

Capital expenditure is incurred when a business spends money either to:

- Buy non-current assets, or
- Add to the value of an existing non-current asset

Include in such amounts should be spending on:

Revenue expenditure

Expenditure which is not spent on increasing the value of non-current assets, but is incurred in running the business on a day-to-day basis, is known as **revenue expenditure**

The difference between revenue expenditure and capital expenditure can be seen clearly with the total cost of using a van for a business. Buying a van is an example of capital expenditure. The van will be in use for several years and is, therefore, a non-current asset.

Paying for petrol to use in the van is revenue expenditure. This is because the expenditure is used up in a short time and does not add to the value of non current assets.

Differences between capital and revenue expenditure

The examples listed in illustration 1 below demonstrate the difference in classification

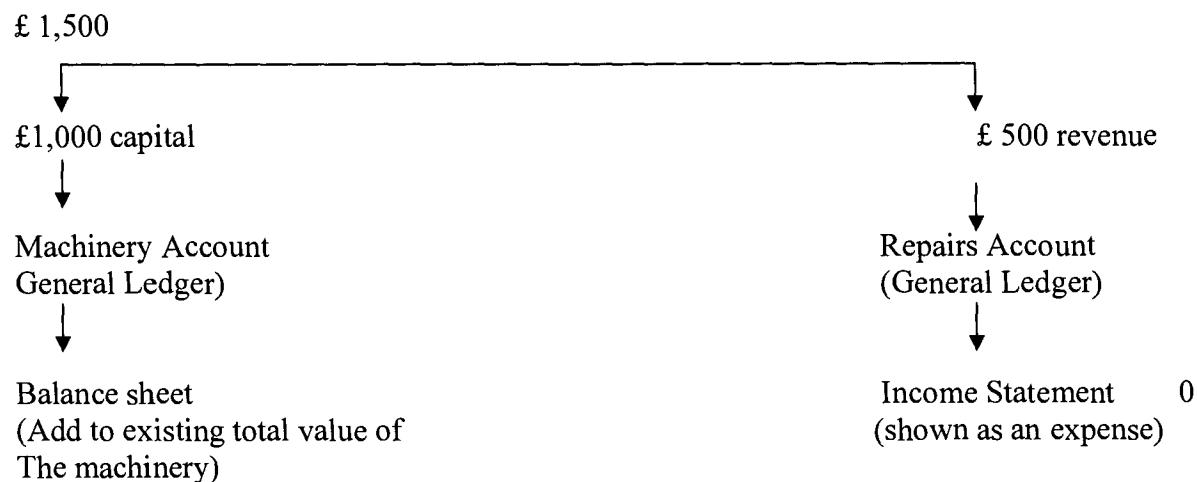
<i>Expenditure</i>	<i>Types of expenditure</i>
1. Buying van	Capital
2. Petrol costs for van	Revenue
3. Repairs to van	Revenue
4. Putting extra headlights on van	Capital
5. Buying machinery	Capital
6. Electricity costs of using machinery	Revenue
7. We spent £1,500 on machinery: £ 1000 was for an item (improvement) added to the machine; and £ 500 was for repairs	Capital £1000 Revenue £ 500
8. Painting outside of new building	Capital
9. three years later- repairing outside of building in (8)	Revenue

Revenue expenditure is chargeable to the income statement, while capital expenditure will result in increased figures for non current assets in the balance sheet. Getting the classification wrong affects the profits reported and the capital account and asset values in the financial statements, it is, therefore important that this classification is correctly done.

Joint expenditure

Sometimes one item of expenditure will need to be divided between capital and revenue expenditure- there was an example in illustration 1 when £1500 spent on machinery was split between capital and revenue

Illustration 2



A builder was engaged to tackle some work on your premises, the total bill being for £ 3,000. If one third of this was for repair work and two thirds for improvements, where should the two parts be entered in the accounting books and where would they appear in the financial statements?

Treatment of loan interest

A company obtained a loan to purchase a fixed asset of \$100,000. Every month, the company is required to pay to the bank monthly interest of \$1,000. In this case, explain what is capital and revenue expenditure

as the loan is used for buying the fixed asset for company's expansion it is a capital expenditure. However, as the loan interest is paid monthly it becomes a part of day-to-day expense hence it is *revenue expenditure*

Capital and revenue receipts

When an item of capital expenditure is sold, the receipt is called 'capital receipt'. Suppose a van is bought for £5,000 and sold five years later for £ 750. The £ 5,000 was treated as capital expenditure. The £

received is treated as a capital receipt and credited to the non current asset account in the general ledger. "Revenue receipts" are sales and other revenue items that are added to gross profit, such as rent receivable and commissions receivable.

Exercise 1

For the business of J Charles, wholesale chemist, classify the following between 'capital' and 'revenue' expenditure:

- a) purchase of extra van
- b) cost of rebuilding warehouse wall which had fallen down
- c) building extension to the warehouse
- d) painting extension to warehouse when it is first built
- e) repairing extension to warehouse three year later than that done in (d)
- f) carriage costs on purchases
- g) carriage costs on sales
- h) legal costs of collecting debts
- i) legal charges on acquiring new premises for office
- j) fire insurance premium
- k) costs of erecting new machine

Exercise 2

A Bloggs, a building contractor, had a wooden store shed and a brick-built office which have balance b/d in the books of £850 and £179,500 respectively. During the year, the wooden shed was pulled down at a cost of £265, and replaced by a brick building. Some of the timber from the old store shed was sold for £180 and the remainder, valued at £100, was used in making door frames etc, for the new store. The new brick-built store was constructed by the builder's own employee, the expenditure thereon being materials (excluding timber from the old store shed) £ 4,750; wages £ 3,510; and direct expenses of £85

At about the same time, certain repairs and alterations were carried out to the office, again using the builder's own materials, the cost of which was; wages £290 and materials £ 460. It was estimated that £218 of this expenditure, being mainly that incurred on providing additional windows, represented improvements, 50% of this being wages, 50% materials.

Required:

Prepare the following four ledger account as they would appear after giving affect to all the above matters

- a) wooden store shed account

- b) office building account
- c) new store account
- d) office building repairs account

SOLUTION

Wooden Store Shed Disposal

Balance b/d	850	Wooden Store Shed Disposal	850
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Office Building

Balance b/d	179,500
Wages	109
Materials	109

Office Buildings Repairs

Wages	181
Materials	351

New Store

Wooden store shed disposal	100
Materials	4,740
Wages	3,510
Direct Expenses	85

Wooden Store Shed Disposal

Wooden store shed	850	Bank	180
Bank	265	New Store	100

Exercise 3

At the beginning of the financial year on 1 April 2005, a company had a balance on plant of *Sh* 372,000 and on provision for depreciation of plant account of *Sh* 205,400

The company's policy is to provide depreciation using the reducing balance method supplied to the non-current assets held at the end of the financial year at the rate of 20% per annum.

On 1 September 2005 the company sold for *Sh* 13,700 some plant which it had acquired on 31 October 2001 at a cost of *Sh* 36,000. Additionally, installation costs totaled *Sh* 4,000. During 2003 major repairs costing *Sh* 6,300 had been carried out on this plant and, in order to increase the capacity of the plant, a new

motor had been fitted in December 2003 at a cost of *Sh* 4,400. A further overhaul costing *Sh* 2,700 had been carried out during 2004.

The company acquired new replacement plant on 30 November 2005 at a cost of *Sh* 96,000, inclusive of installation charges of *Sh* 7,000

Required:

Calculate:

- The balance of plant at cost at 31 march 2006
- The provision for depreciation of plant at 31 march 2006
- The profit or loss on disposal of the plant.

SOLUTION

(a)	<i>Plant at Cost</i>	<i>Sh.</i>
Balance 1 April 2005		372,000
<i>Add</i> Acquisitions during year		<u>96,000</u>
		468,000
<i>Less</i> Disposals (36,000 + 4,000 + 4,400)		<u>44,400</u>
Balance 31 March 2006		<u>423,600</u>

(b)	<i>Provisions for Depreciation of Plant</i>	
Balance 1 April 2005		205,400
<i>Less</i> Depreciation on disposals (W1)		<u>25,200</u>
		180,200
<i>Add</i> Provision for year 20% x (423,600 – 180,200)		<u>48,680</u>
Balance 31 March 2006		<u>228,000</u>

	<i>Plant Sold</i>	
Cost: year to 31 March 2002		40,000
Depreciation: year to 31 March 2002	20%	<u>8,000</u>
		32,000
Depreciation: year to 31 March 2003	20%	<u>6,400</u>
		25,600
Addition		<u>4,400</u>
		30,000
Depreciation: year 31 March 2004	20%	<u>6,000</u>
		24,000
Depreciation: year 31 March 2005	20%	<u>4,800</u>
		<u>19,200</u>

(c)	<i>(W1) Depreciation accumulated: 8,000 + 6,400 + 6,000 + 4,800 = 25,200</i>	
	<i>Sale of Plant</i>	<i>13,700</i>
Less Cost (40,000 + 4,400)	44,400	
Depreciation	<u>25,200</u>	
Book value at date of sale		<u>19,200</u>
Loss on disposal		<u>5,500</u>

BAD DEBTS, ALLOWANCE FOR DOUBTFUL DEBTS, AND PROVISIONS FOR DISCOUNTS ON ACCOUNTS RECEIVABLE

Bad debts

With many businesses a large proportions, if not all, of the sales are on credit. The business is therefore taking the risk that some of the customers may never pay for the goods sold to them on credit. This is a normal business risk and such **bad debts** are a normal business expense. They must be charged to the income statement as an expense when calculating the net profit or loss for the period. The other thing that needs to be done is to remove the bad debts from the asset account. Usually, this will mean closing the debtors' account.

When a debt is found to be 'bad' the assets as shown by the debt in the debtors account is worthless. It must be eliminated from the account. If doing so reduces the balance to zero, the debtors account is closed. To record a bad debt, you credit the debtors' account to cancel the asset and increase the expense account by debiting it to the bad debts account.

There are a range of possible scenarios that may exist concerning a bad debt.

- a) The debtor may be refusing to pay one of a number of invoices
- b) The debtor may be refusing to pay of an invoice
- c) The debtor may owe payment on a number of invoices and have indicated that only a proportion of the total amount due will ever be paid because the debtors business has failed;
- d) The debtors business has failed and nothing is ever likely to be received

Whatever the reason, once a debt has been declared 'bad', the journal entry is the same. You debit the bad debt account with the amount of the bad debt and credit the debtor's account in the sales ledger to complete the double entry.

At the end of the period, the total of the bad debts accounts is transferred to the income statements. An example of debts being written off as bad is shown in Illustration 4

Illustration 4

C Bloom			
2008	£	2008	£
Jan 8 sales	<u>520</u>	Dec 31 Bad debts	<u>520</u>

R Shaw			
2008	£	2008	£
		Page 6 of 53	

Feb 16 Sales	375	Aug 17 Cash	125
		Dec 31 Bad debts	250
	<u>375</u>		<u>375</u>

Bad Debts

2008	£	2008	£
Dec 31 C Bloom	520	Dec 31 Profit and loss	770
R Shaw	<u>250</u>		<u>770</u>
	<u>750</u>		

Income statement (extract) for the year ending 31 December 2008

	£
Gross profit	xxx
<i>Less Expense</i>	
Bad debts	(770)

Allowance for doubtful debts

In order to arrive at a figure for doubtful debts, a business must first consider that some debtors will never pay any of the amounts they owe, while others will pay a part of the amount owing only, leaving the remainder permanently unpaid. The estimated figure can be made:

- a) By looking at each debt, and deciding to what extent it will be bad;
- b) By estimating, on the basis of experience, what percentages of the total amount due from the remaining debtors will ultimately prove to be bad debts.

Accounting entries for allowances for doubtful debts

The accounting entries needed for the allowances for doubtful debts are:

Year in which the allowances is first made:

- a) Debit the profit and loss account with the amount of the allowance (i.e. deduct it from gross profit as an expense).
- b) Credit the *Allowance for doubtful debts account*

Illustration 5

ii

At 31 December 2008, the account receivable figure after deducting bad debts was £10,000. It is estimated that 2 % of debts (i.e. £ 200) will eventually prove to be bad debts, and it is decided to make a provision for these. The accounts will appear as follows:

Profit and Loss

2008	£
Dec 31 Allowance for doubtful debts	200

Allowance for doubtful Debts

2008	£
Dec 31 Profit and loss	200

In the financial statements; the allowances is shown as follows:

Income statement (extract) for the year ending 31 December 2008

	£	£
Current assets		xxx
Accounts receivable	10,000	
Less allowance for doubtful debts	(200)	
		9,800

As shown, in the balance sheet, the balance on the allowance for doubtful debts is deducted from the accounts receivable total

You'll have noticed that we are using two different accounts to make the two different types of adjustments to accounts receivable. This is done in order to make it clear how much is (a) being written-off as bad debts, how much is (b) being treated as an allowance for doubtful debts:

1. Bad debts account. This expense account is used when a debt is believed to be irrecoverable and is written -off.
2. Allowance for doubtful debts accounts. This accounts is used only for estimates of the amount of debt remaining at he year end after the debts have been written off that are likely to finish up as bad debts. (this account is also known as the 'allowance for bad debts account')

By charging both (1) and (2) in the income statement, we present the full picture of the amounts provided for in respect of both bad and doubtful debts. As you have seen in Illustration 4 and Illustration 5 these amounts are shown as deduction from the gross profit.

By showing (2) as a deduction from the figure of accounts receivable in the balance sheet, we get a net figure, which represents a more accurate figure of the value of accounts receivable than the total of all the accounts receivable balances in the sales ledger. It may not be absolutely accurate only time will tell which debts will turn out to be bad- but it is better than not attempting to make an estimate.

When you look at depreciation in the previous topic, you will see that it bears similarities to the allowance for doubtful debts. Depreciation is charged as debit to the profit and loss account and as a credit against non-current asset accounts in the ledger. It represents an estimate of how much of the overall economic

usefulness of a non-current asset has been used up in each accounting period. Like the allowance for doubtful debts, it can never be completely accurate since only in several years' time, when the asset is put out of use, can it be determined whether or not the provisions made have been appropriate. Having to make estimates where absolute accuracy is impossible is a part of accounting.

Increasing the allowance

Dr	Profit \$Loss (deduct it from gross profits expense)
Cr	Allowance for doubtful debts a/c

	£	£
Current assets	xxx	
Accounts receivable	xx	
Less allowance for doubtful debts	<u>(xx)</u>	
		xxx

Reducing the allowance

To reduce the allowance, you simply do the opposite to what you did to increase it. The allowance for doubtful debts has a credit balance. Therefore, to reduce it we would need a debit entry in the allowance account. The credit would be in the profit and loss account. Let's assume that at 31 December 2010, the figure for account receivable had fallen to £10,500 but the allowance remained at 2 per cent, i.e. £ 210 (2 per cent of £ 10,500).

As the allowance had previously been £ 240, it now needs to be reduced by £ 30. The double entry is:

1. Debit allowance for doubtful debts account
2. Credit profit and loss account (i.e add it as a gain to gross profit)

These entries are illustrated in Illustration 6

Illustration 6

Allowance for doubtful debts			
2010	£	2010	£
Dec 31 Profit and loss	30	Jan 1 Balance b/d	<u>240</u>
31 Balance c/d	<u>210</u>		
	<u>240</u>		<u>240</u>
		2011	
		Page 9 of 53	

Jan	1	Balance b/d	210
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Profit and Loss

	2009	£
	Dec 31 Allowance for doubtful debts	30

Income statement (extra) for the year ending as on 31 December 2010

	£	£
Gross profit	xxx	
Add reduction in allowance for doubtful debts		30

Balance sheet (extract) as on 31 December 2010

	£	£
Current assets		
Accounts receivable	10,500	
Less allowance for doubtful debts	(210)	
		10,200

You will have noticed that increases in the allowance for doubtful debts increase the total for expenses and so reduce net profit. On the other hand, a reduction in the allowance for doubtful debts will increase the gross profit.

Bad debts recovered

Sometimes, a debt written off in previous years is recovered. When this happens, you

1. Reinstate the debt by making the following entries:

Dr. Debtors account

Cr Bad debts recovered account

2. When payment is received from the debtors in settlement of all or part of the debt:

Dr. Cash/bank

Cr Debtor's account

With the amount received

At the end of the financial year, the credit balance in the bad debts recovered accounts is transferred either to the bad debts account or direct to the credit side of the profit and loss account. The effect is the same,

since the bad debts account will, in it, is transferred to the profit and loss account at the end of the financial year.

Provisions for cash discounts on accounts receivable

Some businesses create provisions for cash discounts to be allowed on the accounts receivable outstanding at the balance sheet date. This, they maintain, is quite legitimate, as the amount of accounts receivable less any allowance for doubtful debts is not the best estimate of collectable debts, owing to cash discounts which will be given to debtors if they pay within a given time. The cost of discounts, it is argued, should be charged in the period when the sales were made. While this practice is of dubious merit (as cash discounts is treated as a finance charge, not as an adjustment to sales revenue), it is one used in practice by some businesses.

The procedure for dealing with this is similar to the allowance for doubtful debts. It must be borne in mind that the estimate of discounts to be allowed should be based on the net figure of accounts receivable less the allowance for doubtful debts, as it is obvious that cash discounts are not allowed on bad debts! Let's look at an example in Illustration 7

Illustration 7

Year Ended 31 December	Accounts receivable	Allowance for doubtful debts	Provision for Cash discounts allowed
	£	£	%
2007	4000	200	2%
2008	5000	350	2%
2009	4750	250	2%

Provision for cash discounts on accounts receivable

2007	£	2007	£
Dec 31 Balance c/d	<u>76</u>	Dec 31 Profit and loss	<u>76</u>
2008		2008	
Dec 31 Balance c/d	<u>93</u>	Jan 1 Balance b/d	<u>76</u>
		Dec 31 Profit and Loss	<u>17</u>
			<u>93</u>

2009		2009	
Dec 31 Profit and Loss	3	Jan 1 Balance b/d	93
Balance c/d	<u>90</u>		<u>93</u>
	<u>93</u>		
		2010	
		Jan 1 Balance b/d	90

Income statements (extracts) for the years ending 31 December

	£
Gross profits (2007, 2008 and 2009)	xxx
Less expense:	
(2007) provision for cash discount on accounts receivable	76
2008) increase in provision for cash discount on accounts receivable	(17)
(2009) reduction in provision for cash discounts on accounts receivable	3

Balance sheets (extracts) as at 31 December

	£	£	£
2007 accounts receivable		4000	
Less allowance for doubtful debts	200		
Provision for cash discounts on accounts receivable	76		
		<u>(276)</u>	
			3,724
.....			
2008 Accounts receivable		5,000	
Less Allowance for doubtful debts	350		
Provision for cash discounts on accounts receivable	<u>93</u>		
		<u>(443)</u>	
			4,557
.....			
2009 Accounts receivable		4,750	
Less Allowance for doubtful debts	250		
Provision for cash discounts on accounts receivable	<u>90</u>		
		<u>(340)</u>	
			4,410

Exercise 5

J Blance commenced business on 1 January 2006 and prepares her financial statements to 31 December every year. For the year ended 31 December 2006, bad debts written off amounted to £ 1,400. It was also found necessary to create an allowance for doubtful debts of £ 2,600.

In 2007, debts amounting to £ 2,200 proved bad and were written off. J Sweeny, whose debt of £210 was written off as bad in 2006, settled her account in full on 30 November 2007. As at 31 December 2007 total debts outstanding were £92,200. It was decided to bring the provision up to 4 % of this figure on that date.

In 2008, £ 3,800 of debts was written-off during the year, and another recovery of £ 320 was made in respect of debts written off in 2006. As at 31 December 2008, total debts outstanding were £ 72,000. The allowance for doubtful debts is to be changed to 5% of this figure.

You are required to show for the years 2006, 2007 and 2008, the

- a) Bad debts account
- b) Bad debts recovered account
- c) Allowance for doubtful debts account
- d) Extract from the income statement.

DEPRECIATION OF NON –CURRENT ASSETS: NATURE AND CALCULATIONS

DEPRECIATION OF TANGIBLE NON CURRENT ASSETS

According to IAS 16, Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Tangible non-current assets (i.e. long-term assets which can be touched, such as machinery, motor vehicles, fixtures and even buildings) do not last for ever. If the amount received (if any) on the disposal of a non-current asset is deducted from the cost of buying it, the value of the non-current asset can be said to have 'depreciated in value' by that amount over its period of usefulness to the business. For example, if a van was bought for £10,000 and sold five years later for £ 2,000 then its value has depreciated over the period of its use by £ 8,000

This is the only time that depreciation can be calculated accurately. That is, you can only estimate what it should be each year while the non-current asset continues to be used.

Depreciation is an expense

Depreciation is that part of the original cost of a non-current asset that is consumed during its period of use by the business. It needs to be charged to the profit and loss account every year. The amount charged in a year for depreciation is based upon an estimate of how much of the overall economic usefulness of non-current assets had been used up in that accounting period. It is an expense for services consumed in the same way as expense to the profit and loss account, depreciation reduces net profit.

For example, if a PC cost £ 1,200 and was expected to be used for three years, it might be estimated at the end of the first year that a third of its overall usefulness had been consumed. Depreciation would then be charged at an amount equal to one-third of the cost of the PC, i.e. £ 400. Profit would be reduced by £ 400 and the value of the PC in the balance sheet would be reduced from £ 1,200 to £ 800

Using an example of a van and the petrol it consumes, you can see that the only real difference between the expense of depreciation for the van and the expense of petrol incurred in order to use the van is that the petrol expense is used up in a short time, whereas the expense for use of the van is spread over several years. Both the petrol and the cost of the van are expenses of the business.

Causes of depreciation

Physical deterioration, economic factors, time and depletion all give rise to a reduction in the value of tangible non-current asset. Let's look at these in more detail.

Physical deterioration

- a) Wear and tear, when a motor vehicle or machinery or fixtures and fittings are used they eventually wear out. Some last many years, others last only a few years. This is also true of buildings, although some may last for along time.
- b) Erosion, rust, rot and decay. Land may be eroded or wasted away by the action of wind, rain, sun and other elements of nature. Similarly, the metals in motor vehicles or machinery will rust away. Wood will ~~not~~ eventually. Decay is a process which will also be present due to the elements of nature and the lack of proper attention.

Economic factors

These may be said to be the reasons for an asset being put out of use even though it is in good physical condition. The two main factors are usually obsolescence and inadequacy.

- ❖ **Obsolescence.** This is the process of becoming out-of-date. For instance, over the years there has been great progress in the development of synthesizers and electronics devices used by leading commercial musician. The old equipment will therefore have become obsolete, and much of it will have been taken out of use by such musicians.

This does not mean that the equipment is worn out. Other people may well buy the old equipment and use it, possibly because they cannot afford to buy new up-to-date equipment.

- ❖ **Inadequacy.** This arises when an asset is no longer used because of the growth and changes in the size of the business. For instance, a small ferryboat that is operated by a business at a coastal resort will become entirely inadequate when the resort becomes more popular. Then it will be found that it would be more efficient and economical to operate a large ferryboat, and so the smaller boat will be put out of use by the business.

In this case also it does not mean that the ferryboat is no longer in good working order, nor that it is absolute. It may be sold to a business at a smaller resort.

Time

Obviously time is needed for wear and tear, erosion, etc and for obsolescence and inadequacy to take place. However, there are non-current assets to which the time factor is connected in a different way. These are assets which have a legal life fixed in term of years.

For instance, you may agree to rent some buildings for ten years. This is normally called a lease. When the years have passed, the lease is worth nothing to you, as it has finished. Whatever you paid for the lease is now of no value.

A similar case arises when you buy a patent so that only you are able to produce something. When the patents' time has finished it then has no value. Instead of using the term depreciation, the term **amortization** is often used for these assets.

Depletion

Other assets are of wasting character, perhaps due to the extraction of raw materials from them. These materials are then either used by the business to make something else, or are sold in their raw state to other businesses. Natural resources such as mines, quarries and oil wells come under this heading. To provide for the consumption of an asset of a wasting character is called provision for **depletion**.

Land and buildings

Land normally has indefinite economic life and is not depreciated. Land and buildings therefore have to be depreciated separately. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building

IASs 16 (*property, plant and equipment*), 23 (*Borrowing costs*) and 36 (*impairment of assets*) are the relevant international standards

Appreciation

At this stage, you may be wondering what happens when non-current assets increase (appreciate) in value. The answer is that normal accounting procedure would be to ignore any such appreciation, as to bring appreciation into account would be to contravene both the historical cost concept and the prudence concept.

Methods of calculating depreciation charges

The two main methods in use are the **straight line method** and the **reducing balance method**. Other may be used in certain cases. Most accountants think that the straight line method is the one that is generally most suitable.

Straight line method

In this method, the number of years of use is estimated. The cost is then divided by the number of years. This gives the depreciation charge for each year.

For instance, if a van was bought for £ 22,000 the depreciation to be charged each year would be:

$$\text{Cost (£ 22,000)} - \text{Estimated disposal value (£ 2,000)} = \text{£ 20,000}$$

$$\begin{array}{rcl} \text{Number of expected years of use (4)} & & 4 \\ & & = \text{£ 5,000 depreciation each year for four years.} \end{array}$$

On the other hand, if we bought that van after four years the van would have no disposal value, the charge for depreciation would be:

$$\begin{array}{rcl} \text{Cost (£ 22,000)} & = & \text{£ 22,000} \\ \text{Number of expected years of use (4)} & & 4 \\ & & = \text{£ 5,500 depreciation each year for four years} \end{array}$$

Reducing balance method

In this method, a fixed percentage for depreciation is deducted from the cost in the first year. In the second and later years the same percentage is taken of the reduced balance (i.e. cost less depreciation already charged). This method is also known as the diminishing balance method or the diminishing debit balance method.

If a machine is bought for £ 10,000 and depreciation is to be charged at 20 per cent, the calculations for the first three years would be as follows:

Cost	£
First year: depreciation (20%)	10,000
	(2,000)
	8,000
Second year: depreciation (20% of £8,000)	(1,600)
	6,400

Third year: depreciation (20% of £ 6,400)	(1,280)
Cost not yet apportioned, end of year 3	<u>5,120</u>

The basic formula used to find the percentage to apply with this method is:

$$R = 1 - \sqrt[n]{\frac{s}{c}}$$

Where n= the number of years

S= the net residual value (this must be a significant amount or the answers will be absurd, since the depreciation rate would amount to nearly one)

C= the cost of the asset

R= the rate of depreciation to be applied

Using as an example the figures

n= 4 years

s= residual value £ 256

c = cost £ 10,000

The calculation would appear as:

$$R = 1 - \sqrt[4]{\frac{256}{10,000}} = 1 - \frac{4}{10} = 0.6 \text{ or } 60\%$$

The depreciation calculation applied to each of the four years of use would be:

	£
Cost	10,000
Year 1: Depreciation provision 60% of £ 10,000	<u>(6,000)</u>
Cost not yet apportioned, end of year 1	4,000
Year 2: Depreciation provision 60 % of £ 4,000	<u>(2,400)</u>
Cost not yet apportioned, end of year 2	1,600
Year 3: Depreciation provision 60 % of £ 1,600	<u>(960)</u>
Cost not yet apportioned, end of year 3	640
Year 4: depreciation provision 60 % of £ 640	<u>(384)</u>
Cost not yet apportioned, end of year 4	256

Illustration 8

A business has just bought a machine for £ 8,000. It will be kept in use for four years, when it will be disposed of for an estimated amount of £ 500. The accountant has asked you to prepare a comparison of the amounts charged as depreciation using both methods.

For the straight line method, a figure of $(£ 8,000 - £ 500) / 4 = £ 7,500 / 4 = £ 1,875$ per annum is to be used.

For the reducing balance method, a percentage figure of 50 per cent will be used

	<i>Method 1</i>	<i>Method 2</i>
	<i>Straight line</i>	<i>Reducing balance</i>
	£	£
Cost	8,000	8,000
Depreciation: year 1	<u>(1,875)</u>	(50% of £ 8,000)
	6,125	4,000
Depreciation year 2	<u>(1,875)</u>	(50% of £ 4,000)
	4,250	2,000
Depreciation year 3	<u>(1,875)</u>	(50% of £ 2,000)
	2,375	1000
Depreciation: year 4	<u>(1,875)</u>	(50% of £ 1,000)
Disposal value	<u>500</u>	<u>500</u>

Other methods of calculating depreciation

There are many more methods of calculating depreciation, some of which are used in particular industries, such as the hotel and catering industry. We'll now look briefly at five of these other methods

There is no information easily available to show how many organizations are using each method. It is possible to devise one's special method. If it brings about an equitable charge for depreciation for the organization, then the method will be suitable.

The revaluation method

When there are a few expensive non-current assets, it is not difficult to draw up the necessary accounts for depreciation. For each item we:

- a) Find its cost
- b) Estimate its years of use to the business
- c) Calculate and provide depreciation
- d) Make the adjustments when the asset is disposal of
- e) Calculate profit or loss on disposal

Exercise 7

State which depreciation method will be the most appropriate in the case of each of the following assets and why. Also indicate to what extent obsolescence will affect each of the assets.

- a) A delivery van used by a baker
- b) A filling cabinet
- c) A shop held on a 20 year lease
- d) A plastic moulding machines to manufacturer new novelty- plastic fireguards. It is expected that there will be very popular next Christmas and that sales will continue for a year or two thereafter but at a very much lower level.
- e) Machine X. this machine is used as a standby when the normal machines are being maintained. Occasionally it is used to increase capacity when there is a glut of orders. Machine X is of an old type and is inefficient compared with new machines. When used on a full-time basis the machine should last for approximately four years.

Solution

- (a) Reducing balance. Obsolescence probably very slow and not relevant.
- (b) Straight Line. Obsolescence very slow and probably not relevant.
- (c) Straight Line. Obsolescence depends on the market and growth at the business.
- (d) Reducing balance (as it is likely to be more efficient in the early years of use and susceptible to obsolescence).
- (e) Machine hours. Already obsolete.

DOUBLE ENTRY RECORDS FOR DEPRECIATION

Recording depreciation

Previously the charge for depreciation on a non-current asset was recorded in the account for that fixed asset. This is no longer done.

Why do you think this is no longer done?

Recording depreciation now involves maintaining each non-current asset at its cost in the ledger account where the depreciation to date is recorded. This account is known as the '**accumulated provision for depreciation account**' often shortened to the accumulated depreciation account (or sometimes, confusingly, known as the 'provision for depreciation account')

Illustration 9

A business has a financial year end of 31 December. A computer is bought for £ 2,000 on 1 January 2005. It is to be depreciated at the rate of 20 per cent using the reducing balance method. The records for the first three years are:

Computer			
2005	£		
Jan 1 cash	2,000		
Accumulated provision for depreciation- Computer			
2005	£	2005	£
Dec 31 Balance c/d	<u>400</u>	Dec 31 Profit and loss	<u>400</u>
2006		2006	
Dec 31 balance c/d	720	Jan 1 Balance b/d	400
		Dec 31 profit and loss	<u>320</u>
	<u>720</u>		<u>720</u>
2007		2007	
Dec 31 Balance c/d	976	Jan 1 Balance b/d	720
		Dec 31 Profit and loss	<u>256</u>
	<u>976</u>		<u>976</u>
		2008	
		Jan 1 Balance b/d	976

Profit and Loss

2005	£	
Dec 31 Acc Provn for Depn: Computer	400	
2006		
Dec 31 Acc. Provn for Depn: Computer	320	
2007		
Dec 31 Acc Provn for Depn: Computer	256	

Income statement (extracts) for the years ending 31 December

2005 depreciation	<u>400</u>
2006 depreciation	<u>320</u>
2007 Depreciation	<u>256</u>

Note: in this case, the depreciation for the period being entered in the income statement is being described as 'depreciation' and not by the name of the account it originated from (the accumulated provision for depreciation account)

Now the balance on the computer accounts is shown on the balance sheet at the end of each year less the balance on the Accumulated provision for Department Account.

Balance sheets (extract)

	£	£
As at 31 December 2005		
Computer at cost	2000	
Less accumulated depreciation	(400)	
		1,600
.....		
As at 31 December 2006		
Computer at cost	2000	
Less accumulated depreciation	(720)	
		1,280
.....		
As at 31 December 2007		
Computer at cost	2000	
Less accumulated depreciation	(976)	
		1,024

THE DISPOSAL OF NON CURRENT ASSET

Reason for accounting entries

Upon the sale of a non current asset, we will want to remove it from our ledger accounts. This means that the cost of that asset needs to be taken out of the asset account. In addition, the accumulated depreciation on the asset which has been sold will have to be taken out of the accumulated provision. Finally, the profit and loss on sale, if any, will have to be calculated and posted to the profit and loss account.

When we charge depreciation on a non-current asset we have to make an informed guess. We will not often guess correctly. This means that, when we dispose of an asset, the amount received for it is usually different from our estimate.

List as many things as you can think of in one minute that could cause the amount charged for depreciation to have been incorrect.

Accounting entries needed

On the sale of a non current asset, in this example a computer, the following entries are needed:

- a) Transfer the cost price of the asset sold to an assets disposal account (in this case a computer disposal account)
- Debit computer disposals account
- Credit computer account

- b) Transfer the depreciation already charged to the assets disposal account

Debit accumulated provision for depreciation: computer

Credit computer disposals account

- c) For the amount received on disposal;

Debit cash book

Credit computer disposals account

- d) Transfer the difference (i.e. the amount needed to balance the computer disposals account to the profit and loss account.

i) If the computer disposals account shows a difference on the debit side (i.e. if more has been credited to the account than has been debited to it), there is a profit on the sale:

Debit computer disposals account

Credit profit and loss account

- ii) If the computer disposals account shows a difference on the credit side, there is a loss on sale:

Debit profit and loss account

Credit computer disposals account

These entries can be illustrated by looking at those needed if the computer in Illustration 9 was sold on 2 January 2008. At 31 December 2007, the cost was £ 2,000 and a total of £ 976 had been written off as depreciation leaving a net book value of £ 2,000 - £ 976 = £ 1,024. If the computer is sold in 2008 for more than £ 1,024 a profit on sale will be made. If, on the other hand, the computer is sold for less than £ 1,024 then a loss will be incurred.

Illustration 10 shows the entries needed when the computer has been sold for £ 1,070 and a profit of £ 46 on sale has, therefore, been made. Illustration 11 shows the entries where the computer has been sold for £ 950, thus incurring a loss on sale of £ 74. In both cases, the sale is on 2 January 2008 and no depreciation is to be charged for the two days' ownership in 2008, (the letters in brackets refer to the accounting double entries, A-D, above).

Illustration 10 -Non current asset sold at a profit

Computer			
2005	£	2008	£
Jan 1 cash	2,000	Jan 2 machinery disposals	(A) 2,000

Accumulated provision for Depreciation: Computer

2008	£	2008	£
		Page 22 of 53	

Jan 2 Machinery disposals (B)	<u>976</u>	Jan 1 Balance b/d	<u>976</u>
-------------------------------	------------	-------------------	------------

Computer disposals			
2008	£	2008	£
Jan 2 computer (A)	2,000	Jan 2 Accumulated provision for depreciation (B)	976
Dec 31 profit and loss (D)	46	2 Cash (C)	<u>1,070</u>
	<u>2,046</u>		<u>2,046</u>

Profit and Loss			
	2008		£
	Dec 31 computer disposals (gain) (D)	46	

Income statement (extract) for the year ending 31 December 2008

Gross profit

Add gain on sale of computer

Illustration 11 - Non current asset sold at a loss

Computer			
2005	£	2008	£
Jan 1 cash	2,000	Jan 2 Computer disposal (A)	2,000

Accumulated provision for Depreciation computer			
2008	£	2008	£
Jan 2 computer disposals (8)	976	Jan 1 Balance b/d	976

Computer disposals			
2008	£	2008	£
Jan 2 computer (A)	2,000	Jan 2 Accumulated provision for depreciation (B)	976
		2 Cash (C)	950
		Dec 31 profit and loss (B)	74
	<u>2,000</u>		<u>2,000</u>

Profit and loss			
2008	£		
Dec 31 computer disposal (loss) (D)	74		

Income statement (extract) for the year ending 31 December 2008

Gross profit	£
Less loss on sale of computer	xxx
	(74)

Exercise 8

A business with its financial year end on 31 December buys two vans on 1st January 2001, No 1 for £ 8,000 and No 2 for 5,000. It also buys another van, No 3, on 1st July 20003 for £ 9,000 and, another No 4, on 1st October 2003 for £ 7,200. The first two vans are sold, No 1 for £ 2,290 on 30th September 2004, and No 2 for scrap for £ 50 on 30th June 2005

Depreciation on the straight line basis, 20% per annum, ignoring scrap value in this particular case when calculating depreciation per annum.

Required;

Show the extract from the asset account, provision for depreciation account, disposal account, profit and loss account and income statement for the year ended December 2001, 2002, 2003, 2004 and 2005, and the balance sheet as at those dates.

Solution;

Vans			
2001	£	2001	£
Jan 1 Cash	<u>13,000</u>	Dec 31 Balanced c/d	<u>13,000</u>
2002		2002	
Jan 1 Balanced b/d	<u>13,000</u>	Dec 31 Balance c/d	<u>13,000</u>
2003		2003	
Jan 1 Balanced b/d	13,000	Dec 31 Balanced c/d	<u>29,000</u>
July 1 Cash	9,000		<u>29,200</u>
Oct 1 Cash	<u>7,200</u>	2004	
	29,000	Sep 30 Disposals	8,000
2004	<u>29,200</u>	Dec 31 Balanced c/d	<u>21,200</u>
Jan 1 Balanced b/d	29,200		<u>29,200</u>
	<u>29,200</u>	2005	
2005	<u>21,200</u>	June 30 Disposals	5,000
Jan 1 Balanced b/d	21,200	Dec 31 Balanced c/d	<u>16,200</u>
	<u>21,200</u>	Dec 31 Balanced c/d	<u>21,200</u>
2006			
Jan 1Balanced b/d	16,200		

Accumulated Provision for Depreciation: Van

	£		£
2001		2001	<u>2,600</u>
Dec 31 Balance C/D	<u>2,600</u>	Dec 31 Profit and loss	<u>2,600</u>
2002		2002	
		Jan 1 Balanced b/d	2,600
Dec 31 Balanced c/d	<u>5,200</u>	Dec 31 Profit and loss	<u>2,600</u>
	<u>5,200</u>		<u>5,200</u>
2003		2003	
		Jan 1 Balanced b/d	5,200
Dec 31 Balanced c/d	<u>9,060</u>	Dec 31 Profit and loss	<u>3,860</u>
	<u>9,060</u>		<u>9,060</u>
2004		2004	
Sep 30 Disposal	6,000	Jan 1 Balanced b/d	9,060
Dec 31 Balanced c/d	<u>8,500</u>	Dec 31 Profit and loss	<u>5,440</u>
	<u>14,500</u>		<u>14,500</u>
2005		2005	
June 30 Disposal	4,500	Jan 1 Balanced b/d	8,500
Dec 31 Balanced c/d	<u>7,740</u>	Dec 31 Profit and loss	<u>3,740</u>
	<u>12,240</u>		<u>12,240</u>
		2006	
		Jan 1 Balanced b/d	7,740

	£	£
Workings –Depreciation Provisions		
2001 20% of £13,000		2,600
2002 20% of £13,000		2,600
2003 20% of £13,000x 12 months	2,600	
20% of £ 9,000x 6 months	900	
20% of £7,200 x 3 months	<u>360</u>	
		3,860
2004 20% of £21,000 x12 months	4,240	
20% of £8,000 x 9 months	<u>1,200</u>	
		5,440
2005 20% of £16,200 x 12 months	3,240	
20% of £5,000 x 6 months	<u>500</u>	
		3,740

Workings –transfer of depreciation provisions to disposal accounts

Van 1	Bought Jan 1 Cost £8,000 Sold Sep 30 2004 Period of ownership 3¾ years Depreciation Provisions 3¾*20%*£8,000=£6,000
Van 2	Bought Jan 1 2001 Cost £5,000 Sold June 30 2005 Period of ownership 4½ years

Depreciation Provision $4\frac{1}{2} \times 20\% \times £5,000 = £4,500$

Disposals of Vans

		Disposals of Vans	
2004	£	2004	£
Sept 30 Van	8,000	Sept 30 Accumulated Provision	
Dec 31 Profit and loss	<u>290</u>	For depreciation	6,000
	<u>8,200</u>	Cash	<u>2,290</u>
			<u>8,290</u>
2005		2005	
June 30 Van	5,000	June 30 Accumulated Provision	
	—	For depreciation	4,500
		Cash	50
		Dec 31 Profit and loss	<u>450</u>
			<u>5,000</u>

Profit and loss (extracts)

		Profit and loss (extracts)	
		£	£
2001			
Dec 31 Acc provn for Depn: Vans	2,600		
2002			
Dec 31 Acc Provn for Depn: Vans	2,600		
2003			
Dec 31 Acc Provn for Depn: Vans	3,860		
2004 31 Acc Provn for Depn: Vans	5,440	2004	
		Dec 31 Disposal of vans (Gains)	290
2005			
Dec 31 Acc Provn for Depn: Vans	3,740		
Disposal of Vans (loss)	450		

Income statement (extract) for the year ending 31 December

	£	£
Gross profit (each year 2001, 2002, 2003,		***
Less expense		
2001 Provisions for Depreciation: vans	(2,600)	
2002 Provisions for Depreciation: vans	(2,600)	

2003 Provisions for Depreciation: vans	(3,860)
2004 Gross profit	* , ***
Add profit on van sold	<u>290</u>
 <i>Less expenses:</i>	
Provision for depreciation: vans	<u>5,440</u>
	* , ***
2005 Gross profit	* , ***
Less expenses:	
3,740	
Provision for depreciations: vans	<u>450</u>
Loss on van sold	(4,190)

Balance sheet extract as at 31 December

	£	£
2001 Vans at cost	13,000	
<i>Less accumulated depreciation</i>	(2,600)	10,400
2002 Vans at cost	13,000	
<i>Less accumulated depreciation</i>	(5,200)	7,200
2003 Vans at cost	29,200	
<i>Less accumulated depreciation</i>	(9,060)	20,140
2004 Vans at cost	21,200	
<i>Less accumulate depreciation</i>	(8,500)	12,700
2005 Vans at cost	16,200	
<i>Less accumulated depreciation</i>	(7,740)	8,460

ACCRUALS, PREPAYMENTS AND OTHER ADJUSTMENTS FOR FINANCIAL STATEMENTS

Adjustments needed

Let's look at two businesses which pay rent for building in Nairobi. The rent for each building is K£ 6,000 a year.

- Business A pays K£ 5,000 in the year. At the year end it owes K£1,000 for rent

Rent expense used up = K£6,000

Rent paid for = K£5,000

2. Business B pays K£6,500 in the year. This figure includes K£500 paid in advance for the following year.

Rent expense used up = K£6,000

Rent paid for = K£6,500

An income statement for 12 months need 12 months rent as an expense = K£6,000. This means that in both 1 and 2 the double entry accounts will have to be adjusted.

Accrued expenses

Assume that rent of £4,000 per year is payable at the end of every three months. The rent was paid on time in March, but this is not always the case.

Amount	Rent due	Rent paid
K£1,000	31 march 2008	31 March 2008
K£1,000	30 June 2008	2 July 2008
K£ 1,000	30 September 2008	4 October 2008
K£1,000	31 December 2008	5 January

Rent		
2008	K£	
Mar 31	Cash 1,000	
Jul 2	Cash 1,000	
Oct. 4	Cash 1,000	

The rent for the last quarter was paid on 5 January 2009 and so will appear in the books of the year 2009 as the result of a double entry made on that date.

The expense for 2008 is obviously K£4,000 as that is the year's rent, and this is the amount needed to be transferred to the profit and loss account. But, if K£4,000 was put on the credit side of the rent account (the debit being in the profit and loss account) the account would be out of balance by K£1,000 because the payment due on 31 December 2008 was not made until 5 January 2009. That is, if we posted K£4,000 to profit and loss on 31 December, we would have K£4,000 on the credit side of the account and only £3,000 on the debit side.

Rent			
2008	K£	2008	K£
Mar 31	Cash 1,000	Dec 31 Profit and loss	4,000
Jul 2	Cash 1,000		

Oct. 4 Cash 1,000

This cannot be right.

To make the account balance the K£ 1,000 rent owing for 2008, but paid in 2009, must be carried down to 2009 as a credit balance because it is a liability on 31 December 2008. Instead of rent owing it could be called rent accrued or just simply an 'accrual'

Rent			
2008	K£	2008	K£
Mar 31 Cash	1,000	Dec 31 Profit and loss	4,000
Jul 2 Cash	1,000		
Oct. 4 Cash	1,000		
Dec 31 Accrued c/d	<u>1,000</u>		
	<u>4,000</u>		<u>4,000</u>
		2008	
		Jan 1 Accrued b/d	

The balance c/d has been described as 'accrued c/d', rather than as 'balance c/d'. This is to explain what the balance is for. It is for an **accrued expense**.

Prepaid expenses

Insurance for a business is at the rate of £840 a year, starting from 1 January 2008. The business has agreed to pay this at the rate of £210 every three months. However, payments were not made at the correct times. Details were:

Amount	Insurance due	Insurance paid
£210	31 March 2008	£210 28 February 2008
£210	30 June 2008	£ 420 31 August 2008
£210	30 September 2008	
£210	31 December 2008	£420 18 November

The insurance account in the ledger for the year ended 31 December 2008 is:

Insurance			
2008	£	2008	£
Feb 28 Bank	210	Dec 31 Profit and loss	840
Aug. 31 Bank	420		
Nov 18 Bank	420		

Accruals and prepayments and other adjustments for financial statements

The last payment of £420 is not just for 2008. It can be split as £210 for the three months to December 2008 and £210 for the three months ended 31 March 2009. For a period of 12 months the cost of insurance is £840 and this is, therefore, the figure needing to be transferred to the income statement.

If £840 is posted to the debit of profit and loss at 31 December 2008, the insurance account will still have a debit balance of £210. This is a benefit paid for but not used up at the end of the period. It is an asset and needs carrying forwards as such to 2009, i.e. as a debit balance. Items like this are called **prepaid expense**, 'prepayments' or amounts paid in advance'

Insurance					
2008		£	2008		£
Feb 28	Bank	210	Dec 31	Profit and loss	840
Aug. 31	Bank	420			
Nov 18	Bank	<u>420</u>		31 Prepaid c/d	<u>210</u>
		<u>1,050</u>			<u>1,050</u>

Prepayment happens when items other than purchase are bought for use in the business, but are not fully used up in the period

For instance, packing materials are normally not entirely used up over the period in which they are bought. There is usually an inventory of packing materials in hand at the end of the period. This is a form of prepayment and needs carrying down to the period in which it will be used.

This can be seen in the following example:

Year ended 31 December 2008:

Packing materials bought in the year = £2,200

Inventory of packing materials in hand as at December 2008 = £ 400

Looking at the example, it can be seen that in 2008 the packing materials used up will have been £2,200 - £400 = £1,800. (We are assuming that there was no inventory of packing materials at the start of 2008). We have inventory of £400 packing materials at materials will be carried forward as an asset balance (i.e debit balance) to 2009

Packing materials					
2008		£	2008		£
Dec 31	Bank	2,200	Dec 31	Profit and Loss	1,800

	31 Inventory c/d <u>2,200</u>	<u>400</u>
2009		
Jan 1 Inventory b/d	400	

The inventory of packing materials is not added to the inventory of unsold goods in hand in the balance sheet, but it is added to the other prepaid expenses in the balance sheet

Revenue owing at the end of period

The revenue owing for sales is already shown in the books as the debit balances on customers' accounts, i.e. account receivable. There may be other kind of revenue, all of which has not been received by the end of the period, e.g. rent receivables. An example now follows.

Our warehouse is larger than we need. We rent part of it to another business for £1,800 per annum. Details for the year ended 31 December were as follows:

Amount	Rent due	Rent received
£450	31 March 2008	4 April 2008
£450	30 June 2008	6 July 2008
£450	30 September 2008	9 October 2008
£450	31 December 2008	7 January 2009

The rent receivables account entries for 2008 will appear as

Rent receivables		
	2008	£
	Apr 4 Bank	450
	Apr 6 Bank	450
	Oct 9 Bank	450

The rent received of £450 on 7 January 2009 will be entered in the accounting record in 2009. Any rent paid by the business would be charged as a debit to the profit and loss account. Any rent received, being the opposite, is transferred to the credit of the profit and loss account, as it is revenue.

The amount to be transferred for 2008 is that earned for the 12 months, i.e. £1,800. The rent received account is completed by carrying down the balance owing as a debit balance to 2009.

The £450 owing is an asset on 31 December 2008.

The rent receivables account can now be completed:

Rent receivable

	£		£
2008		2008	
Dec 31 profit and loss	1,800	Apr 4 Bank	450
		Jul 6 Bank	450
		Oct 9 Bank	450
		Dec 31 Accrued c/d	<u>450</u>
	<u>1,800</u>		<u>1,800</u>
2009			
Jan 1 Accrued / b d	450		

Expenses and revenue account balances and the balance sheet

In all cases dealing with the adjustments in the financial statements, there will still be a balance on each account after the preparation of the income statement. All such balances remaining should appear in the balance sheet. The only question left is where and how they should be shown.

The amount owing for expenses could be called expenses payable, expenses owing or accrued expenses. However, we'll use the term 'accruals'. They represent very current liabilities they will have to be paid in the very near future.

The items prepaid could be called prepaid expenses or payments in advance, but we'll call them 'prepayments'. Similarly to accruals, they represent very current assets as they should be received very soon.

Illustration 12;

Where different expenses are put together in one account, it can get even more confusing. Let us look at where rent and rates are joined together. Here are the details for the year ended 31 December 2008.

- a) Rent is payable of £6,000 per annum
- b) Rates of £4,000 per annum are payable by installments
- c) At 1 January 2008, rent of £1,000 had been prepaid in 2004
- d) On 1 January 2008, rates of £400 were owed
- e) During 2008, rent of £4,500 was paid
- f) During 2008, rates of £5,000 were paid.
- g) On 31 December 2008, rent of £500 was owing
- h) On 31 December 2008, rates of £600 had been prepaid.

A combined rent and rates account is to be drawn up for the year 2008 showing the transfer to profit and loss, and the balance to be carried down 2009.

Rent and Rates					
2008		£	2008		£
Jan 1 Rent prepaid b/d	(C)	1,000	Jan 1	Rates owing b/d (D)	400
Dec 31 Bank: rent	(E)	4500	Dec 31	Profit and loss (A) + (B)	10,000
31 Bank: rates	(F)	5,000		31 Rates prepaid c/ d (H)	600
31 Rent accrued	(G)	500			
		<u>11,000</u>			<u>11,000</u>
2009			2009		
Jan 1 Rates prepaid b/ d (H)		600	Jan 1 Rates prepaid b/ d (H)		500

To enter the correct figures, you need to keep the two items separate in your own mind. This is easiest if you produce a schedule like the one we produced above for packing materials inventory. The one rent would look like this:

£	£
Rent due during the year	6,000
<i>Less:</i>	
Rent prepaid at start of year	1,000
Rent paid during the year	<u>4,500</u>
Rent accrued at the end of the year	<u>(5,500)</u>
	<u>500</u>

Financial statements in the services sector

So far we have only looked at financial statements for businesses trading in some sort of goods. We drew up a trading account for some of these businesses because we wanted to identify the gross profit on goods sold.

There are, however, many businesses which do not deal in 'goods' but instead supply 'services'. This will include professional businesses such as accountant, solicitors, doctors, dentists, vets, management consultants, advertising agencies, estate agents and internet service providers. Other examples include businesses specializing in computer repairs, window cleaning, gardening, hairdressing, piano tuning, and banks, football clubs, health clubs, gyms and leisure centers. Since they do not deal in 'goods' there is no point in drawing up trading accounts. They will have income/revenue less deductions to arrive at gross

profit. The revenue will be from say, fees charged, commission earned etc. They will however prepare an income statement.

The income statements comparison

A quick glance at income statements: An income statement shows whether a company was profitable or not using accrual basis accounting. For a service firm, we use a single step income statement. For a merchandising firm, it gets a little more complicated. We use what's called a multi-step income statement. Here's a brief "skeleton format" for each type of company:

A Service Firm

ABC Service Company

Income Statement

For the year ended 12-31-XX

Revenues: xxxxxx

Expenses: xxxxxx

Net Income

A Merchandiser

XZY Store

Income Statement

For the year ended 12-31-XX

Net Sales xxxxx

less Cost of Goods Sold xxxx

Gross Profit

Less Operating Expenses

Net Income

Exercise 9

Mr. Muchai has been trading for some years as a wine merchant. The following list of balances has been extracted from his ledger as at 30 April 2007, the end of his most recent financial year.

	£
Capital	83,887
Sales	259,870
Trade account payable	19,840
Returns out	13,407
Allowances for doubtful debts	512
Discounts allowed	2,306
Discount received	1,750

Purchases	135,680
Returns inwards	5,624
Carriage outwards	4,562
Drawings	18,440
Carriage inwards	11,830
Rent, rates and insurance	25,973
Heating and lighting	11,010
Postage, stationery and telephone	2,410
Advertising	5,980
Salaries and wages	38,521
Bad debts	2,008
Cash in hand	534
Cash in bank	4,440
Inventory as at 1 may 2006	15,654
Trade accounts receivable	24,500
Fixtures and fittings- at cost	120,740
Provision for depreciation on fixtures and fittings – as at 30 April 2007	63,020
Depreciation	12,074

The following additional information as at 30 April 2007

The following additional information as at 30 April 2007 is available;

- i. Inventory at the close of business was valued at £17,750
- ii. Insurance have been prepaid by £ 1,120
- iii. Heating and lighting is accrued by £ 1,360
- iv. Rates have been prepaid by £ 5,435
- v. The allowance for doubtful debts is to be adjusted so that it is 3% of trade accounts receivable

Required:

Prepare Mr. Muchai's income statement for the year ending 30 April 2007 and a balance sheet as at that date.

Solution:

**MR.MUCHAI
INCOME STATEMENT FOR THE YEAR ENDING 30 APRIL 2007**

Sales (259,870 – 5,624)	254,246
<i>Less Cost of goods sold:</i>	
Inventory 1.5.2006	15,654
Purchases (135,60 – 13,407)	122,273
Carriage inwards	<u>11,830</u>
	149,757
Less Inventory 30.4.2007	<u>17,750</u>
Gross Profit	132,007
Discounts received	122,239
	<u>1,750</u>
	123,989
 Less Expenses	
Salaries and wages	38,521
Rent, rates and insurance (25,973 – 1,120 – 5,435)	19,418
Heating and lighting (11,010 + 1,360)	12,370
Carriage out	4,562
Advertising	5,980
Postage, stationery and telephone	2,410
Bad debts	2,008
Allowance for doubtful debts	223
Discounts allowed	2,306
Depreciation	<u>12,074</u>
Net Profit	99,879
	24,117
	=====

**MR.MUCHAI
BALANCE SHEET AS AT 30 APRIL 2007**

Non-current assets			
Fixtures and fittings at cost	120,740		
<i>Less Depreciation to date</i>	<u>63,020</u>		57,720
Current assets			
Inventory	17,750		
Accounts receivable	24,500		
Less Allowance for doubtful debts	<u>735</u>	23,765	
Prepaid expense	6,555		
Bank	4,440		
Cash	<u>534</u>	53,044	
		110,764	
Less Current Liabilities			
Accounts payable	19,840		
Expenses accrued	<u>1,360</u>	(21,200)	
Net assets	<u>89,564</u>		
		=====	
Financed by:			
Capital: Balance as at 1.5.2006	83,887		
<i>Add Net Profit</i>	<u>24,117</u>		
	108,004		
<i>Less Drawings</i>	<u>18,440</u>		
	<u>89,564</u>		
		=====	

BANK RECONCILIATION STATEMENTS

Completing entries in the cash book

In the books of a business, funds paid into and out of the bank are entered into the bank columns of the cash book. At the same time, the bank will also be recording the flows of funds into and out of the business bank account.

If all the items entered in the cash book were the same as those entered in the records held by the bank, the balance on the business bank account shown in the cash book and the balance on the account as shown by the records would be the same.

Unfortunately, it isn't usually that simple, particularly in the case of a current account. There may be items paid into or out of the business bank account which have not been recorded in the cash book. And there may be items entered in the cash book entries need to be compared to the record of the account held by the bank. Banks usually send a copy of that record, called a **bank statement**, to their customer on a regular basis, but a bank statement can be requested by a customer of the bank at ^{any} time.

Bank statement should always be checked against the cash book entries' (and you would be wise to do so yourself with your own bank account).

What might cause the two balances to be different?

Illustration 13

Cash book (bank columns only: before balancing on 31.12.2008)

2008		£	2008		£
Dec 1	Balance ✓	250	Dec 5	J Gordon ✓	65
20	P Thomas ✓	100	27	K Hughes ✓	175
28	D Jones ✓	190			

Bank statement

2008		Withdrawals	Deposits	Balance
		£	£	£
Dec 1	Balance b/d	✓		250
8	10625 ^(Note)	✓	65	185
21	Deposit	✓	100	285
28	Deposit	✓	190	475
29	10626	✓	175	300
30	Bank Giro credit: P Smith		70	370
31	Bank charges		50	320

Note: 10625 and 10626 refer to the serial numbers on the cheques paid out
 It is now clear that the two items now shown in our cash book are:

Bank Giro credit: P Smith	£ 70
Bank charges	£ 50

P Smith had paid £ 70 but, instead of sending a cheque, he paid the money by bank giro credit transfer direct into the business bank account. The business did not know of this until it received the bank statement.

The other item was in respect of bank charges. The bank has charged £ 50 for keeping the bank account and all the work connected with it. Instead of sending an invoice, the bank has simply taken the money out of the bank account.

As we have now identified the items missing from the cash book, we can now complete writing it up by entering the two items we have identified.

Cash book (bank column only: after balancing on 31.12.2008)

2008		£	2008		£
Dec	1 Balance b/d	250	Dec	5 J Gordon	65
	20 P Thomas	100		27 K Hughes	175
	28 D Jones	190		31 Bank charges	50
	30 P Smith	70		31 Balance c/d	320
		<u>610</u>			<u>610</u>
2009					
Jan	1 Balance b/d	320			

Where closing balances differ

Although a cash book may be kept up to date by a business, it obviously cannot alter the bank's own records. Even after writing up entries in the cash book, there may still be a difference between the cash book balance and the balance on the bank statement. Illustration 14 shows such a case.

Illustration 14; Cash book (after being completed to date)

2009		£	2009		£
Jan	1 Balance b/d	320	Jan	10 C Morgan	110
	16 R Lomas	160		20 M McCarthy	90
	24 V Verity	140		28 Cheshire CC rates	180
	31 J Soames	470		30 M Peck	200
	31 R Johnson	90		31 Balance c/d	<u>600</u>
<u>1,180</u>				<u>1,180</u>	
Feb	1 balance b/d	600			

		Bank Statement		
		Withdrawals	Deposits	Balance
2009		£	£	£
Jan	1 balance b/d			320
	12 10627	110		210
	16 Deposit		160	370
	29 10628	90		280
	24 Deposit		140	420
	28 Direct Debit: Cheshire CC	180		240
	31 bank Giro credit: R Johnson		90	330

*Identify which items are causing the two balances to be different even after the bank statement has been checked against the cash book and the necessary additional entries have been made in the cash book.
(Hint: there are two items involved)*

You can see that two items are in the cash book but are not shown on the bank statement. These are:

- i) A cheque had been paid to M Peck on January 30. He deposited it in his bank on January 31 but his bank didn't collect the money from the business's bank until February 2. This is known as an ***unpresented cheque***
- ii) Although a cheque for £ 470 was received from J Soames on January 31 and the business deposited it with the bank on that date, the bank did not receive the funds from Soames bank until February. This is known as a '***bank lodgement not yet credited***' to the business bank account.

The cash book balance on January 31 was £ 600, whereas the bank statement shows a balance of £330. To prove that although the balances are different they can be 'reconciled' (i.e made to agree) with each other; a ***bank reconciliation statement*** is prepared. It will either start with the bank statement balance and then reconcile it to the cash book balance, or it will start with the cash book balance and then reconcile it to the bank statement balance. If the second approach is adopted, it would appear as:

Bank reconciliation statement as at 31 December 2008

Balance as per cash book		£
Add unpresented cheque		600
	(i)	<u>200</u>
Less bank lodgment not on statement		800
Balance per bank statement	(ii)	<u>(470)</u> <u>330</u>

If the two balances cannot be reconciled then there will be an error somewhere. This will have to be located and then corrected

This reconciliation technique is also used when dealing with other statements drawn up outside the firm; for example, when reconciling purchase ledger accounts to suppliers' statement

An alternative approach to bank reconciliations

In order to avoid the confusion that may arise concerning what figure to include in the balance sheet, many accountants use a slightly different form of bank reconciliation. In this approach, you take the balance as shown on the bank statement and the balance in the cash book before making any adjustments that are identified when it is compared to the bank statement. You then reconcile each of them in turn to arrive at the balance that should appear in the balance sheet.

Having completed the reconciliation, you then update the cash book so that it balances at the correct amount, i.e. the amount that will be shown in the balance sheet. An example is shown in Illustration 15

Illustration 15

Cash book (bank columns only: before balancing on 31.12.2008)

2008		£	2008		£		
Dec	1 Balance b/d	✓	160	Dec	8 V O'Connor	✓	115
	12 D Tyrrell	✓	80		21 G Francis	✓	35
	23 P McCarthy	✓	130		31 D Barnes		25
	31 S Aisbitt		72				

Bank Statement

2008		Withdrawals	Deposits	Balance
Dec		£	£	£
	1 Balance b/d	✓		160
	11 24621	✓	115	45
	16 Deposit	✓		125
	23 24622	✓	35	90
	24 Deposit	✓		220
	28 Direct Girot: A Parkinson			24
	31 Bank charges		40	204

You can see that the following are missing from the cash book

- a) A bank Giro credit of £ 24 made on December 30 by A Parkinson
- b) Bank charges of £ 40

And you can see that the following are missing from the bank statement

- c) A cheque paid to D Barnes for £ 25 on December 31 has not yet been presented
- d) A bank lodgment has not yet been credited – the cheque for £72 received from S Aisbitt on 31 December

The bank reconciliation statement would be:

Bank reconciliation statement as at 31 December 2008

Balance as per cash book	£	
Add bank giro credit not yet entered	267	
	(a)	<u>24</u>
		291
Less bank lodgment not on balance sheet	(b)	(40)
Balance in balance sheet	251	
Add cheque not yet presented	(c)	25
		276
Less bank lodgment not on statement	(d)	(72)
Balance per bank statement		<u>204</u>

When you have adjustments to make to both the cash book and the bank account balance in order to reconcile them, this form of bank reconciliation statement is more useful than one that simply shows that you know why their balances are different.

An alternative approach that is often used in practice is to start with the balance as per the cash book and adjust it to arrive at the balance per the balance sheet (i.e. the same as the first half of the bank reconciliation statement shown above). You then have a second section that starts with the balance as per the bank statement and adjust it to once again arrive at the balance per the balance sheet. Either of these two approaches is perfectly acceptable and both provide the same information.

Other terms used in banking

Standing orders. A firm can instruct its bank to pay regular amounts of money at ~~start~~ dates to persons or firms. For instance, you may ask your bank to pay £ 200 a month to a building society to repay a mortgage.

Direct Debits. These are payments which have to be made, such as gas bills, electricity bills, telephone bills, rates and insurance premiums. Instead of asking the bank to pay the money, as with standing orders, you give permission to the creditor to obtain the money directly from your bank account. This is particularly useful if the amounts payable may vary from time to time, as it is the creditor who changes the

payments, not you. With standing orders, if the amount is ever to be changed, you have to inform the bank. With direct debits it is the creditor who informs the bank.

Just as with anything else omitted from the cash book, items of these types need to be included in the reconciliation and entered in the cash book before balancing it off at the end of the period.

BANK OVERDRAFTS

The adjustment needed to reconcile a bank overdraft according to the firm's books (shown by a credit balance in the cash book) with that shown in the bank's records are the same as those needed when the account is overdrawn.

Illustration 16 is of a cash book and a bank statement both showing an overdraft. Only the cheque for G Gumberbatch (A) £106 and the cheque paid to J Kelly (B) £63 need adjusting. Work through the reconciliation statement and then read the note after it. Because the balance shown by the cash book is correct (and, therefore, the balance that will appear in the balance sheet), you can use the form of bank reconciliation statement shown in Illustration 14

Illustration 16

Cash book

2008		£	2008		£
Dec	5 I Howe	308	Dec	1 Balance b/d	700
	24 L Mason	120		9 P Davies	140
	29 K King	124		27 J Kelly (B)	63
	31 G Cumberbatch 106			29 United Trust	77
	31 Balance c/d	<u>380</u>		31 Bank Charges	<u>49</u>
					<u>1,038</u>

Bank statement

2008		Dr £	Cr £	Balance £
Dec	1 Balance b/d			709 O/D
	5 Cheques		308	401 O/D
	14 P Davies	140		541 O/D
	24 Cheque		120	421 O/D
	29 K King: Credit transfer		124	297 O/D
	29 United Trust: Standing order	77		374 O/D
	31 Bank Charges	49		423 O/D

Bank reconciliation statement as at 31 December 2008

	£
Overdraft as per cash book	(380)
Add un presented cheque	<u>63</u>
	(317)
Less Bank lodgment not on bank statement	<u>(106)</u>
Overdraft per bank statement	<u>(423)</u>

Note: you may find it confusing looking at this bank reconciliation statement because the opening entry is an overdraft i.e a negative number. However, the adjusting entries are the same as those you make when it is positive

Balance / overdraft per cash book	xxxx
Adjustments	
Unpresented cheque	plus
Bank lodgement not on bank statement	<u>less</u>
Balance / overdraft per bank statement	<u>xxxx</u>

DISHONORED CHEQUES

When a cheque is received from a customer and paid into the bank, it is recorded on the debit side of the cash book. It is also shown on the bank statement as a deposit increasing the balance on the account. However, at later date it may be found that the customer's bank will not pay the amount due on the cheque. The customer's bank has failed to 'honor' the cheque. The cheque is described as a **dishonoured cheque**. There are several possible reasons for this. Imagine that K King paid a business with a cheque for Sh 5,000 on 20 May 2009. The business deposits it at the bank but, a few days later, the bank contacts the business and inform it that the cheque has been dishonoured.

Typical reasons are:

1. King had put Sh 5,000 in figures on the cheque, but had written it in words as 'five thousand five hundred Shillings'. A new cheque correctly completed will need to be provided by king.
2. Normally cheques are considered stale six months after the date on the cheque. In other words, bank will not honour cheque that are more than six months old. If king had put the year 2008 on the cheque instead of 2009, than King's bank would dishonor the cheque and king would need to be asked for a correctly dated replacement
3. King simply did not have sufficient funds in her bank account. Suppose she had previously a balance of only Sh 2,000 and yet she has made out a cheque of Sh 5,000. Her bank account has not allowed her an overdraft in order to honour the cheque. As a result, the cheque has been dishonoured.

The bank inform the business that this has happened and the business would have in contact King, explain what has happened and ask for valid payment of the account

In all of these cases, the bank would record the original entry in its records as being reversed. This is shown on the bank statement, for example, by the entry in its records as being reversed. This is shown on the bank statement, for example, by the entry ‘dishonoured cheque Sh 5,000’. The business then makes the equivalent credit in the cash book while, at the same time, debiting king’s account by the same amount. When king originally paid the Sh 5,000 the accounts in the ledger and cash book would have appeared as:

K. King

2009	Sh	2009	Sh
May 1 Balance b/d	<u>5,000</u>	may 20 Bank	<u>5,000</u>

Bank account

2009	Sh
May 20 K King	5,000

K King

2009	Sh	2009	Sh
May 1 Balance b/d	<u>5,000</u>	May 20 Bank	<u>5,000</u>
May 25 Bank cheque dishonoured	5,000		

Bank account

2009	Sh	2009	Sh
May 20 K King	5,000	May 25 K King: cheques dishonoured	5,000

EXERCISE:

Read the following and answer the questions below;

On 31 December 2008 the bank column of C Tench’s cash book showed a debit balance of £1,500. The monthly bank statement written up to 31 December 2008 showed a credit balance of £2,950.

On checking the cash book with the statement it was discovered that the following transaction had not been entered in the cash book:

Dividends of £ 240 had been paid directly to the bank

A credit transfer- HM revenue and customs VAT refund of £260- had been collected by the bank

Bank charge £30

A direct debit of £70 for the RAC subscription had been paid by the bank

A standing order of £ 200 for C Tench's loan repayment had been paid by the bank.

C Tench's deposit account balance of £1,400 was transferred into his bank current account

A further check revealed the following items:

Two cheque drawn in favor of T Cod £250 and F Haddock £290 had been entered in the cash book but had not been presented for payment.

Cash and cheque amounting to £690 had been paid into the bank on 31 December 2008 but were not credited by the bank until 2 January 2009.

- a) Starting with the debit balance of £1,500, bring the cash book (bank columns) up to date and then balance the bank account.
- b) Prepare a bank reconciliation statement as at 31 December 2008.

SOLUTION

		Cash Book (Bank Columns)			
		2008			
Dec	31 Balance b/d	1,500	Dec	31 Bank charges	30
	31 Dividends	240		31 RAC	70
	31 HM Revenue & Customs	260		31 Loan repayment	200
	31 Deposit account	<u>1,400</u>		31 Balance c/d	<u>3,100</u>
		3,400			3,400
		=====			=====

(b) Bank Reconciliation Statement as on 31 December 2008

Balance per cash book	3,100
Add Unpresented cheques (250 + 290)	<u>540</u>
	3,640
Less Banking not entered on statement	<u>690</u>
Balance per bank statement	2,950
	=====

CONTROL ACCOUNTS

A *control account* is a summary account within a financial general ledger that accumulates the details of an account in a subsidiary ledger — general ledgers track all of the financial transactions within a company.

The information managed in a subsidiary ledger is the detail supporting the information on the general ledger. Subsidiary ledgers are used to track a variety of items that accumulate on a general ledger, including accounts receivable, accounts payable, inventory, and revenue. In addition to transaction amounts, the subsidiary ledgers will often include names, locations, descriptions, and dates. Each of the subsidiary ledger items typically will have a control account on the general ledger.

OR

A control account is a summary account in the general ledger. The details that support the balance in the summary account are contained in a subsidiary ledger—a ledger outside of the general ledger.

The purpose of the control account is to keep the general ledger free of details, yet have the correct balance for the financial statements. For example, the Accounts Receivable account in the general ledger could be a control account. If it were a control account, the company would merely update the account with a few amounts, such as total collections for the day, total sales on account for the day, total returns and allowances for the day, etc.

The details on each customer and each transaction would not be recorded in the Accounts Receivable control account in the general ledger. Rather, these details of the accounts receivable activity will be in the Accounts Receivable Subsidiary Ledger. This works well because the employees working with the general ledger probably do not need to see the details for every sale or every collection transaction. However, the sales manager and the credit manager will need to know detailed information on individual customers, including whether a customer recently reduced their account balance. The company can provide these individuals with access to the Accounts Receivable Subsidiary Ledger and can keep the general ledger free of a tremendous amount of detail.

The benefits of accounting controls

In any but the smallest business, the accounting information system is set up so as to include controls that help ensure that errors are minimized and that nothing occurs that shouldn't, such as the cashier embezzling funds. One of the tasks undertaken by auditors is to check the various controls that are in place to ensure they are working satisfactorily and one of the things they will look out for is segregation of duties. So, for example, the same person will not both invoice customers and act as cashier when payment by someone else. Another form of control you've already learnt about involves whether or not customers are allowed to purchase goods on credit.

All these controls are ‘organizational’. That is, they do not directly impose control measure that does these things was covered in the previous topic- the process of bank reconciliation. In this topic, we’ll look at another type of accounting control which is used mainly in manual accounting systems, **control accounts**. When all the accounts were kept in one ledger a trial balance could be drawn up as a test of the arithmetical accuracy of the accounts. If the trial balance totals disagree, the books of a small business could easily and quickly be checked so as to find the errors. Of course, as you know even when the totals do agree, certain types of error may still have occurred, the nature of which makes it impossible for them to be detected in this way. Nevertheless, using a trial balance ensures that all the double entries appear, at least, to have been recorded correctly.

When a business has grown and the accounting work has been so divided up that there are several ledgers, nay errors could be very difficult to find if a trial balance was the only device used to try to detect errors. Every item in every ledger may need to be checked just to find one error that caused the trial balance not to balance. What is required is a type of trial balance for account that enables you to see at a glance whether the general ledger balance for each ledger and this requirement is met by control accounts. A control account is a summary account that enables you to see at a glance whether the general ledger balance for the ledger to which that control account belongs agrees with the total of all the individual accounts held within that ledger.

If you use control accounts, only the ledgers where the control accounts do not balance need detailed checking to find errors.

Principle of control accounts

The principle on which the control account is based is simple and is as follows: if the opening balance of an account is known, together with information of the additions and deductions entered in the account, the closing balance can be calculated.

Applying this to a complete ledger, the total of opening balances together with the additions and deductions during the period should give the total of closing balances. This can be illustrated by reference to a sales ledger from entries for a month

	£
Total of opening balances, 1 January 2006	3,000
Add total of entries which have increased the balances	<u>9,500</u>
	12,500
Less total of entries which have reduced the balances	<u>(8,000)</u>
Total of closing balances should be	<u>4,500</u>

Because totals are used, control accounts are sometimes known as 'total accounts'. Thus, control account for a sales ledger could be known as either a 'sales ledger control account' or as a 'total accounts receivable account'

Similarly, a control account for a purchases ledger could be known either as a 'purchases ledger control account' or as a 'total accounts payable account'

A control account is a memorandum account. It is not part of the double entry system. It will be prepared either in the general ledger or in the ledger to which it relates. i.e. the purchases ledger or the sales ledger.

A control account looks like any other T-account

Sales ledger Control

2006	£	2006	£
Jan 1 Balance b/d		xx	Jan 31 Returns inwards Day
31 sales day book (total) of sales invoiced in the period	xx,xxx		(total of all goods returned from debtors In the period)
	<hr/>		xxx
	xx,xxx	31 Cash book (total of all cash Received from debtors in the period)	x,xxx
		31 Balances c/d	<hr/> x,xxx
			xx,xxx

Information for control accounts

Illustration 17 and Illustration 18 list the sources of information used to draw up control accounts

Illustration 17

Sales ledger control	Source
1. Opening accounts receivable	List of debtor balance drawn up at the end of the previous period
2. Credit sales	Total from the sales Day book
3. Returns inwards	Total of the returns inwards Day book
4. Cheque received	Cash book: cash column on received side; list extracted or the total of a special column for cash which has been included in the cash book
5. Cash received	Cash book: cash column on received side; list extracted or the total of a special

	column for cash which has been included in he cash book
6. discounts allowed	Total of discounts allowed column in the cash book
7. closing accounts receivable	List of debtor balances drawn up at the end of the period

Illustration 18

Purchases ledger control	Source
1. opening accounts payable	List of creditor balances drawn up at the end of the previous period
2. Credit purchases	Total from purchases day book
3. returns outwards	Total of retruns outwards Day book
4. cheque paid	Cash book; bank column on payments side. List extracted or total of a special column for cheque which has been included in the cash book
5. cash paid	Cash book; cash column on payments side. List extracted or total of a special column for cash which has been included in the cash book
6. discounts received	Total of discounts received column in the cash book
7. closing accounts payable	List of creditor balances drawn up at the end of the period.

Form of control accounts

As shown in Illustration 18, control accounts kept in the general ledger are normally prepared in the same form as an account, with the totals of the debit entries in the ledger on the left-hand side of the control account, and the totals of the various credit entries in the ledger on the right-hand side.

The process is very straightforward. Take the sales ledger as an example.

1. Individual amount received from debtors are transferred from the cash book into the personal accounts in the sales ledger. (The double entry is completed automatically in the normal way, because the cash book is, in itself, a ledger account.)
2. Individual invoice amounts are transferred from the sales day book into the personal accounts in the sales ledger. (You would complete the double entry in the normal way, by crediting the sales account)
3. The sales ledger control account would open each period with the total of the accounts receivable balances at the start of the period
4. Then, post, the total of the returns inwards day book to the credit side of the sales ledger control account. (This is new)
5. At the end of the period, you post the totals of all the payments from debtors received during the period from the cash book to the credit side of the sales ledger control account. (this is new)
6. this is followed by posting to the debit side of the sales ledger control account the totals of all new sales during the period shown in the sales day book (This is new)
7. balance off the control account
8. Check whether the balance on the control account is equal to the total of all the accounts receivable balances in the sales ledger.

If the balance is not the same as the total of all the balance in the sales ledger, there is an error either in the totals entered in the control account from the books of original entry or, more likely, somewhere in the sales ledger.

Illustration 19 shows an example of a sales ledger control account for a sales ledger in which all the entries are arithmetically correct and the totals transferred from the books of original entry are correct;

Illustration 19

Sales ledger control account data	£
Accounts receivable balances on 1 January 2006	1,894
Total credit sales for the month	10,290
Cheques received from customers in the month	7,284
Cash received from customers in the month	1,236
Returns inwards from customers during the month	296
Accounts receivable balances on 31 January as extracted from the sales ledger	3,368

Sales ledger control

2006	£	2006	£
Jan 1 balances b/d	1,894	Jan 31 Bank	7,284
31 Sales	10,290	31 Cash	1,236
		31 Returns inwards	296
		31 Balances c/d	<u>3,368</u>
	<u>12,184</u>		<u>12,184</u>

We have proved the ledger to be arithmetically correct, because the control account balances with the amount equaling the total of the balance extracted from the sales ledger

Like a trial balance, if the totals of a control account are not equal and the entries made to it were correct (i.e the amounts transferred to it from the books of original entry have been correctly summed). This shows an example where an error is found to exist in a purchases ledger. The ledger will have to be checked in detail, the error found, and the control account then corrected.

Illustration 20

Purchases ledger control account data	£
Account payable balances on 1 January 2006	3,890
Cheques paid to suppliers during the month	3,620
Returns outwards to suppliers in the month	95
Bought from supplier in the month	4,936
Accounts payable balance on 31 January as extracted from the purchases ledger	5,151

Purchase ledger control

2006	£	2006	£
Jan 31 Bank	3,620	Jan 1 Balance b/d	3,890
31 returns outwards	95	31 purchases	4,936
31 balances c/d	5,151		
	<u>8,866</u>		<u>8,826</u>

We will have to check the purchases ledger in details to find the error. A double line has not yet been drawn under the total. We will do this (known as 'ruling off the account') when the error has been found and the totals corrected.

Other advantages of control accounts in a manual accounting system

Control accounts are usually only maintained in a manual accounting system. They are not normally maintained in a computerized accounting system.

Control accounts have merits other than that of locating errors. When used, control accounts are normally under the charge of a responsible official, and fraud is made more difficult because transfer made (in an effort) to disguise frauds will have to pass the scrutiny of this person.

The balances on the control account can always be taken to equal accounts receivable and accounts payable without waiting for an extraction of individual balances. Management control is thereby aided, for the speed at which information is obtained is one of the prerequisites of efficient control.

Illustration13 shows a worked example of a more complicated control account.

You will see that there are sometimes credit balances in the sales ledger as well as debit balances. Suppose for instance we sold £500 goods to W young, he then paid in full for them, and then afterwards he returned £40 goods to us. This would leave a credit balance of £ 40 on the account, whereas usually the balances in the sales ledger are debit balances.

Illustration13

2006	£
Aug 1 sales ledger – debit balances	3,816
1 Sales ledger – credit balances	
31 transactions for the month:	
Cash received	
Cheque received	
Sales	
Bad debts written off	
Discounts allowed	
Returns inwards	
Cash refunded to a customer who had overpaid his account	
Dishonorable cheques	
Interest charged by us on overdue debt	
At the end of the month	
Sales ledger – debit balances	

Sales ledger – credit balances

Sales ledger control account

2006	£	2006	£
Aug 1 balance b/d	3,816	Aug 1 balance b/d	22
31 sales	7,090	31 Cash	104
Cash refunded	37	bank	6239
Bank: dishonored cheque	29	bad debts	306
Interest on debts	50	discounts allowed	298
Balances c/d	40	returns inwards	664
	11,062	balances c/d	3,429

Note that you do not set off the debit and credit balances in the sales ledger