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KENYA SCHOOL OF LAW
ADVOCATES TRAINING PROGRAMME
2011/2012 ACADEMIC YEAR

LEGAL PRACTICE MANAGEMENT (ACCOUNTING)

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RECORDING OF INVENTORY

A. Inventory Movements

Most sales are not priced at cost. Therefore, the sales figure include element of profit or loss. Movement of inventory is shown in many ways:

1. *Increase in Inventory:* This can be due to:-

    (a) Purchase of additional goods

    (b) Return into business of goods previously sold

To distinguish the two aspects of increase in inventory, two accounts are opened:

(i) A purchase Account – in which purchases of goods are entered

(ii) A Returns Inwards Account – in which goods being returned into the business are entered.

Therefore one of these two accounts is used to record the debit side of transaction.

2. *Decrease in inventory*-ignoring things like wastage and theft, this can be due to one of two causes:-

    (a) The sale of goods

    (b) Goods previously bought by the business being returned to supplier.

    Once again to distinguish the two aspects of decrease in inventory, two accounts are opened:-

    (i) A sales account – where sales of goods are entered.

    (ii) A return outwards account – in which goods being returned to supplier are entered (it is also called the purchases returns account).

B. Purchase of Inventory on Credit:

Illustration.

On 1st August 2010, goods costing Sh.165,000 are bought on credit from David Henry.

Here two-fold effect of the transaction must be considered so that book keeping entries can be worked out.

(i) The asset of inventory is increased. This needs a debit entry account. Here the account is one designed for this type of inventory movement. This is clearly a 'purchase' movement so that the account to use must be the purchases account.

(ii) There is an increase in liability. This is the liability of the business to David Henry because the goods have not yet been paid for. This will have a credit entry.

The two entries appear as:-

Purchase Account

2010		Shs			
Aug 1	David Henry	165,000			

David Henry Account

			2010		Shs
			Aug 1	Purchases	165,000

C. Purchases of Inventory for Cash.

On 2nd August 2010 goods costing Sh 310,000 are bought, cash being paid for them immediately at the time of purchase.

(i) Asset of inventory is increased, so debit entry is needed. The movement of inventory is that of a 'purchases' so the purchases account needs to be debited.

(ii) The asset of cash is decreased. So we need a credit entry.

Purchase Account

2010		Sh			
Aug 2	Cash	310,000			

Cash Account

			2010		Sh
			Aug 2	Purchases	310,000

D. Sales of Inventory on Credit:

On 3rd August 2010, goods were sold on credit for Sh.375,000 to J. Lewis

Effects:

(i) An 'Asset' (debtor) account is increased. This requires a debit entry and this debtor is J. Lewis so that the concerned account is that of J. Lewis.

(ii) The asset of inventory is decreased. This requires a credit entry. The movement of stock is as a result of a 'sale' and so sales account is credited.

J. Lewis Account

2010		Sh			
Aug 3	Sales	375,000			

Sales Account

			2010		Sh
			Aug 3	J. Lewis	375,000

E. Sale of Inventory for Cash

On 4th August 2010, goods are sold for Sh.550,000, cash being received immediately at the time of sale.

(i) Asset (cash) is increased – Thus, Debit cash account

(ii) Asset (inventory) is reduced – the reduction of the asset requires a credit entry and the movement of inventory is represented by 'sales'. Thus credit sales account.

Cash Account

2008		Shs			
Aug 4	Sales	55,000			

Sales Account

			2010		Shs
			Aug 4	Cash	55,000

F. **Returns Inwards** (sales returns)

On 5th August 2008 goods previously sold to Florence Lowe for Sh.29,000 are now returned to the business. Possible reasons could be:-

- Goods sent were of wrong colour, size, model, etc.
- Goods may have been damaged in transit.
- Goods may have been of poor quality.

Effects

(i) An Asset (inventory) is increased by goods returned. A debit entry is needed. The movement of inventory is that of 'returns inwards'. Thus debit Returns Inwards Account.

(ii) There is a decrease in asset (debtor). The debit of Florence Lowe to the business is now reduced. Thus a credit on Lowe's a/c is needed to record this.

Returns Inwards Account

2010		Sh			
Aug 5	F. Lowe	29,000			

F. Lowe Account

			2010		Sh.
			Aug 5	Return Inwards	29,000

Illustration 2

2009

May	1	Bought goods on credit Shs.220,000 form D. Small
	2	Bought goods on credit, Sh.410,000 from A Leon a& Sons
	5	Sold goods on credit to D. Hughes D. Hughes for Sh.60,000
	6	Sold goods on credit to M. Spencer for Sh.45,000
	10	Returned goods, Sh.15,000 to D. Small
	11	Goods sold for cash Sh.210,000
	12	Goods bought for cash Sh.150,000
	19	M. Spencer returned Sh.16,000 goods to us
	21	Goods sold for cash Sh.175,000
	22	Paid cash to D. Small Sh.205,000
	30	D. Hughes paid the amount owing to him Sh.60,000 cash
	31	Bought goods on credit Sh214,000 from A. Leon & Sons

Record the above transactions in the appropriate accounts

Purchases Account

2009			Sh				
May	1	D. Small	220,000				
	2	A. Leon &Sons	410,000				
	12	Cash	150,000				
	31	A. Leon & Sons	214,000				

Sales Account

			2009		Sh.
			May 5	D. Hughes	60,000
			6	M. Spencer	45,000
			11	Cash	210,000
			21	Cash	175,000

Returns Outwards Account

			2009		Sh.
			May 10	D. Small	15,000

Returns Inwards Account

2009		Sh			
May 19	M. Spencer	16,000			

D. Small Account

2009		Sh.	2009		Sh.
May 10	Return Outwards	15,000	May 1	Purchases	220,000
22	Cash	205,000			

A. Leon & Sons Account

			2009		Sh.
			May 1	Purchases	410,000
			31	Purchases	214,000

D. Hughes Account

2009		Sh.	2009		Sh.
May 5	Sales	60,000	May 3	Cash	60,000

M. Spencer Account

2009		Sh.	2009		Sh.
May 6	Sales	45,000	May 19	R/Inwards	16,000

Cash Account

2009		Sh.	2009		Sh.
May 11	Sales	210,000	May 12	Purchases	15,000
21	Sales	175,000	22	D. Small	205,000
30	D. Hughes	60,000			

Note:-

1. In accounting **purchases** means the purchase of goods which the business buys with the intention of selling. Thus if say business van has been bought it cannot be called purchases even if in the ordinary language, one could say that a van has been purchased.

2. Similarly, **sales** mean the sale of those goods which the business normally deals and which were bought with the prime intention of resale. Thus disposal of old vehicles and furniture cannot be termed as sales.

Comparison of cash transaction and credit transactions four purchase and sales.

CASH & CREDIT SALES	
Cash sales	**Credit sales**
Complete entry: Dr cash a/c Cr sales a/c	**First Part:** Dr Customers' a/c Cr Sales a/c **Second Part** Dr Cash a/c Cr Customers' a/c

CASH & CREDIT PURCHASES	
Cash Purchase	**Credit Purchases**
Dr Purchases a/c Cr Cash a/c	**First Part:** Dr Purchases a/c Cr Supplier's a/c **Second Part** Dr Suppliers' a/c Cr Cash a/c

Exercise:

Write up the following in the books.

2009		
July	1	Started business with cash Sh.750,000
	3	Bought goods for cash Sh.110,000
	7	Bought goods on credit Sh.320,000 from F. Harris
	10	Sold goods for cash Sh.64,000
	14	Returned goods to F. Harris
	18	Bought goods on credit Sh.414,000 from D. Elvis
	21	Returned good to D. Elvis Sh.31,000
	24	Sold goods to B. Sparrow Sh.82,000 on credit
	25	Paid F. Harris' a/c by cash Sh.274,000
	31	B. Sparrow paid us his account in cash Sh.82,000

THE EFFECT OF PROFIT OR LOSS ON CAPITAL AND THE DOUBLE ENTRY SYSTEM FOR EXPENSES AND REVENUES.

To an accountant **PROFIT** means amount by which revenue exceeds expenses for a set of transactions. The term **REVENUE** means value of goods and services that have been supplied to customers.

EXPENSES mean the cost value of all the assets that have been used up to obtain those revenues.

When expenses exceed revenues for a set of transactions, the result is a loss.

EFFECT OF PROFIT AND LOSS ON CAPITAL.

In the accounting equation Capital is presented as;

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

Illustration:

Assume that on January 1st assets and liabilities of a business are:

Assets: Fixtures; Sh.100,000; Inventory, Sh.70,000; Cash; Sh.30,000
Liabilities: Accounts payable; Sh.20,000

Therefore capital is (Sh 100,000 + Sh 70,000 + Sh 30,000 – Sh 20,000 = Sh.18,000)

If in January inventory is sold for Sh.110,000 cash, on 31st January the assets and liabilities becomes;
Assets: Fixtures; Sh.100,000; Inventory, Nil; Cash at bank; Sh.140,000
Liabilities: Accounts payable; Sh.20,000

Therefore Capital will be; (Sh.100,000 + Sh.140,000) – Sh.20,000 = Sh.220,000

Thus capital has increased by Sh.40, 000 because inventory was sold at Sh.40,000 profit for Sh.110,000. Profit therefore increases capital.

A loss on the other hand reduces capital i.e. **Old Capital – Loss = New Capital**

DEBIT OR CREDIT.

Assets involve expenditure by the business and are shown as debit entries. Expenses also involve expenditure by the business and should therefore also have debit entries. Why? Because assets and expenses must ultimately be paid for. This payment involves a credit to the bank account (or cash a/c) and therefore original entry in the assets a/c or the expense must be a debit.

Even where expenses are incurred on credit, the creditor must eventually be paid. This would involve an entry to credit the supplier (creditors' a/c) and then debit expense a/c. When payment is made, the bank a/c is credited and supplier's a/c debited.

Revenue is the opposite of expenses and is therefore treated in the opposite way. Revenue entries appear on the credit side of the revenue accounts.

In other words

Debit	**Credit**
Expenses	Revenues
Losses	Profits
Assets	Liabilities
	Capital

Illustration.

1. Rent of Sh.20,000 is paid in cash

   Summary: Debit rent account with Sh.20,000
   Credit cash a/c with Sh.20,000

2. Motor Vehicle expenses of Sh.35,500 are paid by cheque

   Summary: Debit motor vehicle expenses a/c with Sh.35,500
   Credit Bank a/c with Sh.35,500

3. Sh.6,000 is received for commission earned by the business.

   Summary: Debit cash a/c with Sh.6 000
   Credit Commission received a/c with Sh.6 000

More transactions and their effect upon accounts.

			Increase	**Action**	**Decrease**	**Action**
June	1	Paid for postage stamps by cash Sh.5,000	Expenses of postage	*Debit* Postage a/c	Asset of cash	*Credit* cash a/c
	2	Paid for electricity by cheque Sh.22,900	Expenses of electricity	Debit electricity a/c	Asset of bank	*Credit* bank a/c
	3	Received rent in cash Sh.13,800	Asset of Cash Revenue of Rent	*Debit* cash a/c *Credit* rent received a/c	No action to take	No action to take
	4	Paid insurance by cheque Sh.14,200	Expenses of insurance	*Debit* Insurance A/c	Asset of bank	*Credit* bank a/c

The four transactions are entered into the appropriate accounts as;

Cash Account

2009			Sh	2009		Sh
June	3	Rent Received	13,800	June 1	Postage	5,000

Bank Account

			2009		Sh.
			June 2	Electricity	22,900
			4	Insurance	14,200

Electricity Account

2009			Sh	
June	2	Bank	22,900	

Insurance Account

2009			Sh	
June	4	Bank	14,200	

Postage Account

2009			Sh	
June	1	Cash	5,000	

Rent Received Account

	2009		Sh.
	June 3	Cash	13,800

DRAWINGS.

The cash taken by the owner from the business for private use is known as drawings. Drawing, reduce capital. Drawings are never expenses of a business. An increase in drawings is a debit entry in the drawings a/c, with credit being an asset account, such as cash or bank.

In theory the debit entry should be made in the capital a/c (since drawings reduce capital), but to prevent the capital account becoming full of lots of small transactions, drawings are not entered in the capital account. Instead a drawings account is opened, and the debits are entered there.

Illustration:

On 25 August, the owner takes Sh.5,000 out of the business of own use.

Effect	**Action**
1. Capital is decreased by Sh.5,000	Dr drawings a/c Sh.5,000
2. Cash is decreased by Sh.5,000	Cr cash a/c Sh.5,000

Drawings Account

			Sh	
Aug	25	Cash	5,000	

Cash Account

	2009			Sh
	Aug	25	Drawings	5,000

If goods are taken for private use; purchases a/c is credited.

Illustration:

On 28th August, owner takes Sh.40,000 of goods out of business for own use.

	Effect	**Action**
1.	Capital is decreased by Sh.40,000	Dr Drawings a/c Sh.40,000
2.	Inventory is decreased by Sh.40,000	Cr Purchases a/c Sh.40,000

The appropriate accounts are;

Drawings Account

			Sh				
Aug	28	Purchases	40,000				

Purchases Account

							Sh
				Aug	28	Drawings	40,000

Exercise:

2008

March	1	Started business with Cash Sh.850,000
	2	Bought goods on credit from W. Young Sh.42,000
	3	Paid rent by cash Sh.21,000
	4	Paid Sh.60,000 of the cash of the business into bank a/c
	5	Sold goods on credit to D. Anwar Sh.19,200
	7	Bought stationery Sh.2,500 paying cash
	11	Cash sales Sh.8,100
	14	Goods returned to us by W. Young Sh.5,400
	17	Sold goods on credit to J. Harper Sh.21,200
	20	Paid for repairs to the building by cash Sh.7,800
	22	D. Anwar returned goods to us Sh.2,200
	27	Paid W. Young by cheque Sh.385,000
	28	Cash purchases Sh.47,000
	29	Bought van paying by cheque Sh.385,000
	30	Paid motor vehicle expenses in cash Sh.6,200
	31	Bought fixtures Sh.84,000 on credit from B. Coal.