(a) Identify various users of financial statements and their information needs

1.4 *Accounting principles and concepts*

(a) Define accounting principles and concepts
(b) Explain the principles of accounting: going concern, accruals, consistency, double entry, business entity, materiality and historical cost

1.5 *The role of computers in accounting*

(a) Explain how computers are used in accounting systems
(b) Consider the risks to data security, data protection procedures and the storage of data
(c) Describe the accounting documents and management reports produced by computerized accounting systems and understand the link between the accounting system and other systems in the business
(d) Outline advantages and disadvantages of using computers is accounting

1.6 *Regulation of accounting in Malawi*

(a) Define, understand and apply accounting convention and generally accepted accounting principles (GAAP)
(c) Understand the role of the regulatory system including the roles of the IFRS Foundation (IFRSF), the International Accounting Standards Board (IASB), the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRS IC)
(d) Consider the role of the local regulatory system including Institute of Chartered Accountants in Malawi (ICAM) and Malawi Accountants Board (MAB)
(e) Understand the role of International Reporting Standards

2 Accounting procedures and systems

In the assessment candidates may be required to:-

2.1 Classification of business transactions

(a) Understand a range of business transactions including: sales, purchases, receipts, payments, petty cash and payroll

2.2 Elements of accounting information

(a) Understand and identify the purpose of each of the main financial statements
(b) Define and identify assets, liabilities, equity, revenue and expenses

2.3 Source documents

(a) Outline the contents and purpose of different types of business documentation, including: quotation, sales order, purchase order, goods received note, goods dispatched note, invoice statement, credit note, debit note, remittance advice, receipt

2.4 Books of prime entry

(a) Identify the main types of ledger accounts and books of prime entry, and understand their nature and function.

2.5 The concept of double entry

(a) Understand and apply the concept of double entry accounting and the duality concept.
(b) Define the accounting equation.
(c) Understand and apply the accounting equation.
(d) Understand how the accounting equation relates to the double entry book-keeping system
(e) Process financial transactions from the books of prime entry into the double entry bookkeeping system.

2.6 Charts of accounts and coding

(a) Understand and explain charts of accounts
(b) Understand the principles of coding in entering accounting transactions including:
(i) Describing the need for a coding system for financial transactions within a double entry book-keeping system
(ii) Describe the use of a coding system within a filing system
(iii) Code sales invoices, supplier invoices and credit notes ready for entry into the books of prime entry

NOT FOR SALE

2.7 Trial balance and Journals

(a) Understand and illustrate the uses of journals and the posting of journal entries into ledger accounts.
(b) Illustrate how to balance and close a ledger account
(c) Identify the purpose of a trial balance
(d) Extract ledger balances into a trial balance
(e) Identify and understand the limitations of a trial balance
(f) Prepare ledger balances, clearly showing the balances carried down and brought down as appropriate.
(g) Extract an initial trial balance

3 Application of selected accounting standards

In the assessment candidates may be required to:-

3.1 Accounting for tangible noncurrent assets

The main reference is International Accounting Standard (IAS) 16, Property, Plant and Equipment. The other relevant accounting standards are IAS 36 Impairment of Assets and IAS 40 Investment Property

(a) Define non-current assets.
(b) Recognise the difference between current and non-current assets.
(c) Explain the difference between capital and revenue items.
(d) Classify expenditure as capital or revenue expenditure
(e) Prepare ledger entries to record the acquisition and disposal of non-current assets

(f) Calculate and record profits or losses on disposal of non-current assets in the statement of profit or loss including part exchange transactions.
(g) Record the revaluation of a non-current asset in ledger accounts, the statement of profit or loss and other comprehensive income and in the statement of financial position.
(h) Calculate the profit or loss on disposal of a revalued asset.
(i) Illustrate how non-current asset balances and movements are disclosed in financial statements.
(j) Explain the purpose and function of an asset register.
(k) Define property, plant and equipment, carrying amount, depreciable amount, depreciation, fair value, impairment loss, recoverable amount, residual value and useful life of noncurrent asset
(l) Understand and explain the purpose of depreciation.
(m) Calculate the charge for depreciation using straight line and reducing balance methods.
(n) Identify the circumstances where different methods of depreciation would be appropriate

(o) Illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts
(p) Calculate depreciation on a revalued noncurrent asset including the transfer of excess depreciation between the revaluation reserve and retained earnings.
(q) Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and/or residual value of a noncurrent asset.
(r) Record depreciation in the statement of profit or loss and statement of financial
(s) Explain when cost of an item qualifies to be recognised as an asset
(t) Explain how the value of property, plant and equipment is measured and its elements
(u) Recognize costs that are not costs of an item of property, plant and equipment
(v) Explain the difference between property, plant and equipment under IAS 16 and investment property under IAS 40
(w) Understand and apply the cost measurements: cost model and revaluation model
(x) Recognize examples of separate classes of property, plant and equipment
(y) Explain basis for choosing a depreciation method
(z) Explain the circumstances an item of property, plant and equipment cost should be depreciated separately
(aa) Explain circumstances that would be the basis for derecognition of an asset
(bb) Explain and identify minimum requirements that should be considered in assessing any indication that an asset may be impaired
(cc) Prepare disclosure note for each class of property, plant and equipment

3.2 Accounting for intangible noncurrent assets and amortisation

The main reference is International Accounting Standard (IAS) 38 Intangible Assets

(a) Define intangible asset
(b) Identify intangible asset with reference to identifiability, control and future economic benefits criterion
(c) Recognise the difference between tangible and intangible non-current assets with examples
(d) Explain the basis for recognition of intangible assets
(e) Identify and explain the treatment of intangible assets based on whether it is acquired, or internally generated intangible asset
(f) Define and calculate amortization and explain their treatment for intangible assets with finite and indefinite useful life
(g) Explain and apply the cost and revaluation model options to measurement approach of intangible asset after recognition
(h) Identify and explain circumstances that would be the basis for derecognition of an intangible asset
(i) Prepare disclosure note for each class of intangible assets

3.3 *Accounting for inventories*

The main reference is International Accounting Standard (IAS) 2 Inventories

(a) Define inventories, and net realizable value
(b) Understand the measurement of inventories
(c) Understand the elements of cost of inventories
(d) Identify and apply cost formulas for cost of inventories; first-in, first-out (FIFO) and weighted average cost formulas
(e) Explain when inventories are recognised as an expense
(f) Prepare a disclosure note for accounting policy for inventory cost measurement and the cost formula used in preparation of financial statements

3.4 *Accounting for leases*

The main reference is International Accounting Standard (IAS) 17 Leases

(a) Define lease
(b) Identify and define classes of lease : a finance lease and operating lease
(c) Understand the concepts of minimum lease payments and interest rate implicit in the lease
(d) Explain the recognition of operating lease and finance lease in financial statements
(e) Record transactions of leases in the ledger accounts and financial statements for both the lessor and the lessee
(f) Understand and explain sale and leaseback transaction

3.5 *Accounting for agriculture*

The main reference is International Accounting Standard (IAS) 41 Agriculture

(a) Define agricultural activity and biological transformation
(b) Identify agricultural produce and a biological asset
(c) Identify types of biological transformation outcome
(d) Explain when a biological asset or agricultural produce should be recognized
(e) Classify biological assets into mature and immature assets

3.6 *Accounting for provisions and contingencies*

The main reference is the IAS 37 Provisions, Contingent Liabilities and Contingent assets

(a) Understand the definition of "provision", "contingent liability" and "contingent asset".

NOT FOR SALE

(b) Distinguish between and classify items as provisions, contingent liabilities or contingent assets.
(c) Identify and illustrate the different methods of accounting for provisions, contingent liabilities and contingent assets.
(d) Calculate provisions and changes in provisions.
(e) Account for the movement in provisions
(f) Report provisions in the final accounts.

4 Final accounts for various forms of businesses

In the assessment candidates may be required to:-

4.1 Sole trader

(a) Prepare a statement of profit or loss and other comprehensive income or extracts as applicable from given information using accounting treatments as stipulated within section D, E and examinable documents.
(b) Understand how accounting concepts apply to revenue and expenses.
(c) Calculate revenue, cost of sales, gross profit, profit for the year, and total comprehensive income from given information.
(d) Disclose items of income and expenditure in the statement of profit or loss.
(e) Record drawings in the statement of profit or loss.
(f) Understand the interrelationship between the statement of financial position and the statement of profit or loss and other comprehensive income

4.2 Partnership

(a) Define a partnership and identify types of partners
(b) Understand partnership in respect of ownership and liability
(c) Explain the purpose and content of a partnership agreement.
(d) Explain, calculate and account for appropriations of profit:
(i) Salaries of partners

(ii) Interest on drawings

(iii) Interest on capital

(iv) Share of residual profit (the amount of profit available to be shared between the partners in the profit and loss sharing ratio, after all other appropriations have been made)

(e) Explain the difference between partners' capital and current accounts.
(f) Prepare the partners' capital and current accounts.
(g) Prepare the final accounts for a partnership

(h) Explain and account for the admission of a new partner including the treatment of any goodwill arising and revaluation of assets

4.3 Accounts for non-profit making organizations.

(a) Explain the difference between accrual and cash basis accounting non-profit making organisations
(b) Calculate income from independent fund raising activities such as competition, canteen, bars
(c) Make periodical adjustments including income in arrears and in advance
(d) Understand and calculate accumulated fund
(e) Prepare statement of income and expenditure and statement of financial position for non-profit making organisations such as clubs and societies

4.4 Limited companies

4.4.1 Preparation of final accounts for internal use:

(a) Classify expenses by function; distribution expenses, administrative expenses, and finance expenses.
(b) Calculate and record finance costs in ledger accounts and the financial statements.
(c) Record other income and taxation
(d) Calculate and record dividends in ledger accounts and the financial statements.
(e) Record profit transfers to various reserves in ledger accounts and the financial statements.
(f) Prepare statement of profit or loss and statement of financial statement
(g) Define a bonus (capitalization) issue and its advantages and disadvantages.
(h) Define a rights issue and its advantages and disadvantages.
(i) Record and show the effects of a bonus (capitalization) issue in the statement of financial position.
(j) Record and show the effects of a rights issue in the statement of financial position

4.4.3 Preparation of final accounts for publication

(a) Prepare statement of profit or loss and statement of financial position according to International Financial Reporting Standards, Companies Act and Generally Accepted Accounting Practice
(b) Calculate earnings per share according to IAS 33

4.4.4 Statement of changes in equity.

(a) Identify the components of the statement of changes in equity

(b) Record movements in the share capital, share premium accounts and other equity components

4.4.5 Cash flow statement for a single company.

The reference is IAS 7 Statement of Cash Flows

(a) Differentiate between profit and cash flow
(b) Understand the need for management to control cash flow.
(c) Recognise the benefits and drawbacks to users of the financial statements of a statement of cash flows.
(d) Classify the effect of transactions on cash flows
(e) Calculate the figures needed for the statement of cash flows including:
  (i) Cash flows from operating activities

  (ii) Cash flows from investing activities

  (iii) Cash flows from financing activities

(f) Understand different treatments of interest and dividends
(g) Calculate the cash flow from operating activities using the indirect and direct method.
(h) Identify the elements of cash and cash equivalents

5 Special accounting procedures

In the assessment candidates may be required to:-

5.1 Errors and the correction of errors

(a) Identify types of error in a book-keeping system that are disclosed by extracting a trial balance.
(b) Identify types of error in a book-keeping system that are not disclosed by extracting a trial balance.
(c) Use the journal to correct errors disclosed by the trial balance.
(d) Use the journal to correct errors not disclosed by the trial balance.
(e) Understand the purpose of a suspense account.
(f) Identify errors leading to the creation of a suspense account.
(g) Record entries in a suspense account journal.
(h) Redraft the trial balance following correction of all errors.

5.2 Bank reconciliation statement

(a) Understand the purpose of bank reconciliations.
(b) Identify the main reasons for differences between the cash book and the bank statement.

NOT FOR SALE

(c) Correct cash book errors and/or omissions.
(d) Prepare bank reconciliation statements.
(e) Derive bank statement and cash book balances from given information.
(f) Identify the bank balance to be reported in the final accounts.

5.3 Disposal of non current assets

(a) Calculate and record profits or losses on disposal of non-current assets in the statement of profit or loss including part exchange transactions and scrapping of assets

5.4 Receivables and payables control ledgers

(a) Understand the purpose of control accounts for accounts receivable and accounts payable.
(b) Understand how control accounts relate to the double-entry system.
(c) Prepare ledger control accounts from given information to deduce sales and purchases figures
(d) Perform control account reconciliations for accounts receivable and accounts payable.
(e) Identify errors which would be highlighted by performing control account reconciliation.
(f) Identify and correct errors in control accounts and ledger accounts.

5.6 Incomplete records

(a) Describe the circumstances which lead to incomplete records.
(b) Describe the methods of constructing accounts from incomplete records.
(c) Prepare the final accounts or elements thereof using incomplete record techniques such as:
(i) Use of accounting equation

(ii) Use of ledger accounts to calculate missing figures

(iii) Use of cash and/or bank summaries

(iv) Use of profit percentages to calculate missing figures

6 Introduction to consolidated accounts

In the assessment candidates may be required to:-

Reference standard is IFRS 10

6.1 The definition of various investments (trade investment, subsidiary, an associate and joint ventures.

(a) Define and describe the following terms in the context of group accounting: Parent, Subsidiary, Control, Consolidated or group financial statements, Non-controlling interest, Trade / simple investment
(b) Identify subsidiaries within a group structure.

6.2 Preparation of basic consolidated financial statements for a company with one subsidiary.

(a) Define and describe the following terms in the context of group accounting:
(i) Parent

(ii) Subsidiary

(iii) Control

(iv) Consolidated or group financial statements

(v) Non-controlling interest

(vi)Trade / simple investment

(b) Identify subsidiaries within a group structure.
(c) Calculate goodwill (excluding impairment of goodwill) using the full goodwill method only as follows:

Fair value of consideration	X
Fair value of non-controlling interest	X
Less fair value of net assets at acquisition	(X)
Goodwill at acquisition	X

(d) Describe the components of and prepare a consolidated statement of financial position:
(i) Elimination of inter-company trading balances (excluding cash and goods in transit)

(ii) Removal of unrealized profit arising on inter-company trading

(iv) Acquisition of subsidiaries part way through the financial year taking into account pre and post acquisition profits

7 Interpretation of financial statements

In the assessment candidates may be required to:-

7.1 Importance and purpose of analysis of financial statements

(a) Describe how the interpretation and analysis of financial statements is used in a business environment.
(b) Explain the purpose of interpretation of ratios

7.2 Ratio Analysis.

(a) Calculate key accounting ratios: profitability, liquidity, efficient use of resources and financial position ratios
(b) Deduce elements of financial statements from given ratios

7.3 Analysis of financial statements

(a) Calculate and interpret the relationship between the elements of the financial statements with regard to profitability, liquidity, efficient use of resources and financial position.
(b) Draw valid conclusions from the information contained within the financial statements and present these to the appropriate user of the financial statements.
(c) Recognise limitations of ratio analysis in interpretation of financial statements

REFERENCES

ICAM *Accounting Framework* Manual

Frank wood; *Business Accounting 1 and 2*

Glautier, M N E, Underdown, B; Clark A C; *Basic Accounting Practice*

Lee, G A; *Modern Financial Accounting*: Van Nostrand Reinhold.

Whitehead, G; *Success in Principles of Accounting*: John Murphy.

TABLE OF CONTENTS

CHAPTER 1 INTRODUCTION TO ACCOUNTING 14
CHAPTER 2 CONCEPTUAL FRAMEWORK AND GAAP 21
CHAPTER 3 ACCOUNTING INFORMATION 34
CHAPTER 4 BOOKS OF ORIGINAL ENTRY AND LEDGERS 44
CHAPTER 5 THE CASH BOOK 50
CHAPTER 6 CHARTS OF ACCOUNTS AND CODING OF ACCOUNTS 62
CHAPTER 7 THE ACCOUNTING EQUATION 69
CHAPTER 8 BALANCING OFF ACCOUNTINGS 80
CHAPTER 9 PERIODIC ADJUSTMENTS 90
CHAPTER 10 INTRODUCTION TO FINAL ACCOUNTS 108
CHAPTER 11 ERRORS AND THEIR CORRECTION 122
CHAPTER 12 CONTROL ACCOUNTS 131
CHAPTER 13 PARTNERSHIPS 139
CHAPTER 14 PREPARATION OF FINAL ACCOUNTS FOR LIMITED COMPANIES 164
CHAPTER 15 ACCOUNTS FOR NON PROFIT MAKING ORGANIZATION 181
CHAPTER 16 INCOMPLETE RECORDS 199
CHAPTER 17 TANGIBLE NONCURRENT ASSETS 211
CHAPTER 18 INTANGIBLE ASSETS 226
CHAPTER 19 IMPAIRMENT OF ASSETS 236
CHAPTER 20 INVENTORIES 248
CHAPTER 21 LEASE ACCOUNTING 256
CHAPTER 22 AGRICULTURE 271
CHAPTER 23 STATEMENT OF CASH FLOWS 2822
CHAPTER 24 RATIO ANALYSIS 2933
CHAPTER 25 GROUP ACCOUNTS 3066

NOT FOR SALE

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, 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:

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 decision, 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, bank 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, bank 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 used by management to plan, evaluate, and control.

Attribute	Financial Accounting	Management Accounting
Legal/rules:	Drafted according to GAAP - General Accepted Accounting Procedure.	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.
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 or loss (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.

NOT FOR SALE

Other financial statements that business organizations prepare include:

(a) the Statement of cash flows,
(b) the statement of changes in equity and

1.6 The role of computers in accounting

Linking of computers

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 computernetworks, including:

a) **local-area networks (LANs):** The computers are geographically close together (that is, in the same building).
b) **wide-area networks (WANs):** The computers are farther apart and are connected by telephone lines or radio waves.
c) **campus-area networks (CANs):** The computers are within a limited geographic area, such as a campus or military base.
d) **metropolitan-area networks MANs):** A data network designed for a town or city.
e) **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.

Introduction 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 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.

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.

1.6 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

1. Tutorial questions

a) State the differences between financial accounting and management accounting.

b) Identify any **five** qualitative characteristics of accounting information.

c) Define reliability and its attributes.

2. Exam style question

Accounting is a process that begins with a business transaction and ends with a report for decision making during a specified period.

Required:

(a) Name **two** classes of goods which a business person might buy and sell.**4 Marks**

(b) Name **three** types of business transactions, giving the accounting records in which they are captured, and **two** source documents from which the information might be gathered. **6 Marks**

(c) Name **four** books of accounts in which each of the business transactions is recorded. **4 Marks**

(d) Name **three** accounting reports, briefly explaining the purpose of each one of them.

6 Marks

(TOTAL : 20 MARKS)

NOT FOR SALE

CHAPTER 2 CONCEPTUAL FRAMEWORK AND GAAP

LEARNING OBJECTIVES

The objective of this chapter is to:

- Lay down the framework of accounting
- Orient students the need for conceptual framework
- Other regulatory frameworks in Malawi

1.1 GENERALLY ACCEPTABLE ACCOUNTING STANDARDS (GAAP)

GAAP means all rules, guidelines, and directives from whatever source which govern the recognition, measurement and disclosure of accounting transactions for the purpose of the preparation of financial statements.

The bedrock of accounting is the conceptual framework which was developed by International Accounting Standards Board (IASB).

GAAP sources includes among other instruments as:

- Company law
- The Institute of Chartered Accountants of Malawi
- Malawi Accountants Board
- Malawi Stock exchange
- International Accounting Standards Board

1.2 CONCEPTUAL FRAMEWORK

The conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. Accountants need to have the framework for consistency of presentation of financial statements and also to avoid political intervention in the preparation of financial statement.

The Conceptual framework was developed by International Accounting Standards Board (IASB) in September 2010 with the following as its objectives;

a) to assist IASB in the development of future International Financial Reporting Standards (IFRS) and review of the exiting IFRSs

b) to assist IASB in promoting harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs.

c) to assist national standard setting bodies in developing their national standards.

d) to assist prepares of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS

e) to assist auditors in forming an audit opinion on whether financial statements comply with IFRSs;

f) to assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs and

g) to provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

In short, the Conceptual Framework is supposed to be taken as a constitution guiding all accountants in recognition, presentation and disclosure of financial information. So the Conceptual Framework is considered superior to any accounting standard.

The Conceptual Framework was originally developed in 1989 by International Accounting Standards Committee (IASB) and had seven headings as follows:

a) The objectives of the financial statement
b) Underlying assumptions
c) Qualitative characteristics of financial statements
d) The elements of financial statements
e) Recognition of elements in financial statements
f) Measurement of elements in financial statements
g) Concept of capital and capital maintenance

IASB embarked on a project to revise the conceptual framework to reflect the modern trend. The project is being conducted in phases but at the end of the project, the following will be the new chapters of the Conceptual Framework;

1. The objectives of financial information
2. The reporting entity
3. The qualitative characteristics of useful financial information
4. The definition, recognition and measurement of elements from which financial statements are constructed.
5. The concept of capital and capital maintenance.

A) Objectives of financial statements

The objectives of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

These users include lenders, investors, customers, suppliers, employees, Government and other stakeholders.

These financial statements are supposed to be the general purpose financial statements which meet the needs of all user groups.

a) Financial performance is shown by the statement of Profit or loss and other comprehensive income. Profitability is used to assess the potential changes in economic resources the entity is controlling. This information is usually useful to stakeholders like investors who would like to assess return on their investment, Government which would like to compute tax payable by the business entity, employees who uses profitability as a means of bargaining for better remuneration.

b) Changes in financial position are given by the statement of financial position. This information is more useful to the lenders as it shows the financial stability of an entity, the suppliers as it shows the credit worthiness of the business and Management of the entity to assess how they are managing the resources of an entity.

c) Details of cash generated during the year and how it has been utilized is presented through the statement of cash flows. This statement is also considered important to the lenders as it shows how the business generate its cash flows and which activities

such cash flow is deployed. This stamen provide users with an insight of the future stability of the business. Profit alone is inadequate to assess the future survival of the business but cash is considered as a good yard stick.

B. Reporting entity

Business is supposed to be treated as a separate legal entity from its owner as such business transactions should be recognized separately from the private transactions of the owner.

C. Qualitative characteristics of useful financial information

There are two fundamental qualitative characteristics of financial information which must always be checked on if the financial information is to be meaningful to the intended users and these are relevance and faithful presentation.

a) Relevance

The financial information provided should capable of affecting the decision made by users. Information should influence both the current and future direction to be adopted by the user. The information provided in the financial statements should have predictive and confirmatory role. It should be able to predict the future and confirm that a transaction took place in the past.

Materiality

Relevant information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statements. However, the determination of the materiality is subjective exercise.

An item may be material from one point of view and immaterial from the other perspective.

b) Faithful presentation

The second aspect is faithful presentation. The relevance of financial information can be recognized if such information has been presented in a form which clearly reflects the purpose for which it has been prepared. In this case, the preparer of financial

NOT FOR SALE

information will look at aspects such as completeness, neutrality and freedom from error.

Information must present faithfully the transaction which it is supposed to present. Though some transactions may be presented in an unfaithful way not because of bias but the inherent nature of the transaction.

Enhancing qualitative characteristics

Apart from the fundamental characteristics listed above, IASB recognized that for financial information to be very useful, there other characters which are complementary to the two and makes financial information even more meaningful.

Comparability

Financial information should be presented in a format which can easily be comparable between two different entities but also within the same entity over a number of years.

Consistent application of accounting policies enhance comparison within the same entity over a number of years while usage of agreed format enhances comparison of results for two different entities.

Verifiability

The purpose of financial information is to show the economic resources of an entity and how they have changed over the period. Financial information should be presented in such a way that any independent and reasonable user can be able to verify some figures and also relate to narratives therein.

As stated users may have different reasons for accessing financial information but this qualitative characteristic advocates that users within a similar group should at least come up with relative similar decisions out of the information presented.

Timeliness

Financial information should be presented in good time if the decision made therefrom is to be useful to the users. Decisions made out of stale information tend to result in wrong conclusions from the financial information and is misleading.

The preparers of financial information should always ensure that the information is made available to relevant stakeholders in pre-specified time in order to enhance the relevance of the information.

Understandability

Financial information is usually considered as complex as such must be presented in a simplified manner in recognition of the intended users. Care must be taken when considering simplifying the financial information as some information may lose the meaning while trying to ensure simplicity.

The relevance of financial information will strongly be measured by the way users understand the information provided.

D) The definition, recognition and measurement of elements from which financial statements are constructed.

The following are regarded as elements of financial statements; Assets, Liabilities, Equity, Revenues and Expenses

Assets

A resource controlled by an entity from past event from which future economic benefits are going to flow to the enterprise.

The definition emphasizes three main issues for an item to be an asset:

i. There should be a past event or transaction for an asset to be called an asset
ii. There should be control and not ownership. For example, if there if a finance lease, the lessee will recognize the asset in the financial position much as the item does not belong to him while the lessor will not recognize the same asset in his books much as he is the owner of the asset.
iii. There should be future economic benefit for an asset to be an asset. i.e. an asset of an enterprise may have been rendered not useful at all because of technological advancement of the item being used now. Much as the item was bought by the entity, it is now useless as the will not use it in their production process.

Liability

This is a present obligation of the entity arising from past event, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Obligation may be legal or constructive. It does not matter as long as an entity has a present obligation, then it has to recognize the liability.

Also note that the definition emphasizes past events or transaction, current obligation and future outflows.

Equity

This is the residual interests in the assets of the entity after deducting all its liabilities. This is derived from the accounting equation which says; **A-L=C.** Equity represents ownership interest in the business.

Income

This is the increases in the economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of the liabilities that result in increases in equity, other than those relating to equity participants.

The recognition in income occurs simultaneously with the recognition of increase in asset or decrease in liability.

Expense

These are reduction in economic activities during the accounting period in the form of outflows or depletion other than the reduction because of payments to equity participants.

The recognition in expenses occurs simultaneously with the recognition of increase in liability or decrease in asset.

Recognition of Elements in the financial statements

Recognition is the process of including as item in the financial statements. There is need for an element of financial statement satisfy two criteria for it to be recognized.

i. It is probable that there will be the future flow of economic benefits to or from a firm.
ii. The item has a cost or value that can be measured reliably.

Probable future economic benefits refers to the probability of it happening is more than not happening. In other words, the probability of happening is more than 50%.

Measurement of elements in the financial statements

Measurement is the determination of value to be included in the financial statements. Usually, these are included at the following bases:

i. Historical Cost model. Assets and liabilities are measured at the amount which an item was purchased at. The advantage of this cost is that the amount can be verified.
ii. Current cost. Assets are carried at amounts of cash and cash equivalents that would have to be paid if the same or equivalent asset was acquired now.
iii. Realizable (settlement) Value. The amount of cash that can be currently realized if an asset was sold
iv. Present value: a current estimate of the (present discounted) value of future net cash flows.

E) Capital maintenance

A business should maintain the amount of capital invested and the retained profit is the measured by the value of which capital is increased during the period. For a business to survive it has to ensure that its capital levels are maintained. The measurement of capital can either be in terms of operating (Physical) capacity or financial capacity.

i) Financial maintenance

This is the most common measure of capital. In essence capital is measured as the monetary value of capital at the beginning of the year against the value at the end of financial year.

Example if the business had a capital of K3,000,000 at the beginning of the year and at the end of the year capital is now at K3,500,000 then it is said that capital has been maintained.

NOT FOR SALE

ii) Operating (Physical) maintenance

This is where capital is measured in terms of the physical units of core business activities. The aim of this measurement is to ensure that the business is able to maintain its operating capacity especially in times of high inflation.

Looking at example above on financial capital maintenance. If the business trade in various merchandize whereby the price at the beginning of the year was K400 and at the end of the year is now trading at K500

Operating capital at close of the year (K3,500,00 /500)	7,000 units
Operating capital at the beginning of the year (K3,000,000 / 400)	7,500 units

Please note that for financial capital maintenance, the business is seen to have maintained its capital while at the same time using operating capital maintenance it shows that the business was able to have 7,500 units at the beginning of the year but this has been significantly reduced to 7,000 units.

2.3 OTHER LOCAL GAAP IN MALAWI

For Accountants in Malawi, there are other General Acceptable Accounting Practice (GAAP) which are supposed to be taken into account when preparing financial statements.

A Companies Act

Companies Act is an important framework in the preparation of financial statements. Companies Act 2013 among other issue specifies;

- How a company can be formed and the requirements for each form of business
- The preparation of financial statements and dates for filing such financial statements.
- The requirement for auditing financial statements
- The issues on corporate governance – roles of shareholders and directors

Specific provisions in the new Act relating to Accounting are found from Section 180 - 191

- Every company shall maintain accounting records which shows a true and fair view –S 180
- Every company shall at the end of financial year file an annual return with the registrar of companies – S181
- The directors of every company shall, at a date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year at intervals of not more than fifteen months, cause to be prepared and sent to every member of the company and to every holder of debentures of the company a copy – S 182.
- Every company shall produce a profit or loss account and the balance sheet at the end of an accounting period – S183 & S184.
- Section 185 requires a company which has subsidiaries to prepare group accounts, combining the results of the subsidiary with those of the parent company.
- Requirement to produce directors report which must accompany the financial statements – S 189
- Requirement to have the financial statements of a company audited – S 191
- Appointment and remuneration of the Auditors – S 191

B. Malawi Stock Exchange

Business entities which are listed on the stock exchange are subjected to extra review by the stock exchange rules. Firstly, before a company is listed, there are specific financial information which is supposed to be produced to assist potential investors in deciding whether to invest in the business or not.

Any listed company is required to prepare and publish mid-year results as opposed to only producing financial statements at the end of financial as is the case with other form of business.

C. Institute of Chartered Accountants in Malawi (ICAM)

ICAM is an accountancy profession body of Malawi responsible for overseeing accountancy professional in Malawi.

The role of ICAM include;

1) To promote the development of accountants in Malawi

2) to supervise accounting profession to the best interest of the public

3) to promote the highest order of professional ethics and business conduct of, and enhance the quality of service offered by Chartered Accountants or Diplomat Accountants

4) to protect the public interest by ensuring that members of the institute observe the highest standards of professional and ethical standards

5) to ensure the professional independence of accountants

6) to determine the eligibility criteria to become the member of the Institute

7) to arrange for the assessment of candidates seeking certification as members

8) to promote, maintain and increase the knowledge, skill and competence of members of the institute and students

9) to ensure that members of the instate obtain necessary technical and ethical guidance that enables them to meet the needs of the community in areas in which they have special knowledge and expertise

10) to maintain and monitor high quality practical training at all levels of the profession

11) to maintain the legitimate professional rights of the members of the institute

12) to advance the theory and practice of accountancy in all aspects.

13) to promote high quality accounting, auditing and financial reporting standards and practices

14) to develop professional qualification for accountants and auditors in Malawi.

D) Malawi Accountancy Board

MAB is an accountancy regulatory board of Malawi and the responsibilities include;

1) To promote high quality reporting of financial and non-financial information by entities.

2) To promote the highest professional standards among auditors and accountants.

3) To improve the integrity, competence and transparency of professional activities in accounting and auditing.

4) To adopt and ensure compliance with and the enforcement of applicable local and international accounting and auditing standards.

5) To protect the interests of the general public and investors.

6) To encourage effective collaboration with other regulators.

7) To consider and determine applications for registration as chartered accountants and diplomat accountants.

8) To maintain the Register of chartered accountants and diplomat accountants.

9) To advise training institutions and the Institute of Chartered Accountants in Malawi (ICAM) in matters pertaining to examinations and training of accountants.

2.4 CONCLUSION

It is important for trainee accountants to understand the regulatory framework of accounting as this is regarded as the reasons why accounting as a field exist.

In this chapter, we have looked at how international and local framework affects the preparation of financial statements. This topic is important as it sets the tone on how accounting information should be recognized, the measurement criteria, presentation, disclosure and the intended users of the financial information.

NOT FOR SALE

END OF CHAPTER QUESTIONS

Tutorial questions

Q1. Define GAAP?

Q2. Why do accountants need a conceptual framework?

Q3 List and explain the seven headings of conceptual framework

Q4 Define the following terms in relation to conceptual framework of accounting

i. Assets
ii. Liabilities
iii. Equity

Sample exam style questions

Financial information is considered to be useful to assist various users in making decision making in relation to the business performance and position.

a) Identify **five**users of financial information. For each user outline the kind of information they will be interested in. State the kind of information they will be interested in and the type of financial statement where they will find such information **15 marks**

b) List **five** qualitative characteristics of financial information **5marks**

TOTAL: 20 Marks

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 period.

Current assets

These are assets that are held only for a short time and include inventory heldfor 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 owed to 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 K7000 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:

NOT FOR SALE

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 K3000 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

(viii) 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 (Bank)	increase assets	increase capital
b) Buy goods by cheque (Bank)	decrease asset (Stock of goods)	increase asset
c) Buy goods on credit (Stock of goods)	increase asset (Trade Payables)	increase liability
d) Sale of goods on credit (Stock of goods)	decrease assets (Trade Receivables)	increase asset
e) Sale of goods for cash (Stock of goods)	decrease assets (Bank)	increase asset
f) Pay creditor (Bank)	decrease asset (Creditor)	decrease liability
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) (Bank)	decrease asset	decrease capital
i) Owner pays creditors from Private money outside the Business (Creditor)	decrease liability	increase capital

3.4 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

NOT FOR SALE

that if the proprietor asks the price of some goods, but does not buy them, there is no be

Accounting for Sales

1. **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.

2. **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.

3. 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).

4. 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).

5. 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 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.

6. 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

7. 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 of 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 contained some in-built controls such as salaries and wages control accounts as part of internal checks.

3.6 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

1. Tutorial questions

a) Explain your understanding of an 'accounting transaction'.

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

2. Exam style question

(a) The accounting equation is represented as Capital = Assets-Liabilities.

Required:

(i) Explain the meaning and nature of **each** of the three items in the accounting equation. **6 Marks**

(ii) Mention any **four** ways in which a company may increase its capital. **4 Marks**

(b) The following balance sheet was drawn from the books of Kasingindi Traders as at 31 December 2009:

		K'000
Non-current assets		1,770
Current Assets		
Inventories	506	
Accounts receivable	372	
Bank	124	1,002
		2,772
Represented by		
Capital		2,350
Liabilities		
Accounts payable		402
Accrued expenses		20
		2,772

The following was Kasingindi's financial position at 31 December 2010:

	K'000
Inventory	654
Accounts receivable	486
Bank overdraft	249
Accounts payable	424
Accrued expenses	17
Non-current assets	1,593

During the year 2009, Kasingindi drew K1,080,000 from the business for personal use.

Required:

(i) Calculate Kasingindi's capital as at 31 December 2010. **6 Marks**

(ii) Calculate the profit on the basis of change in the capital. **4 Marks**

(TOTAL : 20 MARKS)

(Adopted from June 2012 Accounting Framework exams)

NOT FOR SALE

CHAPTER 4: BOOKS OF ORIGINAL ENTRY AND LEDGERS

4.0 LEARNING OBJECTIVES

The objective of this chapter is to introduce to the students books of original entry and ledgers. By 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, as one of the day books, the cash book is discussed later in detail to underline its importance.

4.1 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 our 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 transaction are put together and have one book in which they are recorded.

4.2 BOOKS OF ORIGINAL ENTRY

When transactions take place, there is need to record as much details 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.

Types of books of original entry

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

i. Sales day book (sales journal) in which credit sales are entered.
ii. Purchases day book (purchases journal) in which credit purchases are recorded.
iii. Returns inwards day book (returns inwards journal) in which returns inwards are entered
iv. Returns outwards day book (Returns outwards journal) in which returns outwards are recorded.
v. Cash book in which receipts and payments are recorded (both cash and cheque transactions)
vi. General journal (journal) for other items

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.

4.3 TYPES OF LEDGERS

Most businesses use the following ledger:

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

4.4 TYPES OF ACCOUNTS

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

- ***Personal accounts:*** for debtors and 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

4.5 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 transactionstogether 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 periodof which the supplier allows
c. It will want to keep a record of the total purchaseswhich it makes in each period
   Taking advantage of the suppliers' allowed credit periods helps the cash flow of thebusiness. 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	5,000	324
14.08.13	Viwemi Ltd	PL 2	4,300	134
23.08.13	TwandaPlc	PL 3	14,500	2,110

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.

4.6. THE PURCHASE RETURNS DAY BOOK

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

i. A business will return goods that are "faulty" or damaged and will expect a credit note from the supplier
ii. Goods bought on **"**sale or returns**"** basis will be returned if they cannot be sold
iii. 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. **"**Expenses day book"

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

NOT FOR SALE

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.

4.7 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**

Note.

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.

4.8 THE SALES RETURN DAYBOOK

The sales 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.

4.9 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

1. Tutorial questions

a) Give other terms that are used to name day books.

b) State the main reason for having day books in an accounting system.

2. Exam style question

This topic is usually combined with other topics in Exams

CHAPTER 5 THE CASH BOOK

5.0 LEARNING OBJECTIVES

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

5.1 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.

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.

5.2 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.

5.3 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 partof 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.

NOT FOR SALE

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

5.4 THE BANK RECONCILIATION STATEMENTS

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:

i. Items may have been paid into or out of the bank account that have not been recorded in the cash book.
ii. 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 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

2013		Withdrawals K	Deposits K	Balance 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 cash, the balances in the cash book and in the bank statement are the same.

The balance on the cash book might be different from that on the bank statement due to the following reasons

i. Unpresentedcheques will cause the balances to be different
ii. Bank lodgments' not yet credited to the business's bank account will cause the two balances to be different.

Procedure for preparing bank reconciliations

"The cash book and the bank statement will rarely agree at given date.
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 thebank 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

Timing and frequency of the bank reconciliations

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

i. where **Frequency and volume of transactions** – The likelihood of error is greater there are more transactions
ii. **Other controls** – If there are very few other checks on cash, the greater the need for a 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.

NOT FOR SALE

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

Reconciliation on computerised systems

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

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

Many organizations will normally maintain a manual cash book in addition To computerized 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 unpresentedcheques	(942)
Balance as per bank account	(302)

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.

5.5 SUMMARY OF THE CHAPTER

This chapter introduced the cash book as one of 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

1. Tutoarial questions

a) Explain the following terms as they relate to Bank Reconciliations.

i. Deposits in transit
ii. Outstanding checks
iii. Bank charges
iv. Non-sufficient fund cheques (NSF cheques)

b) 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:

The following cheques which had been issued by the company to its customers are still outstanding:

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

1. A deposit of K400.00 made on 31 December does not appear on bank statement.
2. An NSF cheque of K850 was returned by the bank with the bank statement.
3. The bank charged K50 as service fee.
4. Interest income earned on the company's average cash balance at bank was K1,250.
5. 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.
6. 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.

2. Exam style question.

The bank transactions for a sole trader for the month of October 2009 were as follows;

Cash book

					cHQ	
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	Kabulapvt	0029	15,000
			29 Oct	J Banda	0030	12,000
		273,000				273,000

The bank statement as at the 31 October 2009

			Dr	Cr	Balance
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) Briefly explain the difference between a bank lodgment and a direct debit and for each state what would be the cause **4 marks**

b) Prepare an updated cash book as at 31 October 2009 **8 marks**

c) Prepare a bank reconciliation statement as at 31 October 2009 to agree the balance on the bank statement to the balance found in an updated cash book. **6 marks**

d) Apart from the bank reconciliation statement, mention other accounts which are also used as part of internal control to check the accuracy of recordings in the ledger accounts. **2 marks**

TOTAL: 20 MARKS

CHAPTER 6 CHARTS OF ACCOUNTS AND CODING OF ACCOUNTS

6.0 LEARNING OBJECTIVES

The objective of this chapter is to explain theimportance 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 accountsand aspects of coding general ledger accounts are handled.

6.1 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 the can identify items more precisely and concisely than written descriptions, as such the 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

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 bedistinguished. In addition to the customer account number other examples of codes in a sales system can incorporate the following important information:

NOT FOR SALE

- 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 jus 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.

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.

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.

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

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

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.

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

The codes given above have been taken from a sample in a manual.

6.2 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**

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

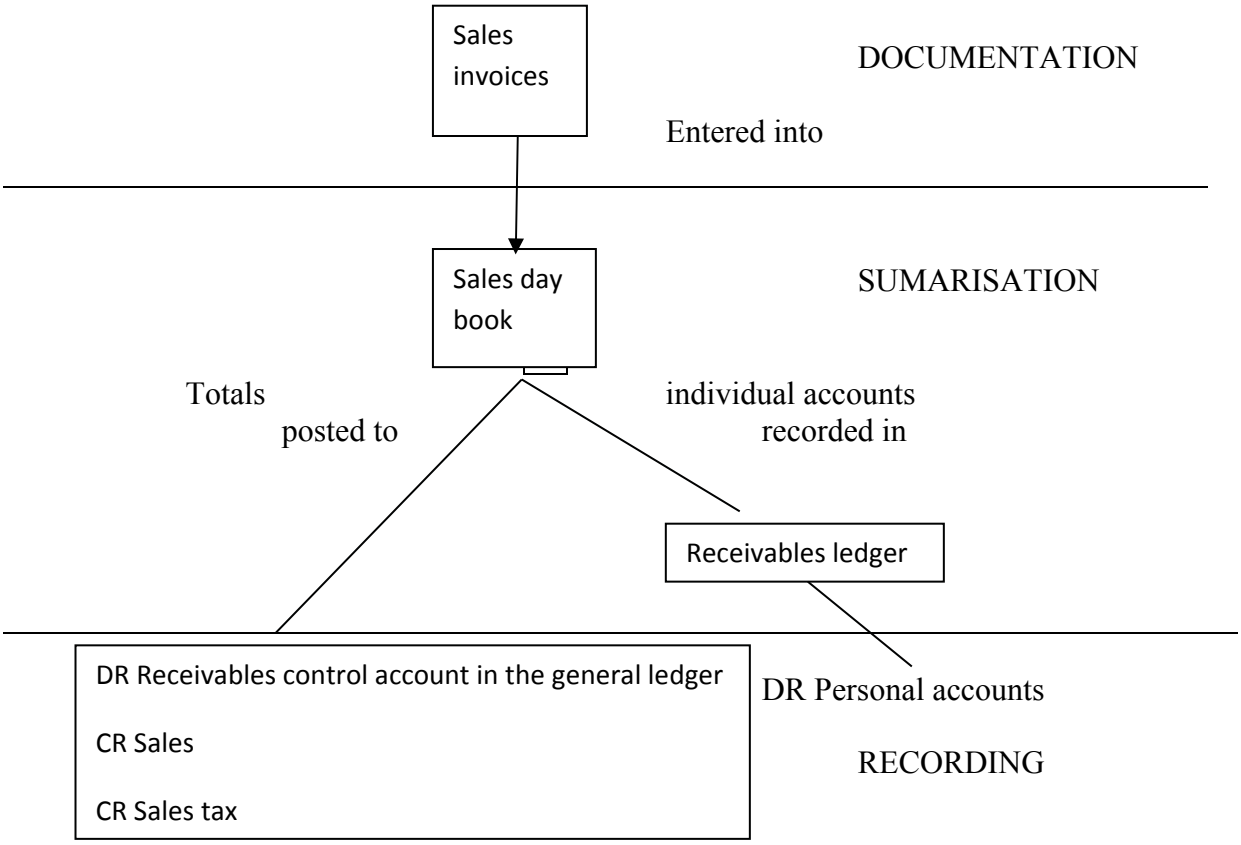
6.3 RECORDING THE DOUBLE ENTRY

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.



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 maintained in the general ledger to record in total the amounts which are posted to customers' individual personal memorandum accounts in the receivables ledger.

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.

6.4 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

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

NOT FOR SALE

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

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

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

1. Tutorial questions

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

b) Why is coding an important element of the financial statement

c) what is the difference between faceted and block code.

CHAPTER 7 THE ACCOUNTING EQUATION

7.0 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.

7.1 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 owned by the owners.

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:

NOT FOR SALE

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

7.2 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.

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.

What else would affect capital?

The accounting equation is expressed in a financial position 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

7.3 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.

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 across 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 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 shop fixtures 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

7.4 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

(a) 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		D Henry account	
Debit			credit
Aug 1 D Henry	K165		Aug 1 purchase K165

(b) Purchase of sock 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		cash account	
Debit			credit
Aug 2 cash	K310		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 area:

(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

On 6th August 2013, goods previously bought for K96 are returned by the business to MrLungu.

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		Credit
Aug 6th Returns outwards K96		

Returns inwards

		Credit
		Aug Lungu K96

7.5 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.

7.6 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 deduce 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

Exercise

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 MrMbewe.
21 paid Mr. Jere by cheque K700
23 bought stationery on credit form stationery Ltd K125
24 paid stationery Ltd by cheque K120

7.7 CONCLUSION

Accounting equation is an important concept and forms the bedrock of accounting profession. A good understanding of the concept assist in understanding the processes in preparation and interpretation of financial statements.

END OF CHAPTER QUESTION

1. Tutorial question

a) 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

2. Exam style question

a) Prepare the journal entries for the following accounting transactions for the month

Of October 2009;

i) Took personal vehicle to be used in business. The vehicle was valued at K250,000
ii) Sold goods on credit to H Adams for K82,000
iii) The value of a machine being traded off to the supplier with a new machine. The machine has been valued at K30,000
iv) Depreciation expenses for Building for the month has been computed as K12,000
v) Adam settled the balance in cash and was allowed 15% discount
vi) Bank overdraft interest of K10,000 was charged for the month of October 2009.

12 marks

b) A trainee accountant was presented with the following data relating to the business of Mr Banda for the month of November 2009

	1 November	30 November
Non current assets		
Cost	120,000	120,000
Depreciation	12,000	15,000
Inventories	80,000	90,000
Receivables	72,000	85,000
Payables	40,000	35,000
Drawings	15,000	20,000
Bank loan	70,000	65,000

Required:

i) **What is an accounting equation** 2 marks

ii) Compute the figure for opening capital as at 1 November 2009. 3 marks

iii) Determine the profit which was generated in the month of November 2009. 3 marks

TOTAL: 20 MARKS

CHAPTER 8 BALANCING OFF ACCOUNTINGS

8.0 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.

8.1 BASIC STAGES

Balancing the accounts is done in five stages as follows:

a) Add up both sides of the accounts to find out their totals (do not write any thing in the account yet)
b) Deduct the smaller total from the larger total to find the balance
c) Now enter the balance on the side with the smaller total. The totals will now be equal**.**
d) Enter the totals on both sides of the accounts level with each other.
e) 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 (balancec/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 kwon 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.

8.2 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

a) 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.**

b) 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.

8.3 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

NOT FOR SALE

8.4 TRIAL BALANCES 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.

8.5 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

1. Tutorial questions

a) 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 9 PERIODIC ADJUSTMENTS

9.0 LEARNING OBJECTIVES

This section will cover some adjustments that must be made before the preparations of financial statements such as;

- Accounting for bad debts and allowance for doubtful debts
- Accounting for depreciation
- Treatment of prepayments and accruals

9.1 BAD DEBTS AND ALLOWANCE FOR DOUBTFUL DEBTS

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 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.

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.

Example

1. 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.

2. At the end of the accounting period it ascertained that John will pay 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.

9.2 BAD DEBTS WRITTEN OFF AND SUBSQUENTLY PAID

Sometimes a debtor who was written off may pay. In such 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: -

Cash Received	K 3,000	
John		K 3,000

Recording the receipt of cash asset

John	K 3000	
Bad debts Recovered		K 3000

Introducing the Bad Debt recovered Account

Bad Debts recovered Account	K 3000	
Income Statement		K 3000

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

9.3ALLOWANCES 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.

NOT FOR SALE

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.

Example

ABC Traders have decided that it will maintain a provision for bad debts of 2% of its outstanding debtors. If this amounts to K 5000,000 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.

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.

Example

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 amounts of receivables.

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.

Example

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

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.

9.4 DEPRECIATION OF NON – CURRENT ASSETs

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.

Classification 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 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 (expect 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 loose 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.

The 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.

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 istherefore 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.

9.5CAUSES OF DEPRECIATION

Most non – current assets loose 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 : -

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

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 refer to the loss of usefulness because of inadequacy or obsolescence.

Obsolescence is the process of becoming out of date. Technological development is bringing new and better and more efficient machines and equipment replacing old ones very fast.

Inadequacy: The growth of a business may bring about a need for bigger machines and equipment

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

The cost of the asset
The estimated salvage value or scrap value.
Estimated economic life of the asset.
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 cannot be realistically estimated because of time. It may be many years to come before the asset is disposed. The economic life as 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.

NOT FOR SALE

9. 6 METHODS OF CALCULATING DEPRECIATION

The most commonly used methods of calculating depreciation are: -

Straight – line method
Declining – balance method
Sum – of – the – years – digits method
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 the number of years as follows: -

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

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: -

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

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: -

Straight – Line – Method
Declining – Balance – Method

Solution

Straight – Line - Method

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

Annual depreciation = K5 million.

Declining – Method

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

$$= (1 - 4\sqrt{\frac{3}{23}}) \times 100$$

$$= 39{,}9\%$$

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 machines 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.

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.

9.7ACCOUNTING FOR DEPRECIATION

The aims of accounting for depreciation is to allocate and reflect the cost of a non – current asset in the general profit and determining progress 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: -

Debit the comprehensive income statement with the amount of depreciation for the year
Credit the accumulated provision for depreciation account

The accumulated balance in the accumulated account will then be used to reduce the book value of the asset at the end of each accounting period.

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

MONTH			YEAR	MONTH		
DEC. 31	Balc/d	K 5 million	1	DEC 31	P & L	K 5 Million
DEC. 31	Bal c/d	K 10 Million	2	JAN 1	Bal b/d	K 5 Million
2 DEC 31	P & L	K 5 Million				
K 10 Million		K 10 Million				
DEC. 31	Bal c/d	K 15 Million	3	JAN 1	Balb/d	K 10 Million
DEC 31	P& L	K 5 Million				
K 15 Million		K 15 Million				
DEC. 31	Bal c/d	K 20 Million	4	JAN 1	Balb/d	K 15 Million
DEC. 31	P&L	K 5 Million				
K 20 Million		K 20 Million				
5 JAN	1 Bal 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: -

It may be discarded or retired
It may be sold
It may be exchanged or traded in for property of similar kind or other property.

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

Identify the value of the asset as recorded in the asset account (Historical Cost)

Credit the asset account and debit a disposal account with the historical cost of the asset .

Debit: Disposal Account
Credit: Asset Account

Identify the accumulated depreciation of the asset to the date of disposal.

Debit the Accumulated depreciation account and credit the disposal account with the amount.

Debit: Accumulated Provision for Depreciation
Credit: Disposal Account

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.

Example

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

On 16th March, weighing scales with an original cost of K 100,000 and K 75,000 accumulated depreciations respectively were discarded.

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.

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%.

NOT FOR SALE

Required:

Draw journal entries to show the disposal of these assets

Solution
Journal Entries

	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.

Statement of Comprehensive Income	K 30,000	
Accumulated depreciation		K30,000

To record depreciation change charge for the year of purchase

	3(a) Bank		K 225,000
Accumulated depreciation		K 90,000	
	Disposal of office equipment		K300,000
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.

9.8WASTING 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

9.9 ACCRALS 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.

Example

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.

Example

ABC Traders LTD makes up its accounts to 31st 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

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			
Balance	b/d	5,000			

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.

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

KamphungaLTD 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	P & L	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.

9.10 ACRUED 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.

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

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

Similarly revenue may be received in advance or be accrued.

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.

Credit closing balance, in an expense account; represent outstanding balance in amount owing. It is a liability and appears as a current liability in the balance sheet.

9.11SUMMARY OF THE CHAPTER

This chapter is important in the process of preparing financial statements. The final adjustments are crucial as in most cases are not included in trial balance.

NOT FOR SALE

CHAPTER QUESTIONS

1. Tutorial questions

a) Indicate the placement of prepayments in the current assets sequence.

b) Indicate the placement of accruals in the current liabilities sequence.

c) 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.

d) 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 yearto 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:

i. The Bad Debts Account for the year ended 31 December 2013.
ii. The Allowance for Doubtful Debts Account for the year.
iii. Extract from Income Statement for the year.
iv. The relevant extract from the Statement of Financial Position as at 31st December 2013.

e) 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

2. Exam style question

On 1 September 2010 Wongani Enterprises purchased a machine which had an invoice list price of K900,000. The terms of payment were 2/10, n/60 (i.e. 2 percent cash discount if the full payment was made within 10 days but the whole amount would be paid if payment was made in 60 days). The cost of installing and testing the machine amounted to K78,000 and freight charges of K25,000 were paid.

The useful life of the machine was estimated at 6 years with a residual value of K40,000. Payment was made upon receipt and inspection of the machine. One month after acquisition, minor repairs were carried out on the machine at a cost of K5,000.

Required:

(a) Determine the cost of the machine. **4 Marks**

(a) Calculate the machine's book value after 2 years under each of the following depreciation methods:

(i) Straight line method; **4 Marks**

(ii) Sum of the years' digits; **4 Marks**

(iii) Fixed percentage on declining basis. **4 Marks**

Note : Depreciation is to be charged at 10% on reduced balance.

(b) Compare and contrast the net book value of the machine after depreciation at the end of year 2 under the three methods and state which method is the best.

4 Marks
(TOTAL: 20 MARKS)

(Adopted from Accounting Framework – June 2011)

CHAPTER 10: INTRODUCTION TO FINAL ACCOUNTS

10.0 LEARNING OUTCOMES:

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

i. Explain the importance of the income statements
ii. Prepare the income statement with all the adjustments

10.1 INTRODUCTION TO FINANCIAL STATEMENTS

You learnt in chapter 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.

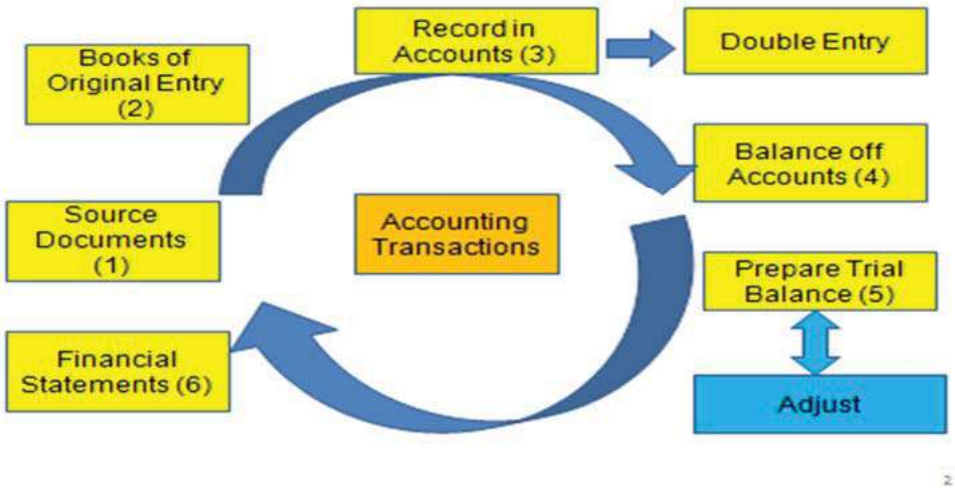


Figure 10.1: The Accounting Process

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

10.2 PURPOSE OF STATEMENT OF PROFIT 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 income statement 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.

Format of profit or loss

The statement of profit or loss has two components:

- Trading account
- Profit and loss account

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 opening inventories and purchase 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.

NOT FOR SALE

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.

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 Statement of Profit or loss for Atate for the period ended 31 December 2013 will be as follows:

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

N

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 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.

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

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.

Accruals and Prepayments

In chapter 11 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 expenses period should be recorded as expenses in that period.

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.

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 statement of profit or loss.

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 profit or loss will be presented as follows:

NOT FOR SALE

Atate Hawkers

Statement of profit 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 been used in the preparation of the statement of profit or loss. These figures will be used when we will be looking at the statement of financial position.

10.4 STATEMENT OF FINANCIAL POSITION

Purpose of the Statement of Financial Position

In the previous, chapter you looked at the accounting process. You will recall that the last step in this 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.

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 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, assets are equal to capital plus liabilities. You will recall that this is the accounting equation.

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 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

NOT FOR SALE

10.5 CHAPTER SUMMARY

This chapter has focused on the preparation of the statement of financial position. You have learnt 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.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What is the difference between carriage inwards and carriage outwards

b) How is gross profit different from net profit

c) which liabilities can be classified as non-current liabilities

2. 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.

CHAPTER 11: ERRORS AND THEIR CORRECTION

11.0 LEARNING OUTCOMES:

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

- Explain the types of errors
- Correct errors
- Prepare suspense accounts

11.1 ERRORS IN FINANCIAL STATEMENT

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. In this chapter you will learn how to correct errors.

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

11.2 ERRORS THAT DO NOT AFFECT THE BALANCING OF THE TRIAL BALANCE

In chapter 11 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 balance. 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 ChisomoKampeni 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 ChisomoKampeni *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	65,000	
	J. Cham'bwinja		65,000
	Being correction of transaction entered in wrong account		

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.

NOT FOR SALE

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 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.

11.3 ERRORSTHAT 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.

11.4 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 13.1 shows an extract of the trial balance with an entry for the suspense account.

Figure 13.1: 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.

NOT FOR SALE

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.

11.5 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.

END OF CHAPTER QUESTIONS

1. **Tutorial questions**

a) What is the difference between error of commission and error of omission

b) When do we open suspense account

c) List the errors which do affect the trial balance.

2. 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:

a. Briefly describe **five** types of errors which do not affect the correctness of the trial balance. **10 Marks**

b. From the information given above from (1) to (7), prepare journal entries **without** narratives to correct the errors identified. **7 Marks**

NOT FOR SALE

CHAPTER 12 CONTROL ACCOUNTS

12.0 LEARNING OBJECTIVES

The objectives of this chapter is to;

- Define what it means by control accounts
- Benefits of using control accounts in accounting
- Control accounts as a reconciliation for receivables and payables
- Importance of other controls in a business

12.1 INTRODUCTION TO CONTROL ACCOUNT

Internal controlis a very important element in assessing the credibility of the financial reporting. For auditors to issue a clean report, they need to be satisfied that all controls have been working perfectly for the period under review.

Control accounts are prepared to check the accuracy of recordings in the financial statements. Control accounts are usually not part of double entry system. Controls are important especially in manual accounting system. For computerized accounting, most systems are able to have in built controls which are able to do the function of control accounts automatically.

The most common control accounts available are receivable control accounts, payable control accounts and bank reconciliation statement.

How control accounts work

Control accounts work as follows:

Both opening and closing balances are known and the accountant has the responsibility to list items which have led to the movement from opening to closing balances.

Take the previously reconciled balance of an account, then add total entries that have increased the balance. Deduct payments made or set off agreed, then you have the closing balance.

	MK
Total opening balances	XXX
Add: total entries which have increased the balance	XXX
Less: total of entries which have reduced the balance	(XXX)
Total closing balance	XXX

As the accounts are using totals, they are also referred to as "totals accounts".

As stated above it is worth noting that control accounts are not part of the double entry system but a memorandum account.

12.2 SALES LEDGER CONTROL ACCOUNT

As stated above, this account is used to cross check the balances in the receivables accounts. Thus is also known as receivables control account.

Sales ledger control account is made up of transactions from credit customers only. The sources of information for the control account include the following;

Item	*Source*
Balances	Obtained from receivable listing (receivable accounts)
Credit sales	from sales account
Cash received	from cash book
Discount allowed	from cash book (three column cash book)
Dishonored cheques	from cash book
Bad debts	from bad debts accounts
Contra accounts	from receivable and payable listings
Return inwards	from returns accounts

Sales ledger control accounts (format)

Balance b/d	x	Cash (from receivables)	x
Credit sales	x	Discount allowed	x
Dishonored cheques	x	Contra purchases	x
		Returns inwards	x
		Bad debts	x
		Balance c/d	x
	xx		xx

NOT FOR SALE

Example

The following information is from accounts office relating to receivables for the month of January 2013

	MK
Accounts receivable balances 1.1. 2013	189,400
Total credit sales for the month of January 2013	1,029,000
Cash sales	320,000
Customers paid by cheques totaled	728,400
Monies received by cash from credit customers	123,600
Returns from credit customers	29,600
Closing balances. 31.1.2013	336,800

Sales Ledger Control Accounts

Balance b/f	189,400	Bank	728,400
Sales	1,029,000	Cash	123,600
		Return inwards	29,600
		Balance c/d	336,800
	1,218,400		1,218,400

12.3 PAYABLES CONTROL ACCOUNTS

The payables control accounts is prepared the same way the receivables control. It is worth noting however, that it is not always that the control accounts would always balance. Just like the Trial balance is used to detect errors in the accounts, these control accounts would do likewise.

Just as in receivables, payable control accounts draw information from the following sources;

Item	*Source*
Balances	Obtained from receivable listing (receivable accounts)
Credit purchases	from purchases account
Cash paid	from cash book
Discount received	from cash book (three column cash book)
Contra accounts	from receivable and payable listings
Return outwards	from returns accounts

.

The following information is available from the accounts of Jimmy limited

	MK
Accounts payable balances on 1 Jan 2013 was	38,900
Cheques paid to suppliers during the month	36,200
Returns to suppliers in the month	950
Total purchases from suppliers in the month was	49,360
Accounts payable balances on 31st Jan. 2012 was	51,510

Prepare payables control account

Payable control account

Bank	36,200	Balance b/d	38,900
Returns outwards	950	Purchases	49,360
Balance c/d	51,510		
	88,660		88,260

Please note that the control account above is not balancing. This will require investigations and make sure that the correct amounts had been entered in the control account before concluding that the ledgers are not incorrect. This will call for

investigations for the difference because it means that the trial balance will as well not balance.

12.4 RECONCILIATION OF CONTROL ACCOUNT

When control accounts are not balancing, it means something is wrong somewhere. This will call for a reconciliation of the control accounts. The control accounts reconciliation would be able to detect the errors in our accounting entries.

Example of purchases ledger control account reconciliation:

		MK
Original purchases ledger control account balance		XXX
Add	Invoices omitted from control account, but entered in Purchases a/c	XXX
	Suppliers balance excluded from Purchases ledger and included accidentally sales ledger account	XXX
	Credit sales posted in error to debit of purchases account instead of the debit of an account in the sales ledger	XXX
	Undercasting error in calculation of total end of period creditor's bal.	XXX
Less	Customer account with a credit balance included in the purchases that should have been included in the sales ledger	(XXX)
	Return inwards posted in error to the credit of purchases ledger account instead of the credit of an account in the sales ledger	(XXX)
	Credit note entered in error in the Return Outwards day book as 435 instead of 453	(XXX)
Revised purchases ledger control account balance		XXX

12.5 CONCLUSION

Control accounts are crucial statements in ensuring that financial statements are accurate and do not contain material arithmetical errors. Despite not being part of double entry accounting system, control accounts are necessary and should be prepared before finalizing the financial statements.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Why are control accounts important in accounting?

b) Which items appear on the bank statement but may not appear in the cash book.

c) What are bank lodgments?

2. Fire broke out at Shumba Groceries' offices during the night of 30 November 2010. The drawers holding the daily takings, the cashbook and the ledgers were completely destroyed. However, the following pieces of information were available from the other books and records that survived the fire.

	K
Total debtors at 1 January 2010	60,000
Total debtors at 30 November 2010	108,000
Total creditors at 1 January 2010	23,100
Total creditors at 30 November 2010	29,190
Purchases from 1 January to 30 November 2010	398,475
Sale from 1 January to 30 November 2010	675,525
Expenses from 1 January to 30 November 2010	129,750
Acquisition of non-current assets up to 30 November 2010	14,400

NOT FOR SALE

Salaries paid from 1 January to 30 November 2010	72,300
Drawings made on 1 November 2010	5,000
Cash balance at bank on 1 January 2010	10,800

It was established that the balance at the bank on the 30 November 2010 was K12,450. All cash sales takings had been banked by the day of the fire, 30 November 2010.

Required:

Prepare:

(i)	Debtors Control Account	**2 Marks**
(ii)	Creditors Control Account	**2 Marks**
(ii)	Shumba's Cashbook Account	**5 Marks**
		(TOTAL: 20 MARKS)

CHAPTER 13: PARTNERSHIPS

LEARNING OBJECTIVES

At the end of this chapter, students should be able to:

- Outline how to prepare accounts for partnership
- Accounting for changes in partnership – admission of new partner
- Understanding steps taken in dissolution of partnership
- Prepare statements for the conversion of a partnership into a limited company.

13.1 PARTNERSHIP ACCOUNTS – GENERAL OUTLOOK

A partnership is where two or more people doing business with an intention of making profits.

Partnerships obey the Partnership Act 1890. If there is a limited Partner, then it must comply with the Limited Partnership Act 1907. There should be at least two partners and at most twenty partners except if they are banks, where there could not be more than ten partners and there is no maximum for the firm of Accountants, lawyers, solicitors, surveyors, auctioneers and insurance brokers.

Limited Liability Partnership is a partnerships which contains one or more limited partners. This type of partnership must be registered with the Registrar of Companies. Limited partners are not liable for partnership debts which the partnership fails to pay,

Limited partners have the following characteristics and restrictions:

- Their liability to debts is limited to the capital they introduced to the partnership
- They are not allowed to take out their capital or receive back any part of their contribution to the partnership

- They are not allowed to take part in the management of the partnership or have they powers to make partnership take a decision
- All the partners cannot be limited.

In any partnership, partners are supposed to agree terms on how they are going to conduct their business. In a situation where the partnership has no agreement, the Partnership Act 1890 dictates that:

- Profit or losses are to be shared equally,
- There is to be no interest allowed on capital
- No interest is to charged on drawings
- Salaries are not allowed
- Partners who put in capital in excess of the agreed capital are entitled to interest at the rate of 5% per annum on such and advance.

Because ownership rights in a partnership are divided among two or more partners, separate capital and drawing accounts are maintained for each partner.

If a partner invested cash in a partnership, the Cash account of the partnership is debited, and the partner's capital account is credited for the invested amount.

If a partner invested an asset other than cash, an asset account is debited, and the partner's capital account is credited for the market value of the asset. If a certain amount of money is owed for the asset, the partnership may assume liability. In that case an asset account is debited, and the partner's capital account is credited for the difference between the market value of the asset invested and liabilities assumed.

NOT FOR SALE

Capital Interest

A capital interest is an interest that would give the holder a share of the proceeds in either of the following situations:

- The owner withdraws from the partnership.
- The partnership liquidates.
- The mere right to share in earnings and profits is not a capital interest in the partnership.

This determination generally is made at the time of receipt of the partnership interest.

Capital account

Capital account of each partner represents his equity in the partnership.

Capital account of a partner is increased in the following situations:

- The owner made additional investments during the year.
- The owner received guaranteed payments from the partnership.
- Partnership earned profits, and a share of profits was allocated to the partner.
- The increased in the capital will record in credit side of the capital account.
- Salary and interest allowances are guaranteed payments, discussed later.
- Capital account of a partner is **decreased** when the owner makes withdrawals of cash or property

The partnership agreement may specify that partners should be compensated for services they provide to the partnership and for capital invested by partners.

For example, one partner contributed more of the assets, and works full time in the partnership, while the other partner contributed a smaller amount of assets and does not provide as much services to the partnership.

Compensation for services is provided in the form of salary allowance. Compensation for capital is provided in the form of interest allowance. Amount of compensation is added to the capital account of the partner.

To illustrate, assume that a partner received MK500 as an interest allowance. The entry is:

Dr.	Partner A, Capital	MK500	
Cr.	Account payable		MK500

As a result of the above entry Accounts Payable, which is a liability account, is reduced by MK500, and the capital account is increased by the same amount.

When the partner makes a cash withdrawal of moneys he received as an allowance, it is treated as a withdrawal, or drawing.

	Debit	**Credit**
Partner A, Drawing	MK500	
Cash		MK500

As a result, Drawing account increased by MK500, and the Cash account of the partnership is reduced by the same account.

At the end of the accounting period the drawing account is closed to the capital account of the partner. The capital account will be reduced by the amount of drawing made by the partner during the accounting period.

13.2 CHANGES IN PARTNERSHIP - ADMITTING A NEW PARTNER

A new partner may be admitted by agreement among the existing partners. When this happens, the old partnership is automatically dissolved and a new partnership is created, with a new partnership agreement.

A new partner may be admitted into the business in three ways:

- By purchasing an interest directly from existing partners
- By making an investment in the business, or
- By contributing assets from an existing business.

Assume that Partner A and Partner B admit Partner C as a new partner, when Partner A and Partner B have capital interests MK30,000 and MK20,000, respectively.
Partner C pays, say, MK15,000 to Partner A for one-third of his interest, and MK15,000 to Partner B for one-half of his interest. These payments go to the partners directly, not to the business. The following entry is made by the partnership.

	Debit	**Credit**
Partner A, Capital	MK10,000	
Partner B, Capital	MK10,000	
Partner C, Capital		MK20,000

The extra MK5,000 Partner C paid to each of the partners, represents profit to them, but it has no effect on the partnership's financial statements.

Now, assume instead that Partner C invested MK30,000 cash in the new partnership. In this case, the following entry would be made to admit Partner C.

NOT FOR SALE

	Debit	Credit
Cash	MK30,000	
Partner C, Capital		MK30,000

Finally, let's assume that Partner C had been operating his own business, which was then taken over by the new partnership. In this case the financial Position for the new partner's business would serve as a basis for preparing the opening entry. The assets listed in the financial position are taken over, the liabilities are assumed, and the new partner's capital account is credited for the difference.

There is always need to analyze the impact of introducing a new partner to the business as this will result in reduction of the capital share for the existing partners. The impact and of the change in partnership is usually different depending on whether the exiting partners have equal holding or have different capital holding ratios.

Where the partners have equal holding.

Example 1. Assume that a sole proprietor agreed to admit a single equal partner for a certain amount of money. The sole proprietor, Partner A, will give the new partner, Partner B, an equal share in the partnership. 100% interest of the sole proprietor will be divided in half, so that each of the two partners will have 50% interest in the partnership. In effect, Partner A sold 50% of his equity to Partner B.

Example 2. Assume that Partner A and Partner B have 50% interest each, and they agreed to admit Partner C and give him an equal share of ownership. Each of the three partners will have 33.3% interest in the partnership. Interests of Partner A and Partner B will be reduced from 50% each to 33.3% each. In effect, each of the two partners sold 16.7% of his equity to Partner C.

Example 3. Assume there are three equal partners, who have 33.3% interest each, and they agreed to admit a forth equal partner. Each of the four partners will have 25% interest in the partnership. Interests of the three partners will be reduced from 33.3% each to 25% each. In effect, each of the three partners sold 8.3% of his equity to the new partner.

In either case, all partners must agree to the specific way to realign their partnership interests as a result of admitting a new partner.

Unequal partners.

Example 1. Assume there are two unequal partners in the partnership. Partner A owns **60% equity**, Partner B owns **40% equity**, and they agreed to admit a third partner. Partner C has several options to join the partnership.

- He can buy equity from Partner A.
- He can buy equity from Partner B.
- He can buy equity from Partner A and Partner B.

Partner A and Partner B may both agree to sell 50% of their equity to Partner C. In that case, Partner A will have 30% interest, Partner B will have 20%, and Partner C will own (30% + 20%) 50% interest in the partnership.

Partner A and Partner B may both agree to sell 25% of their equity to Partner C. In that case, Partner 3 will own (15% + 10%) 25% interest in the partnership.

Partner A may decide to sell 25% of his equity to partner C. Partner B may decide to sell 50% of his equity to partner C. Partner C will own (15% + 20%) 35% of the partnership equity.

Example 2. Assume now that there are three partners. Partner A owns 50% interest, Partner B owns 30% interest, and Partner C owns 20% interest. Collectively, they own 100% interest in the partnership.

They agreed to admit a fourth partner, Partner D. As in the previous case, Partner D has a number of options. He can buy shares of interest from one of the partners, or from more than one partner.

Assume that the three partners agreed to sell 20% of interest in the partnership to the new partner. There are more than one way to realign partnership interests.

13.3 GOODWILL IN PARTNERSHIP

a) Goodwill due to old partners

A new partner may pay a bonus in order to join the partnership. Bonus is the difference between the amount contributed to the partnership and equity received in return.

Assume that Partner A and Partner B have balances MK10,000 each on their capital accounts. The partners agree to admit Partner C to the partnership for MK16,000. In return, Partner C will receive one-third equity in the partnership. The following table illustrates calculation of the bonus.

Equity of Partner A	MK10,000
Equity of Partner B	MK10,000
Contribution of PartnerC	MK16,000
Total equity	MK36,000
Equity contribution of partner C was	MK12,000

In this case, Partner C paid MK4,000 bonus to join the partnership. This amount is known as good will. The amount of any such goodwill paid to the partnership is

distributed among the old partners. The following table illustrates the distribution of the bonus.

	Debit	Credit
Cash	MK16,000	
Capital C		MK12,000
Capital A		MK2,000
Capital B		MK2,000

b) Goodwill paid by a new partner.

Assume now that Partner A and Partner B have balances MK10,000 each on their capital accounts. The partners agree to admit Partner C to the partnership for MK7,000. In return, Partner C will receive one-third equity in the partnership.

Why would the existing partners allow a new partner to buy an equal share of equity with smaller contribution? It might be because the new partner brings something very valuable to the partnership. It might be special skills.

The following table illustrates calculation of the bonus.

Equity of Partner A	MK10,000
Equity of Partner B	MK10,000
Contribution of Partner C	MK7,000
Total equity after admitting Partner C	MK27,000

Equity of Partner C	MK9,000
Contribution of Partner C	MK7,000

NOT FOR SALE

In this case, Partner C received K2,000 bonus to join the partnership. The amount of the bonus paid by the partnership is distributed among the partners according to the partnership agreement.

The following table illustrates the distribution of the bonus. Debit to Cash increases the account, while debit to a capital account of a partner decreases the account.

	Debit	**Credit**
Cash	MK7,000	
Partner C, Capital		MK9,000
Partner A, Capital	MK1,000	
Partner B, Capital	MK1,000	

In an equal partnership bonus paid to a new partner is distributed equally among the old partners. In an unequal partnership bonus is distributed according to the old partnership agreement.

Assume that Partner A is a 75% partner, and Partner B is a 25% partner. Partner C was admitted to the partnership. He paid MK5,000 cash. In return, he received MK9,000equity in the partnership. A MK4,000 (MK9,000 - MK5,000) bonus paid to Partner C would be distributed as follows:

Partner A will pay (MK4,000 * 75%) MK3,000. His capital account will be debited MK3,000.

Partner B will pay (MK4,000 * 25%) MK1,000. His capital account will be debited MK1,000.

	Debit	**Credit**
Cash	MK5,000	
Partner C, Capital		MK9,000
Partner A, Capital	MK3,000	
Partner B, Capital	MK1,000	

13.4 WITHDRAWAL OF A PARTNER

By agreement, a partner may retire and be permitted to withdraw assets equal to, less than, or greater than the amount of his interest in the partnership. The book value of a partner's interest is shown by the credit balance of the partner's capital account.

The balance is computed after all profits or losses have been allocated in accordance with the partnership agreement, and the books closed.

If a retiring partner withdraws cash or other assets equal to the credit balance of his capital account, the transaction will have no effect on the capital of the remaining partners.

To illustrate, assume that several years after the formation of "A,B, & C" partnership Partner C decided to retire. The partners agreed to the withdrawal of cash equal to the amount of Partner C's equity in the assets of the partnership. Assume that the partners' capital accounts had credit balances as follows:

Partner A	MK60,000
Partner B	MK40,000
Partner C	MK30,000

If Partner C withdraws MK30,000 in cash, the entry on the books is as follows:

	Debit	**Credit**
Partner C, Capital	MK30,000	
Cash		MK30,000

If a retiring partner agrees to withdraw less than the amount in his capital account, the transaction will increase the capital accounts of the remaining partners.

For example, if Partner C withdraws only MK20,000 in settlement of the interest, the difference between Partner C's equity in the assets of the partnership and the amount of cash withdrawn is MK10,000 (MK30,000 - MK20,000).

This difference is divided between the remaining partners on the basis of profit sharing ratios stated in the partnership agreement.

Assume that the partnership agreement specifies that in such a case the difference is divided according to the ratio of their capital interests after allocating net income and closing their drawing accounts. On this basis, Partner A's capital account is credited with MK6,000 and Partner B's is credited with MK4,000.

The entry in the books of the partnership is as follows:

	Debit	**Credit**
Partner C, Capital	MK30,000	
Cash		MK20,000
Partner A, Capital		MK6,000
Partner B, Capital		MK4,000

If a retiring partner withdraws more than the amount in his capital account, the transaction will decrease the capital accounts of the remaining partners. The excess of the amount withdrawn over retiring partner's equity in the partnership is divided between the remaining partners on the profit sharing ratio basis stated in the partnership agreement.

The partnership may also ask the retiring partner to withdraw part of their capital and be paid the other balance in future instalments. In this situation, the remaining balance of capital is treated as a loan to the partnership.

13.5 REVALUATION OF ASSETS DUE TO CHANGES IN PARTNERSHIP

The assets of a business may be revalued because of the following reasons:

- A new partner joins the partnership
- A partner leaves the partnership
- The partners change profit or loss sharing ratios
- The partner dies.

Accounting treatment on revaluation of assets

You first have to open a revaluation account where all the profit or loss on the revaluation will be recorded as follows:

Any asset that gains in value,

Debit The asset account

Credit The revaluation account with a profit.

Any asset that losses value:

Debit The revaluation account

Credit The Assets account with a loss

If the net effect of the above transaction is a profit (or a credit balance), then:

Debit The Revaluation account

Credit The Partners' capital accounts.

While as if it is a loss (debit balance in the revaluation account)

Debit The Partners' Capital accounts

Credit The Revaluation Reserves

NOT FOR SALE

The amounts to be debited or credited to partners' capital accounts should be in the partners profit or loss sharing ratios.

13.6 PURCHASING OF PARTNER'S INTEREST

When a partner retires from the business, the partner's interest may be purchased directly by one or more of the remaining partners or by an outside party. If the retiring partner's interest is sold to one of the remaining partners, the retiring partner's equity is merely transferred to the other partner.

For example, assume that Partner C's equity is sold to Partner B. The entry for the transaction on the books of the partnership is as follows:

	Debit	**Credit**
Partner C, Capital	MK30,000	
Partner B, Capital		MK30,000

The amount paid to Partner C by Partner B is a personal transaction and has no effect on the above entry. Any gain or loss resulting from the transaction is a personal gain or loss of the withdrawing partner and not of the business.

If the retiring partner's interest is purchased by an outside party, the retiring partner's equity is transferred to the capital account of the new partner, Partner D.

	Debit	**Credit**
Partner C, Capital	MK30,000	
Partner D, Capital		MK30,000

The amount paid to Partner C by Partner D is also a personal transaction and has no effect on the above entry.

13.7 DEATH OF A PARTNER

The death of a partner dissolves the partnership. On the date of death, the accounts are closed and the net income for the year to date is allocated to the partners' capital accounts. Most agreements call for an audit and revaluation of the assets at this time. The balance of the deceased partner's capital account is then transferred to a liability account with the deceased's estate.

The surviving partners may continue the business or liquidate. If the business continues, the procedures for settling with the estate are the same as those described earlier for the withdrawal of a partner.

Financial statements of a partnership

The financial statements are prepared in the same way as those of a sole trader with the exception of the following:

Statement of Profit or loss

- The partners salary of the partnership will be included as part of the appropriation account
- Interest on drawings for partners
- Interest on capital for the partners
- Sharing of profits

Statement of Financial Position

- There will be partners current accounts
- The partners capital accounts.

13.8 DISSOLUTION OF A PARTNERSHIP

Dissolution of a partnership generally means that the assets are sold, liabilities are paid, and the remaining cash or other assets are distributed to the partners.

When normal operations are discontinued, adjusting and closing entries are made. Thus, only the assets, liabilities and partners' equity accounts remain open.

If noncash assets are sold for more than their book value, a gain on the sale is recognized. The gain is allocated to the partners' capital accounts according to the partnership agreement.

If noncash assets are sold for less than their book value, a loss on the sale is recognized. The loss is allocated to the partners' capital accounts according to the partnership agreement.

As the assets are sold, the cash is applied first to the claims of creditors. Once all liabilities are paid, the remaining cash and other assets are distributed to the partners according to their ownership interests as indicated by their capital accounts.

Example.

Peter and Pious are in partnership sharing profits in the ratio of 2:5. On the date of dissolution, the statement of financial position was as below:

NOT FOR SALE

Non Current assets			MK
Property, Plant and equipment			4,000,000.00
Motor vehicles			2,000,000.00
			6,000,000.00
Current Assets			
inventory		30,000.00	
Accounts payable		65,000.00	
Bank		120,000.00	215,000.00
			6,215,000.00
Capital and liabilities			
Capital	Peter	750,000.00	
	Pious	1,620,000.00	2,370,000.00
Current accounts	Peter	1,539,000.00	
	Pious	1,440,000.00	2,979,000.00
			5,349,000.00
Payable			866,000.00
			6,215,000.00

Account for the dissolution of the partnership if Pious took over the motor vehicle at MK1,800,000. The buildings were sold for MK7,000,000. All receivables were collected in full and payables were paid. Inventory was taken over by Peter at its book value. Dissolution cost were MK20,000.00

Realisation account

Buildings acc		4,000,000.00	Motor Vehicle	pious	1,800,000.00
Motor vehicle		2,000,000.00	Bank	Buildings	7,000,000.00
receivables		65,000.00	Bank	Receivable	65,000.00
Inventory		30,000.00	Payables		866,000.00
Bank	payables	866,000.00	Peter	Inventory	30,000.00
	Dissolutio				
Bank	n cost	20,000.00			
Capital	Peter	794,285.71			
	Pious	1,985,714.29			
		9,761,000.00			9,761,000.00

Peter capital account

Inventory		30,000.00	Balance b/d	capital	750,000.00
Bank		3,053,285.71		Current	1,539,000.00
			Realisation	share	794,285.71
		3,083,285.71			3,083,285.71

Pious capital account

Realisation	M/vehicle	1,800,000.00	Balance b/d	capital	1,620,000.00
Bank		3,245,714.29		Current	1,440,000.00
			Realisation		1,985,714.29
		5,045,714.29			5,045,714.29

Bank account

Balance b/d		120,000.00	Realisation	Payables	866,000.00
Realisation	Buildings	7,000,000.00	Realisation	Dissolution	20,000.00
Realisation	Receivables	65,000.00	Peter		3,053,285.71
			Pious		3,245,714.29
		7,185,000.00			7,185,000.00

Buildings account

Buildings account	4,000,000.00	Realisation acc	4,000,000.00
	4,000,000.00		**4,000,000.00**

Motor vehicle

Bal b/d	2,000,000.00	Realisation	2,000,000.00

Receivable

Balance b/d	65,000.00	Realisation	65,000.00

Inventory			
Balance b/d	30,000.00	realisation	30,000.00

Take note that the bank account will always balance.

13.9 CONVERSION OF A PARTNERSHIP TO A LIMITED LIABILITY COMPANY

The principle behind the conversation of a partnership into Limited Liability Company are basically the same as those of dissolution of a partnership as indicated in part 26 above. The partnership ceases to exist and a new company is formed. Partners become the holders of share capital in the new formed company. They may decide to bring in another person into a limited company, but this will be done after all the partnership has been dissolved.

Example

Peter and Pious are in partnership sharing profits in the ratio of 2:5. On the date of conversion of the partnership, the statement of financial position was as below:

NOT FOR SALE

Non Current assets			MK
Property, Plant and equipment			4,000,000.00
Motor vehicles			2,000,000.00
			6,000,000.00
Current Assets			
inventory		30,000.00	
Accounts payable		65,000.00	
Bank		120,000.00	215,000.00
			6,215,000.00
Capital and liabilities			
Capital	Peter	750,000.00	
	Pious	1,620,000.00	2,370,000.00
Current accounts	Peter	1,539,000.00	
	Pious	1,440,000.00	2,979,000.00
			5,349,000.00
Payable			866,000.00
			6,215,000.00

Account for the conversion of the partnership by preparing the statement of financial position of the P&P Co Limited liability company if the motor vehicle were taken over at MK1,800,000. The buildings were revalued to MK7,000,000. All receivables were collected in full and payables were paid. Inventory was taken over by the new company formed known as P &P company at its book value. Conversion costs were MK20,000.00

In this example all other accounts were already prepared in the dissolution of partnership above. Thus we will just concentrate on the three main accounts from the dissolution. i.e. realization, bank and capital accounts of the partnership. Then we will prepare the P & P co. first statement of financial position.

Realisation account

Buildings acc		4,000,000.00	Motor Vehicle	P&P co	1,800,000.00
Motor vehicle		2,000,000.00	Buildings	P&P co	7,000,000.00
receivables		65,000.00	Bank	Receivable	65,000.00
Inventory		30,000.00	Payables		866,000.00
Bank	payables	866,000.00	Inventory	P&P co	30,000.00
	converstio				
Bank	n cost	20,000.00			
Capital	Peter	794,285.71			
	Pious	1,985,714.29			
		9,761,000.00			9,761,000.00

Peter capital account

			Balance b/d	capital	750,000.00
Capital acc	P&P	3,083,285.71		Current	1,539,000.00
			Realisation	share	794,285.71
		3,083,285.71			3,083,285.71

Pious capital account

			Balance b/d	capital	1,620,000.00
Capital acc	P&P	5,045,714.29		Current	1,440,000.00
			Realisation		1,985,714.29
		5,045,714.29			5,045,714.29

	Peter	Pious	Total
Capital	3,083,285.71	5,045,714.29	8,129,000.00

Bank account

Balance b/d		120,000.00	Realisation	Payables	866,000.00
			Realisation	Dissolution	20,000.00
Realisation	Receivables	65,000.00			
bal c/d		**701,000.00**			
		886,000.00			886,000.00
			bal b/d		701,000.00

Motor Vehicle account

Realisation acc	1,800,000.00	bal. c/d	1,800,000.00

Buildings

Realisation acc	7,000,000.00	Bal. c/d	7,000,000.00

Inventory

Realisation acc	30,000.00	bal c/d	30,000.00

Statement of Financial Position for P&P Co.

Non Current assets	MK
Buildings	7,000,000.00
Motor Vehicles	1,800,000.00
	8,800,000.00
Current Assets	
Inventory	30,000.00
	8,830,000.00
Capital and Liabilities	
Ordinary share capital	8,129,000.00
Bank o/d	701,000.00
	8,830,000.00

Take note that the opening financial position has to balance.

13.10 CONCLUSION

This chapter looked at the preparation of financial statements for partnership and accounting treatment for changes in partnership. It is always important to note that the preparation of financial statement for partnership is similar to sole trader only that after preparing the Statement of Comprehensive Income, profit or loss, there is need to prepare an appropriation account. This statement shows how the profit generated is shared among the members.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What are the advantages of a partnership form of business over sole trading?

b) What is the difference between a sleeping partner and a general partner?

c) Apart from sharing the profits, what are the other ways in which a partner is compensated for investing in business?

d) Which four factors can cause the dissolution of a partnership?

2. Chimombo and Chapola have been in partnership for a number of years sharing profits and losses in the ratio 2:3. The following statement of financial position was extracted from the books of accounts of the partnership as at 30 September 2010:

NOT FOR SALE

	K'000	K'000
Non-current assets		
Land and buildings		600
Motor vehicles (net book value)		800
Fixtures and fittings (net book value)		180
		1,580
Current assets		
Inventories	80	
Accounts receivables	60	
Cash at bank	20	160
		1,740
Capital		
Capital accounts: Chimombo		1,000
Chapola		500
Current accounts: Chimombo		200
Chapola		(60)
		1,640
Current liabilities		
Payables		100
Total capital and liabilities		1,740

The partners, after being together for a long time, decided to dissolve the partnership to pursue other personal interests. Chimombo, however, was to take for his personal use the piece of land and the motor vehicle at agreed prices of K700,000 and K800,000 respectively. A customer has already been identified to purchase the inventory for K72,000. The whole amount of accounts receivables would be fully collectible during the period of dissolution. Suppliers are prepared to offer a 1% discount on full settlement of accounts payables. The partners agreed to transfer fixtures and fittings to an orphanage free of charge and share the cost in the normal profit sharing ratio. Any

balance on their capital accounts will have to be settled by cash either by the partner or to the partner, as the case may be. Dissolution costs amounted to K12,500.

Required:

a) Prepare the realization account upon the dissolution of the partnership. **8 Marks**

(b) Prepare the partners' accounts and the bank account to record the closure of the partnership books. **9 Marks**

(c) Mention **three** disadvantages of a partnership, as a form of business, compared to that of a sole trader. **3 Marks**

(TOTAL: 20 MARKS)

CHAPTER 14: PREPARATION OF FINAL ACCOUNTS FOR LIMITED COMPANIES

14.0 LEARNING OBJECTIVES

By the end of this chapter, students will be able to:

- Classify different types of expenses associated with limited companies
- identify how profit of a limited company is appropriated
- prepare statement of profit or loss and statement of financial position for internal use
- Understand the difference between bonus and rights issue and how they impact of the financial statements.

14.1 REVENUE SOURCES FOR THE BUSINESS

Limited companies are created to make profits for their shareholders through trading activities by selling products or provision of services.

Revenue recognition is accounted in accordance with IAS 18 and is defined as the gross inflow of economic benefits during the period arising in the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contribution from equity participant.

Conditions for recognition revenue from sale of goods include;

i) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
ii) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the gods sold.
iii) the amount of revenue can be measured reliably
iv) it is probable that economic benefits associated with the transaction will flow to the entity and

v) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

The company is supposed to recognize revenue generated in the statement of profit or loss on accrual basis i.e. when all the conditions for recognition mentioned above are satisfied rather than when cash is actually received.

Revenue for the year should be offset against goods which have been returned to the business by the customers. This may result from over supplying the customers, sending wrong products, customer not being satisfied with the quality and the condition of the goods.

Example

The sales for the month of October 2013 were K4, 600,000 but the customer returned goods worth K200,000 for various reasons.

Statement of Profit or loss	
Sales revenue	K4,600,000
Less: sales returns (Return inwards)	(200,000)
Turnover	K4,400,000

14.2 CLASSIFICATION OF EXPENSES

For a sale to be realized, the company should have spent to acquire or produce the goods to be sold. Proper classification of expenses in very critical for the interpretation of the performance of the business.

Major classification of expenses for the statement of profit or loss include;

- Cost of goods sold

NOT FOR SALE

- Distribution expenses
- Administration expenses
- Finance costs

i) Cost of goods sold

The cost of goods sold is an analysis of the actual costs for the items which have been sold. This section include opening inventories, purchases and closing inventories. Any cost incurred to bring the inventories to the business in form of carriage costs is also included as part of purchases.

Goods returned to the supplier for various reasons is deducted to arrive at the cost of goods sold.

Example

The company purchased goods worth K2,3000,000 in the month of October 2013. Transport cost incurred on the purchases was K300,000. At the beginning of the month the company had inventories worth K800,000 and at the end of the month there were inventories worth K950,000 outstanding.

Cost of goods sold will therefore be computed and presented as;

		MK
Opening inventories		800,000
Purchases	2,300,000	
Add: carriage inwards	300,000	2,600,000
Less: Closing inventories		(950,000)
Cost of goods sold		2,550,000

ii) Distribution expenses

These are expenses incurred by a company in selling and distributing goods to the customers. The expenses under this category include warehousing costs, delivery van expenses, sales commissions, salary of sales personnel and general distribution costs.

iii) Administration expenses

These are expenses incurred in the running of the business. These expenses are usually not directly attributable to the goods which are sold. These expenses include salary of administration staff, rental expenses, utility bills, office rentals, depreciation of office equipment and many more.

Example

The company incurred the following expenses in the month of October 2013.

Rentals	300,000
Salaries	600,000
Utility expenses	100,000
Depreciation expenses	600,000
Transport costs	200,000
General administration expenses	500,000
Sales commissions	50,000
Insurance expenses	150,000

The company allocates the expenses between administration and distribution functions as follows;

Rentals - equally, salaries, Utilities, depreciation and insurance 60% to administration, transport costs and insurance costs 70% to distribution; Sales commission 100% to distribution.

The analysis of the expenses will there be as follows;

Distribution expenses	
Rental (300,000/2)	150,000
Salaries (600,000 x 40%)	240,000
Utilities (100,000 x 40%)	40,000
Depreciation (600,000 *40%)	240,000
Transport costs (200,000 x 70%)	140,000
Sales commission (100%)	50,000
Insurance costs (150,000 x 70%)	105,000
	965,000

Administration expenses	
Rental (300,000/2)	150,000
Salaries (600,000 *60%)	360,000
Utilities (100,000 x 60%)	60,000
Depreciation (600,000 x 60%)	360,000
Transport costs (200,000 x 30%)	60,000
General administration expenses	500,000
Insurance costs (150,000 x 30%)	45,000
	1,535,000

iv) Finance costs

Finance costs relate to costs incurred as a charge for obtaining funding from other external financiers. Under this section, the expenses include;

Bank interest on loan

Debenture interest payable

Finance costs in finance lease

14.3 OTHER COMPREHENSIVE INCOME

Revised IAS 1 requires the inclusion of other gains or losses which previously were supposed to be transferred directly to equity.

a) Revaluation surplus

The revaluation surplus of a non-current asset is supposed to be included in other comprehensive income section while a revaluation loss is recognized directly as expenses in the statement.

b) Translation gain or loss

Translation gain or loss occurs when an entity has a receivable or payable denominated in foreign currency as at the end of the financial period. In extreme cases, an entity may own a subsidiary in another country which use another currency than that in a home country.

Translation gain or loss on an account balance is supposed to be recognized as a normal gain or loss in the statement of comprehensive income while translation gain or loss on consolidation of a subsidiary is supposed to be recognized as movement in equity and therefore as a transaction to be recognized as other comprehensive income.

14.4 PROFIT APPROPRIATIONS

The profit generated by the company is supposed to be shared by shareholders and the remainder used for the growth of business.

NOT FOR SALE

a) Dividend payment

Dividend is regarded as a return to the shareholders for investing their money in the business. Dividend paid during the year is called interim dividend while that at the end of the financial year is called a final dividend.

Preference shareholders usually have predetermined dividend receivable through the nature of shares they are holding while ordinary shareholder rely on the declaration by the directors.

Example

The company has the following capital structure;
- 1,000,000 K1 Ordinary shares
- 7% 700,000 K1 preference shares

The company has K600,000 profit available for distribution and the directors have proposed K200,000 as dividend to ordinary shareholders.

Profit for the year		K600,000
Less:	Preference dividend (7% of 700,000)	(49,000)
	Ordinary dividend	(200,000)
Retained profit for the year		351,000

b) Capital redemption reserve

Capital redemption reserve is created whenever the company redeem shares out of the profit reserves. Normally the understanding is that the company will issue new shares in order to redeem old shares but if this is not the case then the company will use the profit reserve.

Example

The company is to redeem 40,000 K1 preference share using own resources.

Dr.	Preference shares	K40,000	
Cr.	Bank		K40,000

Dr.	Profit reserves	K40,000	
Cr.	Capital redemption reserve		K40,000

With the nominal value of shares redeemed out of internal resources (retained profit)

14.5 STATEMENT OF PROFIT OR LOSS

Having looked at the components of the statement of comprehensive income and profit or loss, the information is hereby summarized in the standard format

a) For Internal use

Statement of Comprehensive Income and other Profit or loss

	MK	MK
Sales		xx
Less: Returns inwards		(x)
Turnover		xx
Less: Cost of sales		
Opening inventory	xx	
Purchases	xx	
Carriage inwards	xx	
Return outwards	(x)	
Closing inventories	(x)	(xx)
Gross profit		xx

Distribution expenses		
Sales expenses	x	
Warehousing costs	x	
General distribution expenses	x	(xx)
Administration expenses		
Salaries and wages	x	
Rent and rates	x	
General administration expenses	x	
Advertisement costs	x	(xx)
Operating Profit for the year		xx
Finance costs		
Debenture Interest	x	
Finance costs for lease	x	xx
Profit before tax		xx
Corporation tax		(x)
Profit after tax		xx
Other comprehensive income		
Revaluation surplus	x	
Translation surplus	x	xx
Total profit for the year		xx
Appropriations		
Transfer to general reserve	x	
Capital redemption reserve	x	
Dividend – Preference shares	x	
Ordinary shares	x	(xx)
Retained profit for the year		xx

b) For Publication

A statement of profit or loss for publication provides summaries for major transactions. The aim is to to show broader information which is considered more practical and useful for external information as opposed to detailed presentation for internal use.

Statement of Profit or loss and other Comprehensive income

	MK	MK
Turnover		xx
Cost of sales		(xx)
Gross profit		xx
Distribution costs		(x)
Administration expenses		(x)
Operating profit		xx
Finance costs		(x)
Profit before tax		xx
Taxation		(x)
Profit after tax		xx
Other comprehensive income		xx

14.6 STATEMENT OF FINANCIAL POSITION

The statement of financial position is used to outline the financial base of the business, its standing in terms of assets and liabilities. It is a crucial statement as it provide information needs for various stakeholders.

a) For internal use

	MK	MK	MK
Non-current assets			
	Cost	**Depreciation**	**NBV**
Land and buildings	xx	(x)	xx
Motor vehicles	xx	(x)	xx
Equipment	xx	(x)	xx
Intangible assets			
Goodwill			xx
Other intangibles			xx
Investments			xx
Total non-current assets			xx
Current assets			
Inventories		xx	
Receivables		xx	
Prepayments		xx	
Cash and bank		xx	xx
Total assets			xx
Capital and liabilities			
Capital			xx
Revaluation reserves			xx
Profit reserves			xx
Total capital and reserves			xx

Non- current liabilities		
Bank loan	xx	
Finance lease	xx	
Debentures	xx	xx
Current liabilities		
Payables	xx	
Accruals	xx	
Proposed divided	xx	xx
Total capital and liabilities		xx

b) For external use

	MK	MK
Non-current assets		
Property plant and equipment		xx
Intangible assets		xx
Investments		xx
Total non-current assets		xx
Current assets		
Inventories	xx	
Receivables	xx	
Prepayments	xx	
Cash and bank	xx	xx
Total assets		xx
Capital and liabilities		
Capital		xx
Revaluation reserves		xx

Profit reserves		xx
Total capital and reserves		xx
Non- current liabilities		
Bank loan	xx	
Finance lease	xx	
Debentures	xx	xx
Current liabilities		
Payables	xx	
Accruals	xx	
Proposed divided	xx	xx
Total capital and liabilities		xx

14.7 STATEMENT OF CHANGES IN EQUITY INTEREST

Statement for changes in equity interest is used to record the movement in reserves during the year. It is an important statement as users are provided with vital information on how the profit generated and other reserves have moved during the financial year.

NOT FOR SALE

Statement of changes in equity interest

	Profit Reserve	Revaluation Reserves	Translation Reserves	Total
Balance b/f	xx	xx	xx	xx
Prior year adjustment	xx			xx
Restated balances	xx	xx	xx	xx
Revaluation surplus		xx		xx
Profit for the year	xx			xx
Dividend	(x)			(x)
Excess depreciation	x	(x)		
Translation gain			x	x
Balance c/f	xx	xx	xx	xx

14.8 EARNINGS PER SHARE

As part of presentation for profit or loss for the year, an entity is supposed to present the earnings per share (EPS) for the current year and prior year. EPS is important measure of the performance of the business as such it is presented always at the foot of the Statement of profit or loss.

EPS is computed as $\frac{\text{Profit after tax and preference dividend}}{\text{Number of ordinary shares}}$

Higher EPS figure attracts more inventors to the business as it indicates that the business is able to generate more profit for the shares it hold.

14.9 CONCLUSION

Financial statements are considered as the end product of accounting. All the recognitions, measurement and presentation of transactions end up in a summary form through the financial statements. Financial statements presents the only window at which the other stakeholders may be able to assess the performance and the position of the business.

In preparing financial statements, it is important to note that presentation is the major key. Financial statement is supposed to follow pre-scribed format and departure of which will render the financial statements not to show a true and fair view of the business.

END OF CHAPTER QUESTION

1. Tutorial questions

a) Mention three expenses which can be classified under finance expenses

b) What are the major headings in statement of financial position?

c) List three transactions which are record in Statement of changes in equity interest.

2. The following is a trial balance extracted from the book of accounts for Chitukuko Ltd as at 31 December 2010.

	K	K
Ordinary Share Capital		950,000
Share premium		165,722
Returned Income		145,550
Inventories (1/01/10)	323,000	
Sales		4,484,00
Purchases of goods for sale	2,360,750	0
Returns outwards		
Returns inwards	129,342	117,372
Carriage outwards	40,641	
Warehouse wages	384,028	
Salesmen's salaries	289,750	
Administrative wages and salaries	228,000	
Plant and Machinery	608,000	
Plant and machinery – accumulated depreciation		
Motor vehicle hire	78,612	207,376
General distribution expenses	120,873	
General administrative expenses	140,277	
Accounts receivables	1,539,000	
Accounts payables		
Cash at bank	171,238	343,491
	6,413,511	
		6,413,511

Additional information:

- Inventories were valued at K392,018 as at 31 December 2010.
- Straight line depreciation is provided on plant and machinery at 20% on cost.
- For the purpose of reporting, depreciation on plant and machinery is allocated to distribution cost category at 40% and to administration cost category at 60%.

- K51,841 audit fees had not been paid as at 31 December 2010.
- Motor vehicle hire expenses are for administrative purposes.
- Based on previous year's tax return, the income tax is estimated at K181,659 for the financial period.
- Ordinary dividends valued at 25% on normal share capital were declared for the year but payable in July 2011.

Required:

(a) Prepare the Income Statement for Chitukuko Ltd for the year ended 31 December 2010 for internal use (operating expenses should be grouped into administration and distribution. **10¼ Marks**

(b) Prepare the statement of financial position for Chitukuko Ltd as at 31 December 2010. **7 Marks**

(c) Briefly explain the difference between drawings and dividends. **2¾ Marks**

(TOTAL : 20 MARKS)

NOT FOR SALE

CHAPTER 15 ACCOUNTS FOR NONPROFIT MAKING ORGANIZATION

15.0 LEARNING OBJECTIVES

At the end of this chapter, students should be able to:

- Understand the various income sources for non-profit making organizations
- The basic differences between normal trading organization and non-profit making organization
- Outline how to prepare accounts for non-profit making organization

15.1 FORMS OF NON PROFIT MAKING ORGANISATION

Non-Profit Making Organizations(NPMOs) are institutions created to promote social activities with no profit motive. These institutions include non- governmental organizations (NGOs), clubs and societies, churches.

Examples of non-profit making organizations in Malawi

Clubs -	Blantyre sports club
	Big bullets football club
	Gymkhana club
	Farmers club
NGOs	Malawi Economic Justice Network
	MalawianHealth Equity Network
	Civil Liberty Committee
	Save the Children
Associations	Law Society of Malawi
	Institute of Chartered Accountants of Malawi

	Insurance Institute of Malawi
Religious Institutes	Roman Catholics
	Muslim Association
	Church of Central African Presbyterian
Societies	Bible Society of Malawi
	Scripture Union

As observed, these institutions are there for the promotion of education, healthy, agriculture or sports activities.

Despite not having the profit motive, no profit making organizations need to generate income which is used to meet its operational costs.Some of the income sources for non-profit making organizations include the following;

I) SUBSCRIPTIONS

Usually these institutions are member based. These members are required to contribute funds towards the institutions in form of subscription or membership fees. The subscription can either be annual or life. In annual subscription, the member is required to make contribution every year based on agreed terms of the institution while in life subscription, the member is required to make a one of subscription and they will be exempted from making annual subscriptions.

In some situations, the members are required to pay registration fees in order to be admitted and thereafter required to pay annual subscriptions.

II) DONATIONS

Another major source of income for these institutions comes from donations. Donation can either be to finance operational activities or to meet the capital acquisitions. Most NGO's, this is the major source of income.

III INTEREST FROM INVESTMENTS

The income from most non-profit making organization is often erratic as such most institutions will do maintain liquid investments to cushion in the period when there is no funding.

Interest income is slowly becoming crucial income sources for most non-profit making organization.

IV FUND RAISING ACTIVITIES

Organizations have various means of soliciting funds to supplement those from donations and subscriptions from members. The activities can be one off or a continuing trading activity.

Examples;

- Selling of raffle tickets
- Big walk functions
- Running a restaurant
- Selling of merchant.

NOT FOR SALE

15.2 ACCOUNTING FEATURES FOR NON-PROFIT MAKING ORGANISATION

Most NGO's, clubs and societies are not meant to do trading and their accounting structure is usually different from the normal trading organization. Some of the differences include the following;

a) Capital

For most trading organizations, capital is raised by shareholders or the owners of the business and is used as the bedrock of assessing the financial position of the business. For clubs and society, the capital is called Accumulated funds and is usually built from annual surplus realized by the organization.

On annual basis, the organization determines, opening accumulated funds by producing a statement of affairs, listing all the assets at the beginning of the financial year less liabilities at the same time.

Example;

At the beginning of the financial year, 1st January 2013, MwaiWathu NGO had the following assets and liabilities;

Assets		MK
Motor vehicles		450,000
Bar inventories		100,000
Subscriptions in arrears		80,000
Cash and Bank		120,000
Total		750,000

Liabilities		
Subscription in advance	60,000	
Trade payables	12,000	
Accrued expenses	28,000	100,000

Accumulated fund will there be	650,000

b) Financial statements

i) Receipt and payment

All receipts and payments for these NPMO's are recorded in a receipt and payment account which is the same as Cash book for a trading organization. The account is similar to cash book and the only difference is that while cash book has separate columns for cash, bank and discounts columns, receipt and payment has one column for the receipt and another for payment.

ii) Income and Expenditure

Income and expenditure acts as a statement of profit or loss for anNPMO. As stated above, these organizations may conduct trading activities such as running a bar, a restaurant or a shop. For these activities, normal trading accounts are

opened and profit determined which then is transferred into the Income and expenditure account.

iii) Statement of financial position

The NPMOs are required to prepare the statement of financial position at the end of financial period. The format for the statement is the same as that for trading organizations, except that the statement for NPMOs has accumulated funds as opposed to capital and surplus instead of accumulated profit.

15.3 STAGES IN PREPARING ACCOUNTS FOR NPMOs

The following steps sets out a methodical approach in the preparation of financial statements for an NPMO. This is not a rule which all must follow but has been considered as ideal by the Authors and is aimed at preventing preparers of financial statements from skipping important data relating to the activities of an NPMO.

STAGE 1: Determination of opening accumulated funds

As stated above, accumulated funds represents the opening capital for an NPMO. At this state, a statement of affairs at the beginning of a financial year is opened which is the sum of all opening assets less the sum of all opening liabilities.

STAGE 2 Determination of net income

Most NPMOs have various ways of generating their funds. These activities are usually standalone activities like fund raising dinner dance, big walk, running a bar, subscriptions or running of a tournament.

NOT FOR SALE

The organization is supposed to determine the net proceeds from these activities and only the net figure included in the Income and expenditure account.

i) Profit from bar/ restaurant or any trading activity.

Some NPMOs run full time businesses to increase their financial base. These activities are supposed to be accounted separately and do follow the normal accounting as any trading organization.

The accounting will take into account all revenues and expenditure attributable to the trading activity in order to determine the net proceeds which is included in the Income and Expenditure account for an NMPO.

Example

ABC Club runs a bar for its members and the transactions for the year ending 31st March 2014 were as follows;

	March 2014	March 2013
Bar receivables	12,000	25,000
Bar inventories	45,000	34,000
Owing to bar suppliers	32,000	24,000
Accruals for utilities	8,000	5,000

Activities during the year were as follows;

Bar cash sales	K230,000
Receipts from bar receivables	80,000
Payments to bar suppliers	140,000
Payment for wages of bar staff	40,000
Utility bills payment	18,000

Solution;

Bar trading account

		MK	MK
Bar Sales	(Working 1)		297,000
Less: Cost of sales			
Opening inventories		34,000	
Purchases	(working 2)	148,000	
Closing inventories		(45,000)	137,000
Gross profit			160,000
Less Expenses			
Bar wages		40,000	
Utility expenses (28,000-5,000+8,000)		31,000	(71,000)
Net profit from bar			89,000

Working 1: Determination of sales

Receivables Control account

Balance B/f	25,000	Cash	80,000
Credit Sales	67,000	Balance C/d	12,000
	92,000		92,000

Total sales is therefore MK67,000+ MK230,000 = MK297,000

Working 2: Determination of purchases

Payable control account

Bank	140,000	Balance b/f	24,000
Balance C/d	32,000	Purchases	148,000
	172,000		172,000

ii) Subscriptions

Most NPMOs are membership based. These include clubs, churches and societies. As evidence of membership, members are supposed to make annual contributions towards their organizations.

Apart from annual contributions, other organizations allow some members to make life time contributions instead of making annual payments.

a) Accounting for annual contribution

Annual contributions received are included as income for an organization and are accounted in Income and Expenditure account. As in most transactions not all members honor their annual contribution and sometimes there are other members who will opt to pay subscriptions in advance.

Basing on accruals concept, the club is required to account the subscription which due from the members and not what has actually been received.

Example:

If a club charges its members K25,000 per annum. If the club has 70 members, then the revenue recognized should be K1,750,000.

Now due to payment patterns, the club had the following transactions;

10 members failed to make payment last financial year
6 members already paid for this year
9 members have failed to pay for this year
4 members have paid for next financial year
In total 69 members paid subscription

Accruals brought forward is therefore 10 x 25,000 = K250,000
Prepayment brought forward is 6 x 25,000 = K150,000
Accruals carried forward is 9 x 25,000 = K225,000
Prepayment carried forward is 4 x 25,000 = K100,000

Subscription Account

Subscription accruals b/f	250,000	Prepayment b/f	150,000
Income and Expenditure	1,750,000	Bank	1,725,000
Subscription prepayment c/f	100,000	Subscription Arrears	225,000
	2,100,000		2,100,000

ii) Accounting for life subscription

Some club allows, the members to pay for their subscription once to cover their life time.In this case, the organization is supposed to recognize as liability any amount received and should be recognized as income over the estimated life of the members.

NOT FOR SALE

The organization is supposed to set an estimated life time which members under life subscription are expected to live and this is used to amortize the amount received over that period.

Amount outstanding at the end of period is carried in Statement of Financial position as liabilities.

When a member dies before the expiry of the expected life, amount accrued due to the member is supposed to be recognized as income immediately.

Example

The club allows its members to pay MK250,000 as life time subscription. The expected life span for such members is 25 years.

The club had 30 members on this scheme as at the beginning of the year with a value of K4,800,000 and 3 new people have joined this year and settled their amount in full. Two members died during the year, one had K125,000 remaining and the other had K75,000 remaining.

Solution

Income and Expenditure Account - Extract

Amortization of subscriptions (31 x K10,000)	MK310,000
Realization for dead members (125,000 + 75,000)	200,000

Statement of Financial Position extract

Non-Current liability		
Life Subscriptions		MK5,040,000
Computed as:		
Balance b/f	4,800,000	
Additions (3 x 250,000)	750,000	
Less: Death	(200,000)	
Amortization	(310,000)	
Balance c/f	5,040,000	

iii) Fund raising activity

NPMOs sometimes do organize other fundraising activities. In preparing financial statements, the income and expenses from these activities should be netted off and only the net income included in Income and Expenditure account.

Example.

ABC Club organized a golf tournament to boost its income. The activities relating to the events were as follows;

Entry fees for each participant was K12,000 and 90 people registered

The club rented a golf course for K150,000, Tournament prize money of K500,000 and refreshments worth K30,000.

Solution

Entry fees realized	(K12,000 x 90)		1,080,000
Less: Expenses			
	Renting of golf course	150,000	
	Prize money	500,000	
	Refreshments	30,000	(680,000)
Net surplus			400,000

STAGE 3 Computation of expenses

The next stage involves working out on some expenditure lines which require special adjustments like accruals, prepayments and depreciation.

The workings for these expenses is the same to those of trading organization.

STAGE 4 Income and Expenditure Account

Income and Expenditure account is used as the statement for the assessment of financial performance of an NPMO. The statement is the mirror image of the statement of comprehensive income for trading organization.

The end result of the Income and Expenditure account is either a surplus or a deficit as opposed to profit or loss in the statement of comprehensive income.

Example:

Using the Examples above on ABC Club, other transactions for the year include the following;

NOT FOR SALE

Piece of land acquired in 2012 for future development	3,000,000
Motor vehicles (Cost K2,600,000, Depreciation K850,000)	1,750,000
Office equipment (Cost K3,500,000, Depreciation K980,000)	2,520,000
General administration expenses	230,000
Salaries – excluding bar wages	200,000
Depreciation -10% on cost for Equipment and 20% on net book value for motor vehicle	
City rates and rent	170,000
Advertisement and publicity	54,000
Maintenance costs	120,000
Bank balance (opening was K70,000)	610,000

Income and Expenditure Account

	MK	MK
INCOME		
Profit for the bar		89,000
Annual Subscription		1,750,000
Life Subscription		510,000
Proceeds from golf tournament		400,000
		2,749,000
EXPENDITURE		
General administration costs	230,000	
Salaries	200,000	
City rates and rent	170,000	
Advertisement and publicity	54,000	
Maintenance costs	120,000	
Depreciation - Equipment	350,000	
Motor vehicles	350,000	(1,474,000)
SURPLUS		1,275,000

STAGE 5 Statement of financial position

The statement of financial position for an NPMO does not differ to that of a trading organization. The only difference is that the financed by section is represented by Accumulated funds and surplus or deficit.

Example

Using the data above for ABC Club, the Statement of Financial Position as at 31st March 2014 will be as follows;

Non current assets		MK	MK
Land			3,000,000
Motor vehicle	(K2,600,000 – 1,200,000)		1,400,000
Equipment	(K3,500,000 – 1,330,000)		2,170,000
			6,570,000
Current assets			
Bar inventories		45,000	
Bar receivables		12,000	
Subscriptions in arrears		225,000	
Bank		610,000	892,000
Total assets			7,462,000
Financed by			
Accumulated funds			1,007,000
Surplus			1,275,000

Non-Current liabilities		
Life subscription		5,040,000
Current liabilities		
Subscription in arrears	100,000	
Payables – Bar supplies	32,000	
Accruals for utilities	8,000	140,000
Total		7,462,000

15.4 CONCLUSION

NPMOs as organization are supposed to follow the normal accounting concepts when preparing their financial statements, the only exception arise on the presentation. There are accounting terms which are particular to an NPMO and are not applicable to trading organization.

In Malawi, there having been a growing number of NGOs and non profit marking organizations. This put pressure on accountants to understand how these institutions operate and what sort of information the users of financial statements will need to assess the performance.

END OF CHAPTER QUESTIONS

1. **Tutorial questions**

a) Determine the opening accumulated funds for a club which had the following account balances at the beginning of a financial year;

Non-current assets (net book value)	K350,000
Bar Inventories	120,000
Subscription in arrears	60,000
Bar receivables	30,000

NOT FOR SALE

Cash at bank	45,000
Subscriptions received in advance	40,000
Owing to bar suppliers	35,000
Balance for life subscription	80,000

b) What is the recommended accounting treatment when a non-profit making organization receives life subscription from one of its members?

c) Which statement of account is used to assess the financial performance of a nonprofit making organization?

2.(a) Tinyama Wild Life Club charges K1,000 annual subscription fee for membership. The following are its assets and liabilities as at 1 January 2010:

Subscription fees in areas K91,500
Cash at bank K12,000
Coach hiring charges for the trip to Lengwe National park not paid for K4,000.

Further information extracted from the club's account records as at 31 December 2010 was as follows:

Receipts during the year	K
Subscription fees for 2008 financial year	6,000
Subscriptions for 2009 financial year	81,000
Subscriptions for 2010 financial year	50,000
Anonymous donations	10,000
Interest on bank balances	4,000
Receipts from members for tourism trip tickets to Lengwe National Park	137,500
Receipts from members for coach hiring	62,000
	350,500

Payments during the year	
Tourism tickets	160,000
Coaching hiring	79,000
Sundry expenses	10,000
Printing, stationery and telephone	5,000
	254,000

Additional information

During an annual general meeting held on 20 November 2010 the club's executive committee passed a resolution to write off all subscription fees still in arrears by the end of the year and capitalize all donations for the year.

Subscription fees in arrears amounted to K4,500 as at 31 December 2010.

Required:

i) Prepare the club's cash book as at 31 December 2010. **7 Marks**

ii) Prepare an Income and Expenditure Account for Tinyama Wild Life Club for the year ended 31 December 2010. **5½ Marks**

iii) Prepare the statement of financial position for Tinyama Wild Life Club as at 31 December 2010. **3 Marks**

Total: 15½ Marks

CHAPTER 16 INCOMPLETE RECORDS

16.0 LEARNING OBJECTIVES

At the end of this chapter, students are expected to construct final accounts from any set of accounting records which fall short of complete double entry. Since in extreme cases there may be no any records whatever of the day-to-day transactions, it is expected that the students shall be able to build up accounts largely from estimates. In other instances, books may have been kept by 'single entry' or data may be available by means of which double entry can be constructed.

16.1 APPROACH TO BE ADOPTED

In order to prepare the Statement of Profit or Loss and the Statement of Financial Position, the following procedure is recommended:

Stage 1

Construct a statement of the financial condition at the beginning of the period. This requires assets and liabilities to be determined.

The values of any non-current assets can be obtained from such details as the trader is able to supply of their cost and the dates upon which they were acquired, provision for depreciation from the date of acquisition to the commencement of the current period being deducted. The trader must provide an estimate of the value of his inventories and particulars of any book debts and liabilities. Accounts should be opened, and estimated asset values posted to the debit side. Total of the book debts should be debited to total trade receivables account, and the total of the liabilities credited to a total trade payables account. This is illustrated in a later section. The excess of the aggregate of the assets over the liabilities may be taken to represent the amount of the trader's capital at the commencement of the period and should be credited to his/her capital account.

Stage 2

A careful analysis should be made of the bank statement, and a cash summary (which may take a form of receipts and payments account). For this purpose, analysis columns should be prepared for each of the principal headings of receipts and payments.

For example, the lodgments into the bank may be analysed under the heading of cash takings, income from investments, the sale of assets, new capital paid in and private

NOT FOR SALE

income of the trader. Payments from the bank should be analysed as between payments for goods purchased, rent, rates, insurances and other business expenses, cheques cashed for wages, petty cash and personal expenditure, and cheques drawn for the trader's private purposes.

Stage 3

Ascertain the amounts of any cash takings which have not been paid into the bank, but have been used by the trader for the payment of business expenses, goods purchased for cash and personal expenses. An estimate should also be obtained of the value of any inventory which may have been withdrawn by the trader for his own personal use or for that of his/her family.

Stage 4

On completion of the above analysis, postings will be made as follows:

(1) From the debit side of the cash summary:
   (i) cash takings to the credit side of the total trade receivables account;
   (ii) income from investments (if any) to the credit of income from investments account;
   (iii) proceeds of sale of assets (if any) to the credit of the appropriate asset accounts;
   (iv) other items to the credit of the respective accounts.

If a profit or loss on the sale of assets is disclosed, this should be transferred either to Income Statement (the Statement of Profit and Loss and Comprehensive Income) or the proprietor's capital account.

(2) From the credit side of the cash summary:
   (i) payments for goods purchased to the debit of total trade payables account;
   (ii) payments of expenses to the debit of the relevant nominal account;
   (iii) cheques drawn for petty cash to the debit of petty cash account;
   (iv) the proprietor's personal drawings to the debit of his current account;
   (v) the purchase of assets (if any) to the debit of the respective assets accounts.

Stage 5

The amount of any cash takings used for business or private purposes should be noted, the appropriate account debited and the appropriate receivables (trade or other) account credited. Note, however, that in incomplete record situations, private drawings may need to be calculated as a balancing figure.

Stage 6

This involves calculating year-end adjustments and balances.

A schedule should be compiled of the book debts outstanding, the total of which should be carried down in the total trade receivables account. The balance of this account will now represent the total sales for the period and should be transferred to the credit of trading account.

Similarly, s schedule should be made of liabilities outstanding trade and other payables. The total should be carried down in the total trade payables account. The balance of this account will now represent the total purchase for the period and should be transferred to the debit of trading account.

Accruals and prepayments will be carried down as closing balances in the relevant expenses accounts.

Stage 7

The whole of the transactions will now be recorded in total double entry form and it will be possible to extract a Statement of Profit or Loss as well as a Statement of Financial Position in the usual way.

16.2 RELIABILITY OF INFORMATION

The gross profit percentage revealed by the trading account may afford some indication as to the accuracy or otherwise of the data and estimates used in compiling the accounts. If it is found that this percentage is substantially lower than the percentage of gross profit normally earned in the particular trade, doubt would be thrown on the accuracy of the amounts of the opening and closing inventories, purchases or sales. Further enquiry would therefore be necessary. In particular, information should be elicited as to the style in which the trader lives. It will often be found that the amount of cash takings alleged to be withdrawn for private use is wholly incompatible with the size and character of the

trader's domestic establishment and mode of life. A re-estimation of the amount of personal drawings might thus be necessary. See section x.5 on Use of the Gross Profit Percentage for further comments.

Example

(note: the amounts used are for demonstration purpose only)

A is the proprietor of a grocery and general store. He has not previously engaged an accountant. He has informed you that this year the Commissioner of Taxes has refused to accept the account which A has supplied of his trading results for the year ended March 31 2013. That account is as follows:

	K		K
Payment for goods	9,495		
Takings	10,930		
Payment for expenses	1,130		
Profits	305	-	
	10,930		10,930

He instructs you to examine his records and prepare accounts.

From your examination of the records and from interviews with your client, you ascertain the following information:

(1) The takings are kept in a drawer under the counter; at the end of each day the cash is counted and recorded on a scrap of paper; at irregular intervals Mrs A transcribes the figures into a notebook; a batch of slips of paper was inadvertently destroyed before the figures had been written into the note book, but Mr and Mrs A carefully estimated their takings for that period, and the estimated figure is included in the total of K10,930.

(2) The following balances can be accepted:

	March 31	
	2012	*2013*
	K	*K*
Cash in hand	45	87
Balance at bank	156	219
Book debts	458	491
Payables for purchases of inventory	279	243
Inventory at cost	1,950	1,900

(3) Debts costing K356 were abandoned during the year as bad; the takings included K25 recovered in respect of an old debt abandoned in the previous year.

(4) A rents the shop and living accommodation on a weekly tenancy for K3 per week including rates; the rent is included in expenses of K1,130. The living accommodation may be regarded as one-third of the whole.

(5) The expenses total also includes:
   (i) K35 running expenses of A's private car.
   (ii) K60 for exterior decoration of the whole premises, the landlord having refused to have this done.
   (iii) K160 for alterations to the premises to enlarge the storage accommodation,

(6) A takes K10 per week from the business and hands it over to his wife, who pays all the household and personal expenses except those referred to below.

(7) A pays for his own cigarettes and beer with cash taken from the drawer; this is estimated at K1.50 per week.

(8) A competed in a football pool for 30 weeks of the year, staking K1 each week, buying a postal order with cash taken from the drawer; his winnings totalled K59.

(9) During the year A bought a secondhand car (not used for business) from a friend; the price agreed was K350, but as the friend owed A K67 for goods supplied from the business the matter was settled by a cheque for the difference.

(10) An insurance policy for A's life matured and realized K641.

(11) A cashed a cheque for K100 for a friend; the cheque was dishonoured and the friend is repaying the K100 by instalments. He had paid K40 by March 2013.

(12) Other private payments by chequetotalled K96 plus a further sum of K110 for income tax.

(13) You are to provide K42 for accountancy fees.

You are required to prepare:

(a) A Statement of Financial Position of the business as at March 31 2012;

(b) A Statement of Profit or Loss for the year ended March 31 2013; and

(c) A Statement of Financial Position of the business as at March 31 2013.

NOT FOR SALE

Solutions

(a) A Statement of Financial Position of the business as at March 31 2012

	K
Current assets	
Inventory	1,950
Receivables	458
Cash at bank	156
Cash in hand	45
	2,609
Less payables	279
	2,330

(b) A Statement of Profit or Loss for the year ended March 31 2013

	K	K
Sales		11,638
Opening inventory	1,950	
Purchases	9,459	
	11,409	
Less Closing inventory	1,900	
Cost of sales		9,509
Gross profit		2,129
Rent and rates (2/3 x K3 x 52 weeks)	104	
Sundry expenses	719	
Cost of enlarging storage accommodation	160	
Repairs (2/3 x K60)	40	
Bad debts (356 – 25)	331	
Accountancy fees	42	
		1,396
Net profit for the year		733

Note: the cost of enlarging storage accommodation could be capitalized but it has been written off in the year in which incurred on prudence grounds.

(c) A Statement of Financial Position of the business as at March 31 2013.

	K	K
Current assets		
Inventory		1,900
Receivables		491
Cash at bank		219
Cash in hand		87
		2,697
Less current liabilities		
Trade payables	243	
Accountancy fees	42	
		285
		2,412
Capital account of A		
Balance at 1 April 2012		2,330
Net profit		733
		3,063
Less drawings		651
		2,412

Workings

CASH SUMMARY

	K		K
Balance 1/4/12 (cash K45;		Expenses	1,130
Bank K156)	201	Purchases	9,495
Bad debt recovered	25	Cash drawings	520
Football pool winnings	59	Personal cigarettes etc	78
Insurance policy	641	Football pools	30
Repaid by friend	40	Car (K350 - K67)	283
Balance cash takings carried		Loan to friend	100
To total receivables account	11,182	Drawings by cheque	96
		Income tax	110
Balance 31/3/13 (cash K87;			
		Bank K219)	306
	12,148		12,148

TOTAL RECEIVABLES

	K		K
Trade receivables 1/4/12	458	Cash takings	11,182
Balance = sales	11,638	Friend *re* car	67
		Bad debts w/o	356
		Trade receivables 31/3/13	491
	12,096		12,096

TOTAL PAYABLES

	K		K
Cash	9,495	Trade payables 1/4/12	279
Trade payables 31/3/13	243	Balance = purchases	9,459
	9,738		9,738

SUNDRY EXPENSES

	K		K
Cash	1,130	Rent	156
		Car expenses	35
		Repairs to premises	60
		Alterations	160
Balance = sundry expenses	719		
	1,130		1,130

DRAWINGS

	K		K
Cash	520	Football pool winnings	59
Cheques	96	Life policy money	641
Rent (private element)	52	Repayments by friend	40
Private car expenses	35	Balance = net drawings	651
Decorations (house(one-Third of K60)	20		
Purchase of car	350		
Cash paid to friend	100		
Cigarettes etc	78		
Football pools	30		
Income tax	110		
	1,391		1,391

16.3 USE OF THE GROSS PROFIT PERCENTAGE

In the above illustration there was sufficient information to enable the sales figure of K11,638 to be calculated from total trade receivables account.

In some questions, however, such information is not always readily available. In cases such as these, it may be possible to calculate sales indirectly as long as a gross profit percentage is provided.

The approach is quite simple:

(1) Calculate cost of sales:
Opening inventory + purchases – closing inventory;

(2) Convert cost of sales to sales:
eg if gross profit percentage is 20%, sales = 100/80 x cost of sales.

Once sales for the year have been estimated, and opening and closing trade receivables taken into account, the figure of cash takings can be calculated as a balancing figure in the total trade receivables account.

16.4 DEFICIENT ACCOUNTING RECORDS

Where the available records are so deficient that it is impossible to compile a reasonably complete cash summary, the only method of estimating the profit or loss for the period is to prepare statements of affairs showing the 'net worth' of the business at the beginning and at the end of the period respectively.

A statement of affairs for this purpose is a document in the form of a Statement of Financial Position, showing on one side the estimated amounts of the various assets, and on the other the liabilities, the difference between the two sides representing the proprietor's 'net worth' or capital at the date of the statement.
If a statement of affairs has been drawn up at the end of the preceding period, the opening capital for the current period would be shown thereby. It would then be necessary to prepare a similar statement at the end of the current period, and to find the difference between the opening and closing figures of capital, the amount of which, after adding back any sums withdrawn, and deducting any new capital introduced, would represent the profit or loss for the period.

NOT FOR SALE

Example

J's last statement of affairs prepared at January 1 was:

STATEMENT OF AFFAIRS

January 1

	K		K
Payables	6,000	Office furniture	500
Bills payable	500	Inventories	2,000
Capital account – being		Trade receivables	4,500
excess of assets over		Bills receivable	1,000
liabilities at this date	3,000	Cash	1,500
	9,500		9,500
	=====		=====

On December 31 he finds his liabilities to be: trade payables K4,500, bills payableK700; and his assets: office furniture K450, inventory K1,500, trade receivables K5,300, bills receivable K700, cash K800. His drawings during the period have amounted to K450.

What profit has he made?

STATEMENT OF AFFAIRS

December 31

	K		K
Trade payables	4,500	Office furniture	450
Bills payable	700	Inventories	1,500
Capital account – being		Trade receivables	5,300
excess of assets over		Bills receivable	700
liabilities at this date	3,550	Cash	800
	8,750		8,750
	=====		=====

	K
Calculation of profit	
Capital, December 31	3,550
Drawings for the year	450
Capital,January1	(3,000)
Estimated net profit for the year	1,000
	=====

No great difficulty should be experienced in estimating values of the assets and liabilities at the end of the period under review, provided that the work of preparing the statement is undertaken shortly after that date, since the necessary material for the valuation will probably be still accessible. 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 book-keeping without delay.

16.5 SUMMARY OF THE CHAPTER

The chapter explained how accounts may be prepared from incomplete records. There are different situations where this approach may be appropriate. However, reliability of the information may be brought into question at times since the amounts used are mainly based on estimates.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What is the purpose of preparing a statement of affairs?

b) What might be some of the causes of having incomplete records at a company?

c) In determination of gross profit, what is the difference between margin and mark up.

2. The following is a summary of Jenifer's bank account for the year ended 31 December 2010:

JENIFER'S BANK ACCOUNT

	K		K
Balance 1.1.10	4,100	Payments	67,360
Receipts	91,190	Rent	3,950
Balance 31.12.10	6,300	Insurance	1,470
		Sundry expenses	610
		Drawings	28,200
	101,590		101,590

All the business takings have been paid into the bank except an amount of K17,400 out of which Jenifer paid wages of K11,260; drawings of K1,200 and purchase of goods amounting K4,940.

The following information relates to opening and closing balances as follows:

	31.12.09 K	31.12.10 K
Inventory	10,800	12,200
Accounts payable	12,700	14,100
Accounts receivable	21,200	19,800
Prepaid insurance	420	440
Rent owing	390	-
Non-current assets – cost	1,800	1,600

Required:

(a) Prepare T accounts to record the following:

(i) Accounts receivable. **4 Marks**

(ii) Accounts payable. **4 Marks**

(iii) Explain why accounts receivable and accounts payable are known as "Totals accounts" and state what they are used for. **2½ Marks**

(b) Prepare the opening statement of affairs to determine the business's sales, purchases and capital balances. **3½ Marks**

(c) Prepare the Profit or loss for the period. **6 Marks**

(TOTAL : 20 MARKS)

CHAPTER17: TANGIBLE NONCURRENT ASSETS

17.0 LEARNING OBJECTIVES

The object of this topic is to;

- Know the definition of non-current assets
- The accounting treatment of non-current assets
- The definition and accounting treatment for depreciation.

17.1 DEFINITION OF AN ASSET

An asset is a resource controlled by an entity as a result of past event from which future economic benefits are expected to flow to the enterprise. (IASB *framework*)

For a transaction to be classified as an asset, all the attributes included in the definition should be fulfilled. An asset should be as a result of past event or transaction. If there was no past event or transaction, then it is not an asset.

As asset should be controlled by an entity. Control does not mean ownership. This means the entity should be able to secure the item and make sure that it is in good working condition.

An asset should give an entity future economic benefits. If it does not give future economic benefit to an enterprise, then it is not worthy including in the financial statements.

A non current asset is one intended for use on a continuing basis in the company's activities.

NOT FOR SALE

17.2 IAS 16: PROPERTY, PLANT AND EQUIPMENT

The principal issues are recognition of assets, the determination of their carrying amounts and depreciation charges and impairment losses to be recognized in relation with them.

Scope of IAS 16

The standard applies to property, plant and equipment.

It does not apply to:

- Assets classified as held for sale in accordance with IFRS 5
- Exploration and evaluation of assets (IFRS 6)
- Biological assets related to Agricultural Activities (IAS 41)
- Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources

Property, plant and equipment are tangible assets which have the following:

- Is held by the entity for use in production or supply of services, for rental to others and administrative purposes
- Is supposed to be used for more than one accounting period

17.3 RECOGNITION AND MEASUREMENT

The item of property, plant and equipment should be recognized when

- It is probable that future economic benefits associated with the asset will flow to the enterprise
- The cost of the asset can be measured reliably

Initial measurement

An item of property, plant and equipment must initially be measured at cost. In this case, the cost includes the purchase price all costs incurred in bringing an item to its present location and working condition.

These costs include the following:

- Cost of site preparation
- Delivery and handling costs
- Installation costs
- Related professional fees
- Estimated costs of dismantling and removing the asset and restoring the assets

Please note that the same costs listed above if incurred after the asset is brought into use will not be capitalized but rather written off as periodic expenses

Measurement subsequent to initial

After initial measurement, the entity is required to measure the asset using either cost or revaluation model. There is no preferred method but the only requirement is that whichever method is adopted, it has to be applied over the years consistently.

Cost model

This is the cash or cash equivalent paid or fair value of other consideration given to acquire an asset or construction. The standard gives further clarifications of what it means by cost. This is the cost of bringing an item to its present location and working condition.

IAS 23 Borrowing Costs states that where a property being is being constructed using borrowed funds, any interest payable on the loan which is financing the asset should be included as part of capital cost for the asset until when either the loan is fully paid or when the asset is ready for use.

Under cost model, the asset is recorded cost less accumulated depreciation or any impairment loss realized.

The Revaluation Model

Revaluation model is where the asset is measured at fair value. This is the amount that an asset would be exchanged or a liability settled between knowledgeable, willing parties at an arm's length transaction.

Revaluations should be carried out regularly, so that the carrying amount of an asset does not differ materially from its fair value at the financial Position date.

If an item is revalued, the entire class of assets to which that asset belongs should be revalued. This is aimed at preventing creative accounting where entities opt to revalue only those assets where they believe the fair value is high and leaving out those where they believe will result in revaluation loss.

Revalued assets are depreciated in the same way as under the cost model.

If a revaluation results in an increase in value, it should be credited to other comprehensive income and accumulated in equity. While as a decrease arising as a result of a revaluation should be recognized as an expense to the extent that it exceeds any amount previously credited to the revaluation surplus relating to the same asset.

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to retained earnings, or it may be left in equity under the heading revaluation surplus.

Example

An asset was purchased at on 1 January 2010 for MK100,000. Depreciation policy is 5 years on straight line basis. In December 2012, the asset was revalued to MK70,000 while its useful life did not change. In December 2013 there was credit crunch which affected the asset value which now was only MK15,000.

Required:
Account for the asset movements in December 2012 and December 2013?

Solution

Depreciation from 2010 to 2012
MK100,000/5= MK20,000 per year
Number of years =3 years
Thus total Depreciation =3*20,000= MK60,000.
Carrying amount = MK100000-MK60,000=MK40,000
Therefore Revaluation surplus=MK70,000-MK40,000=MK30,000

The double entry

	Dr	Cr
Non Current Asset	MK30,000	
Revaluation Surplus		MK30,000

To record the revaluation increase
In 2013 Depreciation will be MK70,000/2= MK35,000
Thus the carrying value will be MK70,000-MK35,000=MK35,000

NOT FOR SALE

Double entry will be

	Dr	Cr
Proft or loss Account	MK35,000	
Provision for Depreciation		MK35,000

Realized revaluation will be MK35,000 – MK20,000=MK15,000.
(the difference between the new depreciation based on revalued amount less the original depreciation)

Double entry will be

	Dr	Cr
Revaluation Reserve	MK15,000	
Proft or loss		MK15,000

To record the realized revaluation as the revalued asset has passed one period

When the non current asset losses value,

The non current Asset which has now the carrying of MK15,000 down from MK35,000. Thus the non current asset has reduced in value by MK20,000

With the amount of the decrease. Thus the revaluation which will now remain will be;

Original revaluation surplus	MK30,000
Less: Excess depreciation	(15,000)
Balance	MK15,000
Revaluation loss	20,000
Additional revaluation loss	(5,000)

This indicates that the loss is more than what was left of the revalued amount. Since the revaluation reserve had a balance of K15,000 and the loss was K20,000. The K5,000 will be considered as a new revaluation loss so it will be debited to profit or loss.

Double entry is therefore	Dr	Cr
Revaluation Reserve	MK15,000	
Profit or loss	5,000	
Non-Current Asset		MK20,000

17.4 DEPRECIATION (Cost and Revaluation Models)

The depreciable amount (cost less residual value) should be allocated on a systematic basis over the asset's useful life.

The residual value and the useful life of an asset should be reviewed at least at each financial year-end. The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity.

The depreciation method should be reviewed at least annually and, if the pattern of consumption of benefits has changed, the depreciation method should be changed prospectively.

Depreciation should be charged to the income statement to the extent that it is a surplus over the revaluation reserve of the same asset.

Depreciation begins when the asset is available for use and continues until the asset is derecognized.

The standard does not specify the preferred depreciation method and the entity is free to select any method considered suitable for their assets. The most common methods are as follows;

i) Straight line method – where the depreciation charge is consistent throughout the asset life computed as original cost less residual value divided by the estimated useful economic life. Straight line method is ideal for such assets which are considered to have a long useful life. The asset which shows that the capabilities does not really change with passage of time like buildings.

Residual value is the estimated amount that an entity would receive on a disposal after removing the disposal costs.

ii) Reducing balance method – where the depreciation charge is higher in the early life of the asset and reducing with passing years. Depreciation charge is based on the carrying value of an asset (which is cost less accumulated depreciation). This method is suitable for assets which have a short estimated economic life. These assets are considered more productive in early life than in later years. Example include office equipment and motor vehicles.

17.5 DERECOGNITON (Retirements and Disposals)

An asset should be removed from the financial statements on disposal or when it is withdrawn from use and no future economic benefits are expected from its disposal. The gain or loss on disposal is the difference between the proceeds and the carrying amount and should be recognized in the income statement.

When the asset is disposed, a gain or loss should be computed and recognized in the Profit or loss. The profit or loss is computed as the difference between the disposal proceeds and the net book value of the asset.

Example

A motor vehicle was acquired in January 2009 at K800,000 and is being depreciated over 5 years at 20% per annum using reducing balance method. There is no residual value for the asset.

The company decided to sale the asset on 31st December 2011 for K320,000.

Solution

	MK
Disposal proceed	520,000
Less : Netbook value of the asset	(409,600
Gain or loss	110,400

Note: Net book value of the asset

Cost	800,000
Depreciation – Dec 2009 (800,000x20%)	(160,000)
Net book value	640,000
Depreciation – Dec 2010 (640,000 x 20%)	(128,000)
Net book value	512,000
Depreciation – Dec 2011 (512,000 x 20%)	(102,400)
Net book value as at 31st December 2011	409,600.

NOT FOR SALE

17.6 INVESTMENT PROPERTY –IAS 40

Investment property refers to a property which is;

- Complete as to construction
- Is being let out on commercial basis and
- Not used by the owners for manufacturing, distribution or administrative purpose.

Investment property should be differentiated from other properties (buildings) as follows;

- Any property used by business for manufacturing, distribution or administrative purpose. – Use IAS 16 – Property, plant and equipment.
- Property which is held for sale as ordinary course of business – Use IAS 2 – Accounting for inventories.
- Property which is under construction for a client – Use IAS 11 – Construction contract.
- For own use – Use IAS 16.

Accounting requirements for IAS 40.

Investment property should initially be measured at its historical cost to the business or at fair value if acquired in business acquisition.

Subsequent measurement should be at fair value- i.e. based on market value of the property.
Where market value can not reliably be measured, then subsequent measurement can be at depreciated historical cost.

Any movement in fair value should recognized through profit or loss account.

17.7 IMPAIRMENT OF ASSETS

A tangible non- current asset is considered as impaired if its carrying value is more than the amount expected to be recovered from either usage or sale of the asset.

Please note that impairment does not necessarily means that the asset is damage but that the asset is being recorded in the books of accounts at a higher than what is a realistic value.

The standard requires that is considered as impaired should be recorded at its recoverable amount. i.e. the higher of net realizable value (net selling price) and its economic value (present values of future cash flows to be generated by the asset).

The impairment loss should be charged as expense in through the profit or loss unless if they affect an asset which had been revalued, the charge against revaluation reserve. The topic is covered in detail in Chapter 8.

17.8 ASSET REGISTER

It is important that every company should maintain the asset register. This is a listing of all assets which are owned by the business. Some information for the register will include;

- the identification for the asset
- if possible the location of the asset
- the description of the asset
- the date of purchase
- the cost of the asset or its revalued amount
- additions and disposal of assets during the year
- depreciation rate used for the asset

- the opening value for accumulated depreciation
- the charge for depreciation for the asset
- the closing value for depreciation

An asset register act as a control measure in management of the assets. What is presented in asset register should agree with the ledgers for non-current asset, depreciation account and the asset disposal account.

17.9 DISCLOSUREFOR ALL NON CURRENT ASSETS

For each class of property, plant, and equipment:

- basis for measuring carrying amount
- depreciation method(s) used
- useful lives or depreciation rates
- gross carrying amount and accumulated depreciation and impairment losses
- reconciliation of the carrying amount at the beginning and the end of the period, showing:
- additions
- disposals
- acquisitions through business combinations
- revaluation increases or decreases
- impairment losses
- reversals of impairment losses
- depreciation
- net foreign exchange differences on translation
- other movements

For investment property also disclose the changes in fair value which has been recognized in profit or loss account.

NOT FOR SALE

17.10 CONCLUSION

Non -current assets are important elements of the financial statements. In most organization non-current asset have a significant value on the overall financial position of the business. This calls for prudent recognition and measurement of these assets.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Define the following:

i. Non Current Asset
ii. Cost
iii. Carrying amount
iv. Depreciation
v. Revaluation

b) A non current asset was purchased for MK250,000.00 on 1 January 2008. The useful life was 4 years. At the end December 2010, the asset was revalued to MK300000.

Account for the transactions from 2008 to December 2011?

c) Outline the major differences in accounting for property under IAS 16 and IAS 40.

2(a) Mention any **three** pieces of information contained in the non-current assets register. **3 Marks**

(b) The following information has been extracted from the books of Zilinkudza Ltd, as opening balances on 1 December 2009:

		K'000
Land and buildings, at cost		10,600
Plant and machinery, at cost		5,250
Motor vehicles, at cost		6,200
Accumulated depreciation – buildings		2,600
	plant and machinery	960
	motor vehicles	2,800

Additional information:

Land is valued at K5,000,000

One piece of plant and machinery that had originally cost K750,000 and in use for the past two years was sold for K550,000. Depreciation is provided on a straight-line basis at 10% on cost of plant and machinery.

A new piece of land was acquired for K1,100,000 during the year.

Depreciation is also provided on straight line basis on cost of motor vehicles at 25% and buildings 5%.

Required:

(i) Prepare, for Zilinkudza Ltd, for the year ended 30 November 2010, a schedule of non-current assets that would be part of notes to published accounts of a limited company. **8½ Marks**

(ii) Prepare journal entries, with narratives, for posting the additions, disposals, and depreciation charges for non-current assets for Zilinkudza Ltd for the year ended 30 November 2010. **8½ Marks**

(TOTAL : 20 MARKS)

NOT FOR SALE

CHAPTER18: INTANGIBLE ASSETS

18.0 LEARNING OBJECTIVES

The objectives of this chapter is to;

- Define of intangible asset
- The accounting treatment of an intangible asset in the accounts
- Disclosures required in the standard

18.1 DEFINITION OF INTANGIBLE ASSETS

An intangible Asset is an asset without physical substance. As the asset has no physical substance, it means it is not easy to include the asset in the financial statements.

However, though not tangible, it has to meet the measurement criteria of an asset as defined in IAS 16 in chapter 6 above.

Accounting for intangible assets is specified in IAS 38.

Scope of IAS 38

IAS 38 applies to all intangible assets other than:

- financial assets
- exploration and evaluation assets (extractive industries)
- expenditure on the development and extraction of minerals, oil, natural gas, and similar resources
- intangible assets arising from insurance contracts issued by insurance companies
- intangible assets covered by another IFRS, such as intangibles held for sale, deferred tax assets, lease assets, assets arising from employee benefits, and goodwill. Goodwill is covered by IFRS 3

Key Definitions from IAS 38

Intangible asset:

This is an identifiable nonmonetary asset without physical substance.

An intangible asset should be recognized when the three critical attributes of an intangible asset are met:

Identifiability – though not having physical substance, the asset should have the capability of being recognized and measured reliably but also be able to be identified separately.

Control – the entity is supposed to prove that it has power to obtain economic benefits associated with the asset. This include title rights to the intangible asset.

Future economic benefits- the entity is supposed to demonstrate the capability of the asset to generate benefits in form of either future revenues or reduced future costs.

Identifiability: an intangible asset is identifiable when it:

- Is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract) or
- Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

  Examples of possible intangible assets include:

  - computer software
  - patents
  - copyrights
  - motion picture films
  - licenses
  - franchises

18.2 RECOGNITION OF INTANGIBLE ASSETS

IAS 38 requires an entity to recognize an intangible asset, whether purchased or self-created (at cost) if, and only if:

- it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally.

The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions that will exist over the life of the asset.

If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, IAS 38 requires the expenditure on this item to be recognized as an expense when it is incurred.

Initial Recognition: Research and Development Costs

IAS 38 prohibits the recognition of brands, mastheads, publishing titles, internally generated goodwill, customer lists and items similar in substance that are internally generated..

Intangible assets are initially measured at cost. Cost relates to either acquisition costs or development costs where the intangible is internally generated.

For research and development, it is important to recognize that;

- Research costs are costs in search of new ideas and with no direct business value. Research costs are supposed to be charged as expense to profit or loss

NOT FOR SALE

- Development costs are capitalized only after technical and commercial feasibility of the product for sale or use have been established.
- The technical and commercial feasibility is met when:
- An entity intends to use the asset and will be able to complete the project
- An entity be able to demonstrate how the asset will generate future economic benefits.

Measurement Subsequent to Acquisition:

Subsequent measurement can either be through Cost Model or Revaluation Model

After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortization and impairment losses.

Revaluation gains (i.e. increases in an intangible asset's carrying amount) should be credited directly to 'revaluation reserve' within equity, except to the extent that this gain reverses a revaluation decrease previously recognized in the profit and loss. In this case the amount of the reversal is recognized as income and as such is credited to the income statement.

Decreases in value are recognized as expenses and are charged against the profit for the year. However, if the decrease in value is a reversal of a previous revaluation gain, the amount of the reversal should be offset against the revaluation surplus.
When considering subsequent measurement intangible assets are usually classified as:
Indefinite life: no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Finite life: a limited period of benefit to the entity.

The cost less residual value of an intangible asset with a finite useful life should be amortized on a systematic basis over that life:

- The amortization method should reflect the pattern of benefits.
- If the pattern cannot be determined reliably, amortize by the straight line method.
- The amortization charge is recognized in profit or loss.
- The amortization period should be reviewed at least annually.
- The asset should also be assessed for impairment in accordance with IAS 36.

An intangible asset with an indefinite useful life should not be amortized but should be assessed for impairment annually in accordance with IAS 36.

18.3 GOODWILL

Goodwill can be self-generated or purchased. IAS 38 *Intangible Assets* deals with self-generated goodwill and prohibits its recognition as an intangible asset within the financial statements.

The reason for this is the potential to alter reported figures. If companies were permitted to includeself-generated goodwill in their financial statements they could manipulate the financial position of the business by including negative goodwill whenever there are signs that the asset value is weak.

IFRS 3 *Business Combinations* deals with purchased goodwill. As already noted, goodwill is a residualamount and is defined as: 'future economic benefits arising from assets that are not capable of being individually identified and separately recognized'.

Goodwill is the amount remaining after applying valuation rules to the *identifiable* assets andliabilities.

From the acquiring company's point of view, this excess amount paid over the fair value of the netassets acquired is expected to yield future benefits. The anticipation of expected future benefitseffectively constitutes goodwill as an asset in the same way as any other tangible asset that would be expected to yield future benefits. In essence, the acquiring company is paying more than the value of the net assets acquired because there is belief that the acquired business is worth more than the combined value of net assets.

Accounting treatment of purchased goodwill

Carry the purchased goodwill as an asset and amortize it over its estimated useful life through theprofit or loss account. The useful economic life should be based on the expected period which the acquiring company is expected to enjoy economic benefits arising from the acquisition.

The company is required to review the value of goodwill at the end of first year of acquisition and assess if there have been significant changes to the condition for continued recognition of goodwill. This may include incorporation of any contingent consideration which was not recognized at the time of acquisition.

Where the estimated useful economic life of goodwill is considered as indefinite, the entity is supposed to conduct annual assessment of impairment.

18.4 IMPAIRMENT LOSS FOR INTAGIBLE ASSETS

Intangible assets should also be assessed if they have not been impaired. IAS 36 states that an asset is considered as impaired if its carrying value is more than its recoverable amount.

IAS 36 requires the review of intangible assets for impairment as follows;

NOT FOR SALE

- Goodwill should be reviewed for impairment at the 1st anniversary of its recognition and subsequent reviews should only be made if there are indications of impairments.
- All other intangible non-current assets should be reviewed for impairment only if there are indications of impairment.
- All intangible non-current assets with indefinite useful economic life should be reviewed for impairment annually.

Impairment loss should be recognized through profit or loss as expenses unless if the loss is reversing a revaluation surplus recognized for the same intangible asset.

18.5 DERECOGNITION

Intangible non-current asset should be derecognized from the financial statements if;

The intangible asset has been disposed off separately or in business disposal
The entity no longer have the rights to economic benefits arising from the asset. i.e. it has expired, surrendered to another party or has been realized through disposal.

When removing the intangibles from the records of accounts, the entity should compute a gain or a loss on de-recognition. The gain or loss is computed as the difference between disposal value and the carrying value of the intangible asset.

18.6 DISCLOSURE REQUIREMENTS

For each class of intangible asset, disclose:

- useful life or amortization rate
- amortization method
- gross carrying amount
- accumulated amortization and impairment losses

- line items in the profit or loss in which amortization is included
- reconciliation of the carrying amount at the beginning and the end of the period showing:
    - additions (business combinations separately)
    - assets held for sale
    - retirements and other disposals
    - revaluations
    - impairments
    - reversals of impairments
    - amortization
    - foreign exchange differences
    - other changes
- basis for determining that an intangible has an indefinite life
- description and carrying amount of individually material intangible assets
- certain special disclosures about intangible assets acquired by way of government grants
- information about intangible assets whose title is restricted
- contractual commitments to acquire intangible assets

18.7 CONCLUSION

Intangible assets by their nature have no physical substance and this usually confuse many students. The most important aspect is to use the asset test; does it result in future inflow of economic benefits, is it controlled by the entity and can the benefits be measured reliably in monetary value. If all these questions can be answered, then it is an asset despite not having the physical substance.

Intangible assets are becoming significant assets of the business ahead of tangible assets. Assets such as patents, goodwill and development expenditure are considered as crucial and valuable for the success of the business.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What are the conditions required to recognize an intangible non-current asset.

b) What are the difference between research and development costs.

c) What is the difference between inherent and purchased goodwill.

2.(a) What are the conditions necessary to capitalize development expenditure as an intangible asset? **4 Marks**

b) ABC purchased a patent to manufacture Mazoe drinks in Malawi on 1 January 2011 for K900, 000. ABC has bought equipment to be manufacturing this product in Malawi but the patent has been obtained from a Zimbabwean company. At the date of acquisition, the estimated useful economic life of the patent was 10 years.

An expert conducted an assessment on 31st January 2013 and recommended that the patent should have the market value of K960, 000 and that the remaining useful economic life should be 15 years.

Financial year for ABC end on 31st December.

NOT FOR SALE

the years 2011 to December 2013? **3 marks**

(ii) Compute revaluation surplus on the transaction and show the journal entries. **3 marks**

(iii) Show the Balance Sheet extract for 2011 to 2013 showing the net book value for the patent. **5 marks**

c) Outline the accounting requirement for goodwill in accordance to IAS 38-Accounting for Intangible assets and IFRS 3 on Business combination. **4 marks**

TOTAL: 20 MARKS

NOT FOR SALE

ACCOUNTING FRAMEWORK(P1)
KNOWLEDGE LEVEL

THE INSTITUTE OF
CHARTERED ACCOUNTANTS
IN MALAWI

Institute of Chartered Accountants in Malawi
Stansfield House
Haile Selassie Road
P.O. Box 1
Blantyre

Tel: 01 820 301/318/423 Fax: 01 822 354
Email: icam@icam.mw Website: www.icam.mw

ISBN 978-99908-0-425-6
9 789990 804256