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## DEPARTMENT OF BUSINESS AND SOCIAL STUDIES

COURSE CODE: BAF1101

COURSE TITLE: FUNDAMENTAL OF ACCOUNTING 1

*Instructional Material for BBM- distance learning*

## COURSE CONTENT

## BAF1101: FUNDAMENTALS OF ACCOUNTING I

**Purpose:** To develop the learners understanding of the principles of book-keeping and accounts and the ability to maintain books of accounts and preparation of financial statements

**Course Objectives:** By the end of the course unit the student should be able to:-

- Compile accounting data
- Prepare financial statements
- Interpret accounting information
- Use accounting information in decision making.

**Course Content:**

- Introduction to Accounting- Purpose of accounting, basic principles; concepts and conversions underlying accounting reports, accounting equation, accounting terminology, users of financial statements and their information needs
- Double entry book:- keeping and books of original entry
- Distinction between and treatment of capital revenue and expenditure in accounts
- Types of ledgers and their uses
- Petty cash book:- Analysis petty cash book; imprest system
- Reconciliation of bank and cash balances
- Types of errors and their correction
- Control ledger accounts
- Provisions:-
- Preparation of final accounts:- Preparation of the trading, profits and loss accounts; balance Sheet

**Recommended Text Books:**

- Honrgren and Sundem, G. L, *Introduction to Financial Accounting,* (6th Edition), New York; Prentice Hall.
- Heinz and Party, college accounting, 18th edition.
- International accounting standards (IASs ) and International reporting standards (IFRs)
- KASNEB newsletters.
- The journal of accountants-ICPAK.
- Wood, Frank, *Business Accounting* (17th Edition), International Thompson.

Other support materials: Various applicable manuals and journals; variety of electronic information resources.

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# TOPIC ONE: INTRODUCTION TO ACCOUNTING

**Learning Objectives**

*Upon completion of this topic you should be able to:*

- Define the nature and purpose of accounting
- Explain the users of financial information and their needs
- Explain accounting concepts and conventions
- Explain qualities of useful accounting information

## 1.1 The Nature and Purpose of Accounting

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

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

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

The main *purpose* of Accounting is to provide financial information about an economic entity. It provides a means where the steward reports to the owner how the funds entrusted to him are used to enhance the wealth of the business.

*Business Transaction* is an event which involves the transfer of money or money's worth of financial events. The following summarises the business transaction that a firm might have:

- ♦ Acquisition of assets from owners and other creditors
- ♦ Investing resources in assets to produce goods or services
- ♦ Using resources to produce goods and services
- ♦ Selling goods or services of the firm
- ♦ Paying those to whom money is owned
- ♦ Returning assets to owners

*Difference between Book-Keeping and Accounting*

Book-keeping means the recording of transactions of a business in methodical manner so that information relating to them may be quickly obtained. It intends to be mechanical and repetitive.

Accounting includes the design of accounting system, preparation of financial statements, and development of budgets, cost studies, audits, income tax work, and computer applications to accounting processes and the analysis and interpretation of accounting information as an aid to making business decision.

*Types of Business Firms*

- Proprietorship—a business owned by one person
- Partnership—co-owned by two or more persons
- Limited Companies—owned by investors called stockholders (The business—not the owners—are responsible for the company's obligations.)

## 1.2 Users of Accounting Information

Accounting information is produced in form of financial statement. These financial statements provide information about an entity financial position, performance and changes in financial position.

Financial position of a firm is what the resources the business has and how much belongs to the owners and others.

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

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

The following are the users of accounting information:

i. *Owners:* They have invested in the business and examples of such owners include sole traders, partners (partnerships) and shareholders (company). They would like to have information on the financial performance, financial position and changes in financial position. This information will enable them to assess how the managers of the business are performing whether the business is profitable or not and whether to make drawings or put in additional capital.

ii. *Customers:* Customers rely on the business for goods and services. They would like to know how the business is performing and its financial position. This information would enable them to assess whether they can rely on the firm for future supplies.

iii. *Managers:* The managers are involved in the day-to-day activities of the business. They would like to have information on the financial position, performance and changes in financial position so as to determine whether the business is operating as per the plans. In case the plan is not achieved then the managers come up with appropriate measures (controls) to ensure that the set plans are met.

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

v. *Government and its agencies:* The Government is interested in the financial performance of the business to be able to assess the tax to be collected in the case there are any profits made by the business. The other government agencies are interested with the financial position and performance of the business to be able to come with National Statistics. This statistics measure the average performance of the economy.

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

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

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

viii. *Members of the Public:* Institutions and other welfare associations and groups represent the public. They are interested with the financial performance of the firm. This information will be important for them to assess how socially responsible is the firm. This responsibility is in form the employment opportunities the firm offers, charitable activities and the effect of firm’s activities on the environment.

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

## 1.3 Accounting Concepts and Conventions

*Concepts/conventions/principles*

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

i) *The going concern concept:* implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or to make drastic cutbacks to the scale of operations.
   Financial statements should be prepared under the going concern basis unless the entity is being (or is going to be) liquidated or if it has ceased (or is about to cease) trading. The directors of a company must also disclose any significant doubts about the company's future if and when they arise. The main significance of the going concern concept is that the assets of the business should not be valued at their 'break-up' value, which is the amount that they would sell for it they were sold off piecemeal and the business were thus broken up.

ii) *The accruals concept (or matching concept):* States that revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate.
   Assume that a firm makes a profit of Sh.100 by matching the revenue (Sh.200) earned from the sale of 20 units against the cost (Sh.100) of acquiring them.
   If, however, the firm had only sold eighteen units, it would have been incorrect to charge profit and loss account with the cost of twenty units; there is still two units in stock. If the firm intends to sell them later, it is likely to make a profit on the sale. Therefore, only the purchase cost of eighteen units (Sh.90) should be matched with the sales revenue, leaving a profit of Sh.90.
   If, however the firm had decided to give up selling units, then the going concern concept would no longer apply and the value of the two units in the statement of financial position would be a break-up valuation rather than cost. Similarly, if the two unsold units were now unlikely to be sold at more than their cost of Sh.5 each (say, because of damage or a fall in demand) then they should be recorded on the statement of financial position at their net realizable value (i.e. the likely eventual sales price less any expenses incurred to make them saleable, e.g. paint) rather than cost. This shows the application of the prudence concept.

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

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

iii) *The Prudence Concept:* The prudence concept states that where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business's financial position or results.

Therefore, revenue and profits are not anticipated but are recognized by inclusion in the profit and loss account only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty: provision is made for all liabilities (expenses and losses) whether the amount of these is known with certainty or is best estimate in the light of the information available.

Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities or losses.

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

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

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

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

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

iv) *Consistency concept:* The consistency concept states that in preparing accounts consistency should be observed in two respects.

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

v) *Business entity concept:* The concept is that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited company (and so recognized in law as a separate entity) or a sole proprietorship or partnership (in which case the business is not separately recognized by the law.

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

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

The monetary measurement concept introduces limitations to the subject matter of accounts. A business may have intangible assets such as the flair of a good manager or the loyalty of its workforce. These may be important enough to give it a clear superiority over an otherwise identical business, but because they cannot be evaluated in monetary terms they do not appear anywhere in the accounts.

vii) *Separate valuation principle:* The separate valuation principle states that, in determining the amount to be attributed to an asset or liability in the statement of financial position, each component item of the asset or liability must be determined separately.

These separate valuations must then be aggregated to arrive at the statement of financial position figure. For example, if a company's stock comprises 50 separate items, a valuation must (in theory) be arrived at for each item separately; the 50 figures must then be aggregated and the total is the stock figure which should appear in the statement of financial position.

viii) *Materiality concept:* An item is considered material if it's omission or misstatement will affect the decision making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts.

An error that is too trivial to affect anyone's understanding of the accounts is referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.

Determining whether or not an item is material is a very subjective exercise. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example to define material items as those with a value greater than 5% of the net profit disclosed by the accounts). But some items disclosed in accounts are regarded as particularly sensitive and even a very small misstatement of such an item would be regarded as a material error. An example in the accounts of a limited company might be the amount of remuneration paid to directors of the company.

The assessment of an item as material or immaterial may affect its treatment in the accounts. For example, the profit and loss account of a business will show the expenses incurred by he business grouped under suitable captions (heating and lighting expenses, rent and rates expenses etc); but in the case of very small expenses it may be appropriate to lump them together under a caption such as 'sundry expenses', because a more detailed breakdown would be inappropriate for such immaterial amounts.

*Example:*

a) If a statement of financial position shows fixed assets of Sh.2 million and stocks of Sh.30, 000 an error of Sh.20, 000 in the depreciation calculations might not be regarded as material, whereas an error of Sh.20, 000 in the stock valuation probably would be. In other words, the total of which the erroneous item forms part must be considered.

b) If a business has a bank loan of Sh.50,000 balance and a Sh.55,000 balance on bank deposit account, it might well be regarded as a material misstatement if these two amounts were displayed on the statement of financial position as 'cash at bank Sh.5,000'. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error.

ix) *Historical cost convention:* It's a basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that resources are normally stated in accounts at historical cost, i.e. at the amount that the business paid to acquire them. An important advantage of this procedure is that the objectivity of accounts is maximized: there is usually objective, documentary evidence to prove the amount paid to purchase an asset or pay an expense. Historical cost means transactions are recorded at the cost when they occurred.

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

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

xi) *Realization concept:* Revenue and profits are recognized when realized. The concept states that revenue and profits are not anticipated but are recognized by inclusion in the income statement only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty.

xii) *Duality:* Every transaction has two-fold effect in the accounts and is the basis of double entry bookkeeping.

*xiii) Substance over form:* It's the principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form e.g. a non current asset on hire purchase although is not legally owned by the enterprise until it is fully paid for, it is reflected in the accounts as an asset and depreciation provided for in the normal accounting way.

*Example*

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

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

    i) It becomes virtually certain that cash will eventually be received from the customer.
    ii) Cash is actually received.

Usually, revenue is 'recognized'

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

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

*Required*

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

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

*Answer*

(a) A sale must never be recognized before a customer has even ordered the goods. There is no certainty about the value of the sale, nor when it will take place, even if it is virtually certain that goods will be sold.

(b) A sale must never be recognized when the customer places an order. Even though the order will be for a specific quantity of goods at a specific price, it is not yet certain that the sale transaction will go through. The customer may cancel an order, the supplier might be unable to deliver the goods as ordered or it may be decided that the customer is not a good credit risk.

(c) A sale will be recognized when delivery of the goods is made only when:

i) The sale is for cash, and so the cash is received at the same time.
ii) The sale is on credit and the customer accepts delivery (e.g. by signing a delivery note).

(d) The critical event for a credit sale is usually the dispatch of an invoice to the customer. There is then a legally enforceable debt payable on specified terms, for a completed sale transaction.

(e) The critical event for a cash sale is when delivery takes place and when cash is received, both take place at the same time. It would be too cautious or 'prudent' to await cash payment for a credit sale transaction before recognizing the sale, unless the customer is a high credit risk and there is a serious doubt about his ability or intention to pay.

(f) It would again be over-cautious to wait for clearance of the customer's cheques before recognizing sales revenue. Such a precaution would only be justified in cases where there is a very high risk of the bank refusing to honour the cheque.

*Accounting Bases*

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

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

*Accounting Policies*

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

## 1.4 Qualities of useful Financial Information

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

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

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

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

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

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

## 1.5 Review Questions

Question One

Explain, with examples, each of the following terms:

- Fundamental accounting concepts
- Accounting bases
- Accounting policies

Question Two

Accounting practice depends upon the guidance provided by a number of accounting concepts, some of which are to be found in IAS 1 and/or in the conceptional framework of the International Accounting Standards Committee.
Required:

(a) Define and explain the relevance of the following accounting concepts.

- Neutrality
- Money measurement
- Accruals
- Substance over form
- Consistency (15 marks)

(b) Give two examples of situations in which there is a clash or inconsistency between two accounting concepts or conventions, and explain how the inconsistency should be resolved. (In answering this part of the question, you need not confine yourself to considering the concepts listed in part (a)) (5 marks)

Question Three

If the information in financial statements is to be useful, regard must be had to the following:

- Materiality
- Comparability
- Prudence
- Objectivity
- Relevance

*Required*

Explain the meaning of each of these factors as they apply to financial accounting including in your explanations one example of the application of each of them.

(4 marks for each)

Question Four

a) Explain what is meant by materiality in relation to financial statements and state two factors affecting the assessment of materiality. (4 marks)

b) Explain what makes information in financial statements relevant to use (5 marks)

c)

i) Two characteristics contributing to reliability are 'neutrality' and 'prudence'. Explain the meaning of these two terms.

ii) Explain how a possible conflict between them could arise and how that conflict should be resolved. (5 marks)

d) One of the requirements of financial statements is that they should be free from material error. Suggest three safeguards, which may exist, inside or outside a company to ensure that the financial statements are free from material error. (6 marks)

## 1.6 References


- Wood, Frank, *Business Accounting* (17th Edition), International Thompson. Pages 3-5, 82-93.

- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 6-12

# TOPIC TWO: RECORDING BUSINESS TRANSACTIONS

**Learning Objectives**

*Upon Completion of this topic you should be able to*:

- Define the meaning of double entry book-keeping system
- Define assets, capital and liabilities
- Prepare simple balance sheet
- Explain what is meant by` double entry`
- Explain the debit and credit principles
- Record assets capital and liabilities in accounts
- Extract the ledger balances into trail balances
- Identify the purpose of trail balances

## 2.1 Introduction

A business can be set up in two ways-

i) Owner supplying all the resources

ii) Owner supplying some of the resources and the rest being supplied by outside parties.

The two cases bring out the *accounting equation* also called book- keeping equation

*Case one: owner supplying all the resources*

In this case we say that-

Resources in the business = Resources supplied by the owner**…………… (i)**

Resources in business are called *assets* and resources supplied by the owner are called *capital*

Therefore equation (i) can be re -written as-

ASSETS = CAPITAL

*Case two: resources supplied by owner and outside parties*

In this case we say that-

Resources in business = Resources supplied by the owner + Resources supplied by out- side parties……………………………………………… (ii)

The new term in the equation is *resources supplied by out side parties*, in accounting, we call them *liabilities.*

Therefore equation (ii) can be re-written as-

ASSETS = CAPITAL + LIABILITIES…………………………………… **(ii)**

## 2.2 Components of accounting equations

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

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

Assets are classified into two main types:

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

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

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

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

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

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

Liabilities are also classified into two main classes.

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

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

Major examples:

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

*Capital:* This is the residual amount on the owner's interest in the firm after deducting liabilities from the assets.

The Accounting equation can be expressed in a simple report called the Statement of financial position (formerly, balance sheet). The basic format is as follows:

**Name**

**Statement of financial position as at 31.12.**

| | Sh | Sh | | Sh | Sh |
|---|---|---|---|---|---|
| Capital | | xx | **Non Current Assets** | | |
| | | | Land & Buildings | | xx |
| **Non Current Liabilities** | | | Plant & Machinery | | xx |
| Loan | | | Fixtures, furniture & fittings | | |
| xx | | | | | |
| | | | Motor vehicles | | xx |
| **Current liabilities** | | | | | xx |
| Overdraft | xx | | **Current Assets** | | |
| Creditors | xx | xx | Stocks | xx | |
| | | | Debtor's | xx | |
| Capital and Liabilities | | | Cash at bank | xx | |
| | | | Cash in hand | xx | xx |
| | | xx | Total assets | | xx |

The above format of the statement of financial position is the horizontal format however currently the practice is to present the Statement of financial position using the vertical format which is shown below.

**Name**

**Statement of financial position as at 31.12. 20xx**

| | Shs. | Shs. | Shs. |
|---|---|---|---|
| **Non Current Assets** | | **xx** | |
| Land & Buildings | | **xx** | |
| Plant & Machinery | | **xx** | |
| Fixtures, furniture & fittings | | **xx** | |
| Motors vehicles | | **xx** | **xx** |
| **Current Assets** | | | |
| Stocks/inventories | | **xx** | |
| Debtors/ trade receivables | | **xx** | |
| Cash at bank | | **xx** | |
| Cash in hand | | **xx** | |
| | | **xx** | |
| **Current Liabilities** | | | |
| Bank Overdraft | **xx** | | |
| Creditors/trade payables | **xx** | | |
| | **xx** | **xx** | |
| Net Current Assets | | | **xx** |
| Net assets | | | **xxx** |
| **Capital** | | | **xxx** |
| **Non current liabilities** | | | |
| Loan (from bank or other sources) | | | **xx** |
| **Total Capital & liabilities** | | | **xxx** |

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

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

Note that in the vertical format, current liabilities are deducted from current assets to give net current assets. This is added to Non Current assets, which give us net assets. Net assets should be the same as the total of Capital and Non Current Liabilities.

**Example 1.2**

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

You are required to calculate the amount of his capital.

*Solution*

| **Asset** | **Sh** | **Sh** |
|---|---|---|
| Motor Vehicle | | 3,000 |
| Premises | | 7,000 |
| Stock | | 2,000 |
| Cash at bank | | 600 |
| Cash in hand | | 300 |
| | | **12,900** |
| Liabilities | | |
| creditors | 800 | |
| Loan- D Evans | 4,000 | **(4,800)** |
| | | **8,100** |
| | | |
| Capital | | **8,100** |

Remember the Accounting equation:
Assets = Liabilities + Capital.

To get capital we rearrange the equation as follows:
Capital = Assets - Liabilities
Total Assets =Sh.12,900
Total Liabilities =Sh.4,800
Capital =Sh. 12,900 - 4,800
=Sh. 8,100

*Example 2.2*

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

| | Sh. |
|---|---|
| Creditors | 15,800 |
| Equipment | 46,000 |
| Motor Vehicle | 25,160 |
| Stock | 24,600 |
| Debtors | 23,080 |

| | |
|---|---|
| Cash at bank | 29,120 |
| Cash in hand | 160 |

During the first week of May 2002 Moody:

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

Required:

a. Determine the capital as at 1st May 2002.
b. Draw up a statement of financial position after the above transactions have been completed.

**Solution:**

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

| Assets | Sh. | Liabilities | Sh. |
|---|---|---|---|
| Equipment | 46,000 | Creditors | 15,800 |
| Motor Vehicle | 25,160 | | |
| Stock | 24,600 | | |
| Debtors | 23,080 | | |
| Cash at bank | 29,120 | | |
| Cash in hand | 160 | | |
| | 148,120 | | |

Capital = Assets – Liabilities
= Sh.148,120 - Sh.15,800 = Sh.132,320

(ii) To draw up the statement of financial position, we consider the effect of the above transactions on the relevant balances:

a. Buying extra equipment means that the equipment balance will increase by Sh.5,520 and the creditors will also increase by the same amount.
b. Buying extra stock by cheque means that the level of stock goes up by Sh.2,280 and the balance at bank reduces by the same.
c. Paying creditors by cheque reduces the balance on the creditors account and also reduce the amount at the bank.
d. Debtor paying the firm reduces the debtors balance by Sh.3,600 and increases the cash at bank and cash in hand by Sh.3,360 and Sh.240 respectively.
e. Additional cash of Sh.1,000 increases the cash in hand balance by Sh.1,000 and the capital balances.

This is also summarized as follows:

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

The statement of financial position will therefore be prepared as follows:

D Moody
Statement of financial position as at 7 May 2002

| **Non Current Assets** | **Sh** | **Sh** |
|---|---|---|
| Equipment | | 51,520 |
| Motor Vehicle | | 25,160 |
| | | 76,680 |
| | | |
| Current Assets | | |
| Stock | 26,880 | |
| Debtors | 19,480 | |
| Cash at Bank | 1,400 | |
| | 74,800 | |
| | | |
| Current Liabilities | | |
| Creditors | (18,160) | |
| NetCurrent Assets | | 56,640 |
| Net Assets | | 133,320 |
| Capital | | 133,320 |

## 2.3 Cause of Changes in Capital

The capital in a business does not remain intact but changes over time due to the following factors: additional investments, profits drawings or losses.

1) *Additional investments (I)*-occurs when the owner of the business brings in his personal cash or assets into the business for business use. Addition investment increase the capital of the business.

2) *Profits (P)* **-**defined as the excess revenue obtained after paying costs of a business increase the level of capital and assets of the business.

3) *Drawings (D)*-refer to the money or other assets taken from the business by the owner for personal use. Drawings reduce the of business capital**.**

4) *Losses ( l )*–occurs when the cost of goods or services are greater than their sale price .losses reduce the level of business capital.

## 2.4 Initial Capital and Final Capital of a Business

Initial capital refers to any funds and other assets invested into the business by the owner at the beginning of the trading period.

Final capital refers to the business capital at the end of the trading period. Thus, final capital is initial capital when it has been influenced by factors such as additional investment, profits, drawings and losses.

The formula for determining initial capital is represented as follows:

Initial capital =final capital – addition investment – net profits +drawings

i.e : I .C = F.C - I - P + D

*Example 3.2*

The following information was extracted from the books of Lima traders for the year ended 31st dec 2009.

a) Closing capital as at 31st /12/2009 -: sh 4000,000.
b) Made profit of -: sh .200,000.
c) The proprietor invested into the business from her personal use -: sh. 250,000.
d) The proprietor withdrew in cash for her personal use -:sh 60,000**.**

*Required*

Using initial capital formula, find the intial capital

*Solution*

I.C = F.C – I – P + D

I,C =sh 4000,000 – sh 250,000 –sh 200,000 +sh 60,000

I.C =sh 3,610,000.

## 2.5 Double Entry Aspects

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

**Name**

Debit Credit

| Date | Detail | Folio | Amount | Date | | Detail | Folio | Amount |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

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

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

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

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

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

When we make a debit entry we are either:

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

When we make a credit entry we are either:

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

*Example 4.2*
H Jumps has the following assets and liabilities as on 30 November 2002:
Creditors Sh.39,500; Equipment Sh.115,000; Motor vehicle Sh.62,900; Stock Sh.61,500; Debtors Sh.57,700;Cash at bank Sh.72,800 and Cash in hand Sh.400.

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

During the first week of December 2002, Jump:

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

You are to record the above transactions in respective accounts.

**Answer:**
Capital = Assets – Liabilities

| Assets | Sh. | Liabilities | Sh. |
|---|---|---|---|
| Equipment | 115,000 | Creditors | 39,500 |
| Motor vehicle | 62,900 | | |
| Stock | 61,500 | | |
| Debtors | 57,700 | | |
| Cash at bank | 72,800 | | |
| Cash in hand | 400 | | |
| | 371,300 | | |

Capital = Sh.371, 300 - Sh.39, 500 = Sh.330, 800

Creditors A/C
a/c

| 2002 | Sh.B | 2002 | Sh. |
|---|---|---|---|
| Bank | 7900 | 1.12 Bal b/d | 39,500 |
| 1.12 Bal c/d | 31,600 | | |
| | 39,500 | | 39,500 |

Motor Vehicles

| 2002 | Sh. | 2002 | Sh. |
|---|---|---|---|
| 1.12 Bal b/d | 62,900 | 1.12 Bal c/d | 62,900 |
| | 62,900 | | 62,900 |

Equipment a/c

| | | | |
|---|---|---|---|
| 2002 Sh. | | 2002 | Sh. |
| 1.12 Bal b\d | 115,000 | | |
| Creditors | 13,800 | 7.12 Bal c\d | |
| | | 128,800 | |
| 128,800 | | 128,800 | |

Stock a/c

| | | | |
|---|---|---|---|
| 2002 Sh. | | 2002 | Sh. |
| 1.12 Bal b\d | 61,500 | | |
| Bank | 5700 | 7.12 Bal c\d | 67,200 |
| 67,200 | | 67,200 | |

Debtors a/c

| | | | |
|---|---|---|---|
| 2002 Sh. | | 2002 | Sh. |
| 1.12 Bal b\d | 57,700 | Bank | 8,400 |
| | | Cash | 600 |
| Bank | 570 | 7.12 Bal c\d | 48,700 |
| 57,700 | | 57,700 | |

Cash at Bank a/c

| | | | |
|---|---|---|---|
| 2002 Sh. | | 2002 Sh. | |
| 1.12 Bal b\d | 72,800 | Stock | 5,700 |
| | | Creditors | 7,900 |
| Debtors | 8,400 | 7.12 Bal c\d | 67,600 |
| 81,200 | | 81,200 | |

Cash in hand a/c

| | | | |
|---|---|---|---|
| 2002 Sh. | | 2002 Sh. | |
| 1.12 Bal b\d 400 | | | |
| Debtors | 600 | | |
| Capital | 2500 | 7.12 Bal c\d | 3500 |
| 3500 | | 3500 | |

Capital

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| | | | 1.12 | Bal b\d | 330800 |
| 7.12 | Bal b\d | 333300 | | Cash | 2500 |
| | | 128,800 | | | 128,800 |

Creditors Of Equipment

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 7.12 | Bal b\d | 13800 | | Equipment | 13800 |
| | | 13,800 | | | 13,800 |

*Example 5.2*

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

| 2002 | | |
|---|---|---|
| June | 1 | Started business with Sh.50,000 in the bank. |
| " | 2 | Bought motor van paying by cheque Sh.12,000. |
| " | 5 | Bought Fixtures Sh.4,000 on credit from Office Masters Ltd. |
| " | 8 | Bought a van on credit from Motor Cars Ltd Sh.8,000. |
| " | 12 | Took Sh.1,000 out of the bank and put it into the cash till. |
| " | 15 | Bought Fixtures paying by cash Sh.600. |
| " | 19 | Paid Motor Cars Ltd by cheque Sh.8000. |
| " | 21 | A loan of Sh.10,000 cash is received from J Marcus. |
| " | 25 | Paid Sh.8,000 of the cash in hand into the bank account. |
| " | 30 | Bought more Fixtures paying by cheque Sh.3,000. |

Capital a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 30/6 | Bal c/f | 50,000 | 1/6 | Bank | 50,000 |
| | | 50,000 | | | 50,000 |

Cash at bank a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 1/6 | Capital | 50,000 | 2/6 | Van | 12,000 |
| 12/6 | Cash | 8,000 | 12/6 | Cash | 1,000 |
| | | | 19/6 | Motor ltd | 8,000 |
| | | | 30/6 | Fixtures | 3,000 |
| | | | 30/6 | Bal c/f | 34,000 |
| | | 58,000 | | | 58,000 |

Motor Van

| | | | | | |
|---|---|---|---|---|---|
| 2002 | | Sh. | Sh. | | |
| 2/6 | | Bank | | | |
| 12,000 | | | | | |
| 8/6 | Super | M | 30/6 | Bal | c/f |
| 8,000 | | | 20,000 | | |
| 20000 | | | 20000 | | |

Fixtures

| | | | |
|---|---|---|---|
| 2002 | Sh. | 2002 | Sh. |
| 5/6young | | | |
| 4,000 | | | |
| 15/6 | Cash | | |
| 600 | | | |
| 30/6 | Bank | Bal c/f | 7,600 |
| 3000 | | | |
| 7,600 | | 7,600 | |

Motor Car Ltd – Creditors

| | | | |
|---|---|---|---|
| 2002 | Sh. | 2002 | Sh. |
| 19/6 | Bank | 8/6 Van | 8000 |
| 8000 | | | |
| 8000 | | 8000 | |

Office Masters Ltd - Creditor

| | | | |
|---|---|---|---|
| 2002 | Sh. | 2002 | Sh. |
| 30/6 B\f | 4000 | 8/6 Fixtures | 4000 |
| 4000 | | 4000 | |

Cash in hand

| | | | |
|---|---|---|---|
| 2002 | Sh. | 2002 | Sh. |
| 12/6 | Cash | 15/6 | Cash |
| 1,000 | | 600 | |
| | | 25/6 Bank | 800 |
| 21/6 J. Marcus | 10000 | 30/6 Bal c/f | 2400 |
| 11000 | | 11000 | |

J. Marcus - Loaner

| | | | |
|---|---|---|---|
| 2002 | Sh. | 2002 | Sh. |
| 30/6 c\f | 10000 | 21/6 Cash | 10000 |

Note that the difference between the debit side and the credit side is the balancing figure. Most assets will have a balance on the credit side and most liabilities and capital accounts will have a balance on the debit side.

## 2.6 Accounting for Sales, Purchases, Incomes and Expenses.

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

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

For a credit sale:

i. Debit debtors/ Accounts receivable account.
ii. Credit sales account.

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

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

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

For credit purchases, we:

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

A new account is also opened for purchases where both cash and credit purchases are posted. *Note*: no entry is made into the stocks account.

*Incomes:*

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

- Rent
- Bank interest
- Discounts received.

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

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

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

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

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

- Postage and stationery
- Salaries and wages
- Telephone bills

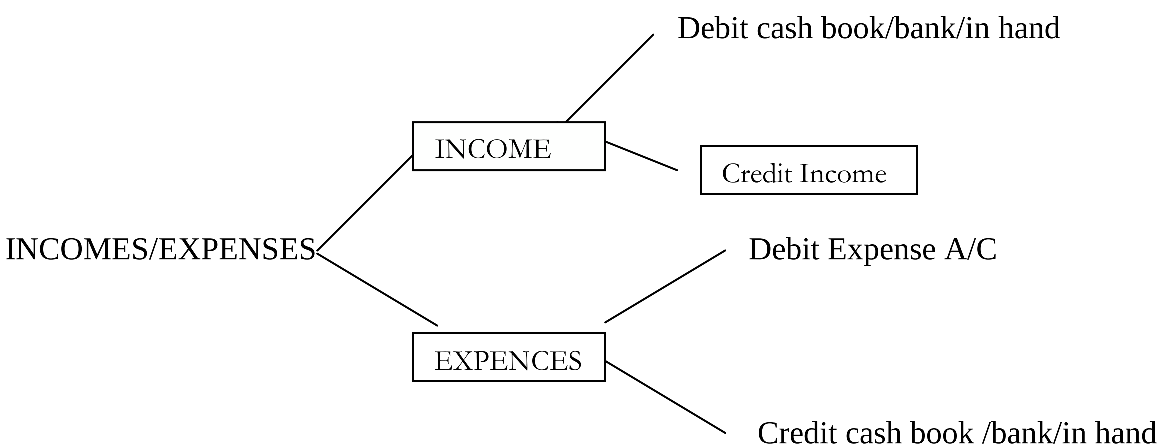
- Motor vehicle running expenses.
- Bank charges.

When a firm pays for an expense, we:

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

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

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




### 2.7 Returns Inwards and Returns Outwards.

*__Returns Inwards__:* These are goods that have been returned by customers due to various reasons e.g.

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

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

i. Debit returns – inwards
ii. Credit cashbook.

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

i. Debit returns inwards.
ii. Credit debtors.

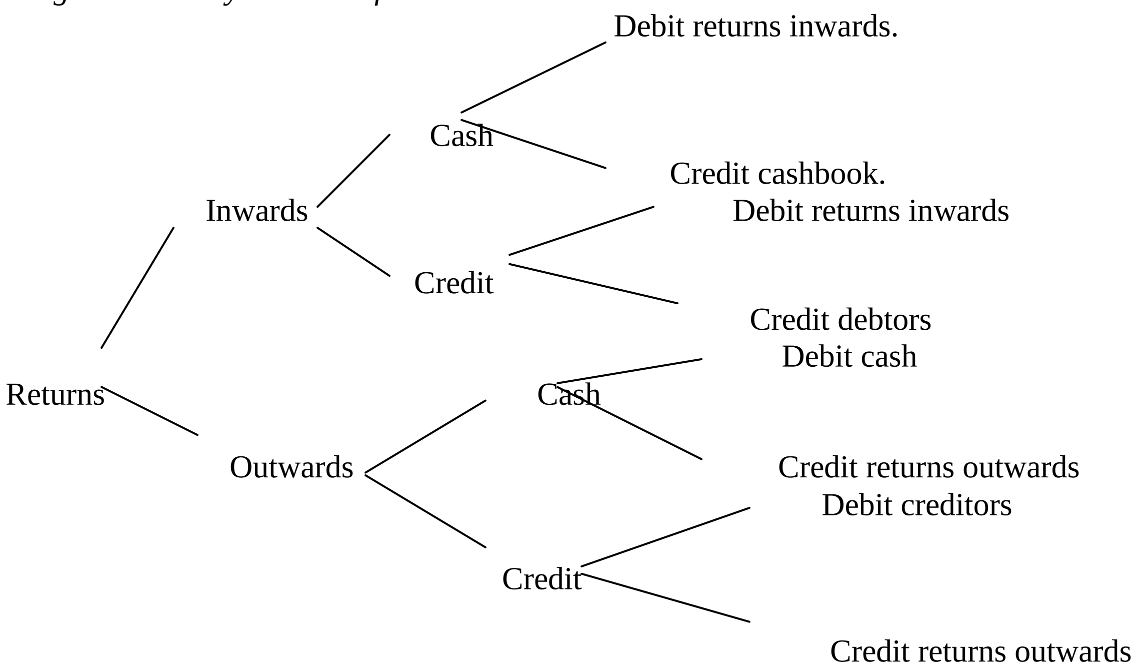
*Returns Outwards*: These are goods returned to suppliers/creditors. They may be for cash purchases or for credit purchases. For cash purchases a cash refund given to the firm by the supplier,

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

For credit purchases and no refund has been made:

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

*Diagrammatically shown as follows:*




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

*Example 6.2*

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

| | | |
|---|---|---|
| 2002 | | |
| May | 1 | Started business with Sh.2,000 in the bank. |
| " | 2 | Purchased goods Sh.175 on credit from M Rooks. |
| " | 3 | Bought furniture and fittings Sh.150 paying by cheque. |
| " | 5 | Sold goods for cash Sh.275. |
| " | 6 | Bought goods on credit Sh.114 from P Scot. |
| " | 10 | Paid rent by cash Sh.15. |
| " | 12 | Bought stationery Sh.27, paying in cash. |
| " | 18 | Goods returned to M Rooks Sh.23. |
| " | 21 | Let off part of the premises receiving rent by cheque Sh.5. |
| " | 23 | Sold goods on credit to U Foot for Sh.77. |
| " | 24 | Bought a motor van paying by cheque Sh.300. |

“ 30 Paid the month’s wages by cash Sh.117.
“ 31 The proprietor took cash for himself Sh.44.

*Solution*

Bank a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 1/5 | Capital | 2,000 | 3/5 | Furn& fitting | 150 |
| | | | 24/5 | Motor vehicle | 300 |
| 21/5 | Rent | 5 | 31/5 | Bal c/f | 1,555 |
| | | 2,005 | | | 2,005 |

Capital a/c

| | | | | | |
|---|---|---|---|---|---|
| 31/5 | Bal c/f | 2,000 | 1/5 | Bank | 2,000 |

Purchases a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 2/5 | M Rooks | 175 | | | |
| 6/5 | P Scot | 114 | 31/5 | Bal c/f | 289 |
| | | 289 | | | 289 |

Creditor – M Rooks a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 18/5 | Returns in | 23 | 2/5 | Purchases | 175 |
| 31/5 | Bal c/f | 152 | | | |
| | | 175 | | | 175 |

Furniture & Fittings a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 3/5 | Bank | 150 | 31/5 | Bal c/f | 150 |
| | | 150 | | | 150 |

Sales a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/f | 352 | 5/5 | Cash | 275 |
| | | | 23/5 | U. Foot | 77 |
| | | 352 | | | 352 |

Cash in hand a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 5/5 | Sales | 275 | 10/5 | Rent | 15 |
| | | | 12/5 | Stationery | 27 |
| | | | 30/5 | Wages | 117 |
| | | | 31/5 | Bal c/f | 116 |
| | | 275 | | | 275 |

P Scot a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/f | 114 | 6/5 | Purchases | 114 |
| | | 114 | | | 114 |

Expenses – Rent a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 1/5 | Bal c/f | 15 | 10/5 | Cash | 15 |

Expenses – Stationery a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 12/5 | Cash | 27 | 31/5 | Bal c/f | 27 |
| | | 27 | | | 27 |

Returns – Out a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/f | 23 | 18/5 | M Rooks | 23 |

Income – Rent a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 21/5 | Bal c/f | 5 | 31/5 | Bank | 5 |

Debtors – U Foot a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 23/5 | Sales | | 31/5 | Bal c/f | 77 |

Motor vehicle a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 24/5 | Bank | 300 | 31/5 | Bal c/f | 300 |

| Expenses – Wages a/c | | | | | |
|---|---|---|---|---|---|
| 2002 | | Sh. | 2002 | | Sh. |
| 30/5 | Cash | 117 | 31/5 | Bal c/f | 117 |

| Drawings a/c | | | | | |
|---|---|---|---|---|---|
| 2002 | | Sh. | 200 | | Sh. |
| 31/5 | Cash | 44 | 31/5 | Bal c/f | 44 |

## 2.8 Accounting for Drawings, Discounts Allowed and Discounts Received.

*Drawings* The owner makes drawings from the firm in various ways:

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

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

*iii) Personal expenses, paid by the business*
Here we debit the drawings and credit expense account

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

*Discounts*
*Discounts received*.
A discount received is an allowance by the creditors to the firm to encourage the firm to pay the amount dues within the agreed time. It is an amount deducted from the invoice price.
When a discount is given by the supplier then we debit creditor's account and credit discounts received e.g. A. Ltd sells some goods on credit to B Ltd.Sh.1,000 under the terms of sale, B Ltd, will receive a discount of 5% if they pay the amount due within one month. B decides to take up the offer and pays the amount within the given time. B will record the transaction as follows.

Debit: Creditor – A Ltd
Credit: Discounts Received

Creditor A. Ltd a/c

| 2002 | Sh. | 2002 | Sh. |
|---|---|---|---|
| Bank | 950 | Purchases | 1,000 |
| Disc received | 50 | | |
| | 1000 | | 1000 |

Purchases a/c

| 2002 | Sh. | 2002 | Sh. |
|---|---|---|---|
| A Ltd | 1,000 | | |

Discounts Received a/c

| 200 | Sh. | 2002 | Sh. |
|---|---|---|---|
| Bal c/f | 50 | A Ltd | 50 |

Bank a/c

| 2002 | Sh. | 2002 | Sh. |
|---|---|---|---|
| | | A Ltd | 950 |

*Discounts Allowed*

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

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

Debtors B Ltd a/c

| 2002 | Sh. | 2002 | Sh. |
|---|---|---|---|
| Sales | 1,000 | Bank | 950 |
| | | Discount | 50 |
| | 1,000 | | 1,000 |

Sales a/c

| 2002 | Sh. | 2002 | Sh. |
|---|---|---|---|
| | | Debtor | 1,000 |

Discount allowed a/c

| 2002 | sh. | 2002 | Sh. |
|---|---|---|---|
| Debtor | 50 | Bal c/f | 50 |

Bank a/c

| 2002 | Sh. | | Sh. |
|---|---|---|---|
| Debtor | 950 | | |

## 2.9 Trial Balance

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

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

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

**Na**me

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

From the trial balance please note that assets and expenses are on the debit side. Capital, liabilities and incomes are normally listed on the credit side.
The next example is a detailed one that shows extracting of trial balance once all the postings have been made in the relevant accounts.

*Example7.2*
Write up the following transactions in the books of S Pink:
2003

| | | |
|---|---|---|
| March | 1 | Started business with cash Sh.1,000. |
| " | 2 | Bought goods on credit from A Cliks Sh.296. |
| " | 3 | Paid rent by cash Sh.28. |
| " | 4 | Paid Sh.1,000 of the cash of the firm into a bank account. |
| " | 5 | Sold goods on credit to J Simpson Sh.54. |
| " | 7 | Bought stationery Sh.15 paying by cheque. |
| " | 11 | Cash sales Sh.49. |
| " | 14 | Goods returned by us to A Cliks Sh.17. |
| " | 17 | Sold goods on credit to P Lutz Sh.29. |
| " | 20 | Paid for repairs to the building by cash Sh.18. |

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

*Solutions*

Capital a/c

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| Sh. | | | | | |
| 31/3 | bal c/d | 1,500 | 1/3 | Cash | 1,500 |

Cash in hand a/c

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 1/3 | Capital | 1,500 | 3/3 | Rent | 28 |
| 1/3 | Sales | 49 | 4/3 | Bank | 1,000 |
| | | | 20/3 | Repairs | 18 |
| | | | 28/3 | Purchases | 125 |
| | | | 30/3 | Motor exp. | 15 |
| | | | 31/3 | Bal c/d | 363 |
| | | 1,549 | | | 1,549 |

Purchases a/c

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 2/3 | Hanson | 296 | 31/3 | Bal c/d | 421 |
| 28/3 | Cash | 125 | | | |
| Sh. | | | | | |
| | | 421 | | | 421 |

Creditors – A Cliks ac

| 2003 | | Sh. | 2003 | | |
|---|---|---|---|---|---|
| 14/3 | Returns out | 17 | 2/3 | Purchases | 296 |
| 27/3 | Bank | 279 | | | |
| | | 296 | | | 296 |

Rent –Expenses a/c

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 3/3 | Cash | 28 | 31/3 | Bal c/d | 28 |

Bank a/c

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 3 | Cash | 1,000 | 5/3 | Stationery | 15 |
| | | | 27/3 | A. Hanson | 279 |
| | | | 29/3 | Motor van | 395 |
| | | | 31/3 | Bal c/d | 311 |
| | | 1,000 | | | 1,000 |

Debtor – J Simpson a/c

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 3/3 | sales | 54 | 22/3 | Returns in | 14 |
| | | | 31/3 | Bal c/d | 40 |
| | | 54 | | | 54 |

Sales a/c

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2002 | | Sh. |
| 31/3 | Bal c/d | 132 | 5/3 | JSimpson | 54 |
| | | | 11/3 | Sales | 49 |
| | | | 17/3 | P Lutz | 29 |
| | | 132 | | | 132 |

Stationery a/c

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 7/3 | Bank | 15 | 31/3 | Bal c/d | 15 |

Returns outwards a/c

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| /3 | Bal c/d | 17 | 14/3 | A Cliks | 17 |

P Lutz – Debtor a

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 17/3 | Sales | 29 | 21/3 | Bal c/d | 29 |

Building repairs - expenses

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 20/3 | Cash | 18 | 31/3 | Bal c/d | 18 |

Returns - Inwards

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 22/3 | J Simpson | 14 | 31/3 | Bal c/d | 14 |

Motor vehicle

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 29/3 | Bank | 395 | 31/3 | Bal c/d | 395 |

R West – Creditor (others)

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | Sh. |
| 31/3 | Bal c/d | 120 | 31/3 | Fixtures | 120 |

Motor expenses

| | | | | | |
|---|---|---|---|---|---|
| 2003 | | Sh. | 2003 | | |
| 30/3 | Cash | 15 | 31/3 | Bal c/d | 15 |

Fixtures

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 31/3 | A. Webster | 120 | 31/3 | Bal c/d | 120 |

**Pinks**
**Trial Balance As At 31 March 2003**

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

*Example 8.2*
The following transactions took place during the month of May:

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

| | | |
|---|---|---|
| " | 18 | Bought goods on credit from P Combs Sh.43; Mobile Sh.110. |
| " | 21 | Sold goods on credit to B Long Sh.67. |
| " | 31 | Paid rent by cheque Sh.18. |

*Solution*

Capital

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/d | 250 | 1/5 | Cash | 250 |

Cash in Hand

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 1/5 | Capital | 250 | 6/5 | Rent | 12 |
| | | | 15/5 | Carriage | 23 |
| | | ___. | 31/5 | Bal c/d | 215 |
| | | 250 | | | 250 |

Creditor R Kelly

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 12/5 | Bank | 54 | 2/5 | Purchases | 54 |

Creditor P Combs

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/d | 130 | 2/5 | Purchases | 87 |
| | | ___. | 18/5 | Purchases | 43 |
| | | 130 | | | 130 |

Creditor – J Role

| 2003 | | Sh. | | | Sh. |
|---|---|---|---|---|---|
| 12/5 | Bank | 25 | 2/5 | Purchases | 25 |

Creditor – D Mobile

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/d | 186 | 2/5 | Purchases | 76 |
| | | ___. | 18/5 | Purchases | 110 |
| | | 186 | | | 186 |

Creditor I Sims

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/d | 64 | 2/5 | Purchases | 64 |

Debtor C. Blares

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 4/5 | Sales | 43 | 4/5 | Bank | 43 |

Debtor B Long

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 4/5 | Sales | 62 | 31/5 | Bal c/d | 129 |
| 21/5 | Sales | 67 | | | |
| | | 129 | | | 129 |

Debtor F Smith

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 4/5 | Sales | 176 | 10/5 | Bank | 150 |
| | | | 31/5 | Bal c/d | 26 |
| | | 176 | | | 176 |

Purchases

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

Sales

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 31/5 | Bal c/f | 348 | 4/5 | C Blanes | 43 |
| | | | 4/5 | F Long | 62 |
| | | | 4/5 | F Skin | 176 |
| | | | 4/5 | B Long | 67 |
| | | | | | 348 |

Bank

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 9/5 | C Blanes | 43 | 12/5 | J Role | 25 |
| 10/5 | H F Skin | 150 | 12/5 | R Kelly | 54 |
| | | | 31/5 | Rent | 18 |
| | | | 31/5 | Bal c/d | 96 |
| | | 193 | | | 193 |

Carriage Expenses

| 2003 | | Sh. | 2003 | | Sh. |
|---|---|---|---|---|---|
| 15/5 | Cash | 23 | 31/5 | Bal c/d | 23 |

Rent

| 19x6 | | Sh. | 19x | | Sh. |
|---|---|---|---|---|---|
| 6/5 | Cash | 12 | 31/5 | Bal c/d | 30 |
| 31/5 | Bank | 18 | | | |
| | | 30 | | | 30 |

Trial Balance as at 31/5/2003

| | **Debit** | **Credit** |
|---|---|---|
| Capital | - | 250 |
| Cash | 215 | - |
| Creditor-P Comb | - | 130 |
| Creditor – D Mobile | - | 186 |
| Creditor-L. Simms | - | 64 |
| Purchase | 459 | - |
| sales | - | 348 |
| Debtor- B. Long | 129 | - |
| Debtor-F Skin | 26 | - |
| Bank | 96 | - |
| Carriage | 23 | - |
| Rent | 30 | - |
| | **978** | **978** |

## 2.10 Review Questions

Questions One

C Kings has the following items in his statement of financial position as on 30 June 2002.
Capital Sh.41,800, Creditors Sh.3,200, Fixtures Sh.7,000, Motor Vehicles Sh.8,400, Stock of goods Sh.9,900, Debtors Sh.6,500, Cash at bank Sh.12,900 and Cash in hand Sh.240.

During the first week of July 2002:

a. He bought extra stock of goods Sh.1,540 on credit.
b. One of the debtors paid him Sh.560 in cash.

c. He bought extra fixture by cheque Sh.2,000.

You are to draw up a statement of financial position as on 7 July 2002 after the above transactions have been completed. (10 marks)

Question two

a) Explain the nature of accounting and the accounting equation (8 marks)
b) Calculate the profit for the year ended 31 December 2001 from the following information

(12 marks)

| | | |
|---|---|---|
| **Non Current Assets** | 01.01.2001 Sh. | 31.12.2001 Sh. |
| Property | 20,000.00 | 20,000.00 |
| Machinery | 6,000.00 | 9,000.00 |
| | 26,000.00 | 29,000.00 |
| **Current Assets:** | | |
| Debtors | | 8,000.00 |
| | 4,000.00 | |
| Cash | 1,000.00 | 1,500.00 |
| | 5,000.00 | 9,500.00 |
| **Current Liabilities:** | | |
| Creditors | 5,000.00 | 3,000.00 |
| Overdraft | 6,000.00 | 9,000.00 |
| | 11,000.00 | 12,000.00 |
| Net Current Liabilities | (6,000.00) | (2,500.00) |
| Net Assets | 20,000.00 | 26,500.00 |

Drawings during the year amounted to Sh.4,500.00

Question Two

Mary- shop centre, is small business owned by Mary.

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

a) Mary withdrew a total of Sh.10,000.00 in cash
b) Stock in trade was bought, all on credit, for Sh.34,000.00
c) Sales were made totaling 60,000.00 of stock in trade which had cost Sh.37,000.00. Of these sales Sh.51,000.00 were on credit and Sh.9,000.00 for cash.
d) A total of Sh.16,000.00 was drawn from the bank in cash to the cash till.

e) Electricity for the year paid by cheque totaled Sh.2,000.00
f) Rates for the year paid by cheque totaled Sh.1,000.00
g) Wages for the year all paid cash totaled Sh.10,000.00
h) Sundry expenses all paid in cash totaled Sh.2,000.00
i) Creditors were paid a total of Sh.36,000.00 all by cheque
j) Debtors paid a total of Sh.54,000.00 all in cheques.
k) The bank charged interest on the loan deducting Sh.3,000.00.

Required:

Enter the above transactions in appropriate accounts. (20 marks)

Question Three

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

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

**Required:** Prepare a trial balance, from the above li t of balances.

## 2.11 References


- Wood, Frank, *Business Accounting* (17th Edition), International Thompson. Pages 5-14,15-52.

- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 6-12, 44-45
- Heinz and Party,*College Accounting*, (18th Edition).pages 6-12.

## TOPIC 3: SOURCE DOCUMENTS AND BOOKS OF ORGINAL ENTRY

**Learning Objectives:**

*Upon completion of this chapter you will be able to*

- Identify the main data sources and records in an accounting system
- Describe the content and purpose of different types of business documentation
- Record transactions using the day books
- Post day books totals to the ledgers accounts
- Explain division of the ledger accounts

### 3.1 Definition and Purpose

A book of original entry is a book of record in which transactions are recorded as they occur on a daily basis and in a chronological order, before they are posted to the relevant accounts in the ledger. These books are also known as books of prime entry as transactions are first recorded in them before they are posted to the accounts in the ledger.

Information from source documents is first recorded in such books before being posted to the ledger. These books act as aid to the ledger in respect of certain transactions which cannot be posted directly to the ledger. They are minor or subsidiary to the ledger which remains the main book of account.

### 3.2 Source Documents

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

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

*(i) Sales Invoice*

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

The sales invoice contains the following:

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

vii. Terms of sale

*(ii) Purchases Invoice*

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

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

*(iii) Credit note*

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

i. Name and address of the firm
ii. Name and address of the debtor
iii. Amount of credit
iv. Credit note number
v. Reason for credit e.g. if goods sent but of the wrong type.

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

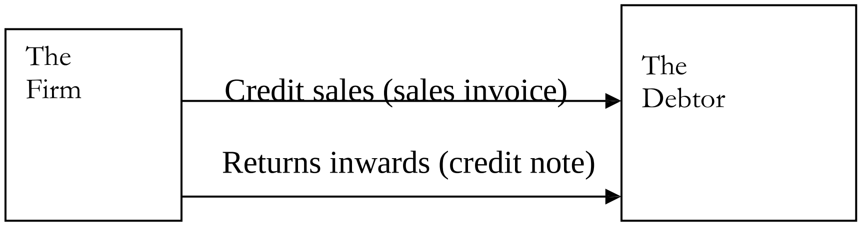
The credit note may also be issued when the firm gives an allowance of the amounts due from the debtors. From the context we can assume that all credit notes are issued when goods are returned.

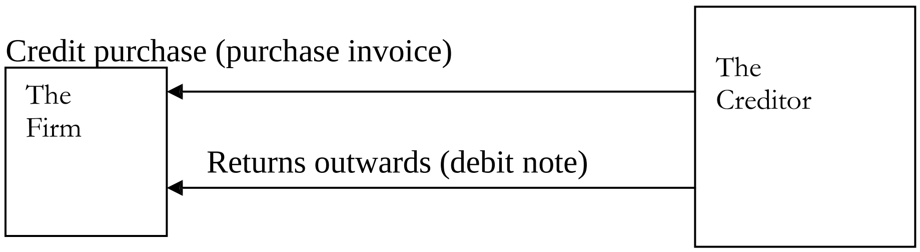
*(iv) Debit note*

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

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

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






*(vi) Receipts*

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

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

*Cheques*

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

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

*Petty cash vouchers*

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

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

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

*(vii) Other correspondence*

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

Examples are:

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

### 3.3 Books of Prime Entry

They record the source documents.

*Sales Journal*

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

| Sales Journal | | | Page 5 |
|---|---|---|---|
| Date 19x 8 | Detail | Folio | Amount Sh. |
| 1st March | S.Spikes | SL.10 | 200 |
| 3rd March | T.Binns | SL.19 | 350.00 |
| 5th March | L.Thompson | SL.8 | 150.00 |
| Total | | | 700.00 |

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

This is shown below:

**Sales Ledger** **General Ledger**

S Spikes

| 19x8 | | Sh. | 19x8 | Sh. |
|---|---|---|---|---|
| 1/3 | Sales | 200 | | |

General Account

| 19x8 | Sh. | 19x8 | | Sh. |
|---|---|---|---|---|
| | | 5/3 | Credit sales for period | 700 |

**Sales Ledger**

T Binus

| 19x8 | | Sh. | 19x8 |
|---|---|---|---|
| 3/3 | Sales | 350 | |

L Thompson

| 19x8 | | Sh. | 19x8 | Sh. |
|---|---|---|---|---|
| 3/3 | Sales | 150 | | |

*Example 1.3*

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

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

*Answer*

| Sales Journal | | | Page 10 |
|---|---|---|---|
| Date (2003) | Detail | Folio | Amount |
| 1st March | J. Gordon | | 1,870.00 |
| 3rd March | G.Abrahams | | 1,6660.00 |
| 6th March | V.White | | 120.00 |
| 10th March | J. Gordon | | 550.00 |
| 17th March | F.Williams | | 2,890.00 |
| 19 March | U. Richards | | 660.00 |
| 27th March | V.Wood | | 280.00 |
| 31st March | L.Simes | | 780.00 |
| | | | 8,810.00 |

*Sales Ledger*

**J Gordon**

| **2003** | | **Sh.** | **2003** | **Sh.** |
|---|---|---|---|---|
| 1/3 | | 1570 | | |
| 10/3 | | 550 | | |

**U Richards**

| **2003** | | **Sh.** | **2003** | **Sh.** |
|---|---|---|---|---|
| 19/3 | Sales | 660 | | |

**G Abrahams**

| 2003 | | Sh. | 2003 | Sh. |
|---|---|---|---|---|
| 3/3 | Sales | 1,660 | | |

**V Wood**

| 2003 | | Sh. | 2003 | Sh. |
|---|---|---|---|---|
| 27/3 | Sales | 280 | | |

**U White**

| 2003 | | Sh. | 2003 | Sh. |
|---|---|---|---|---|
| 6/3 | Sales | 120 | | |

**L Simes**

| 2003 | | Sh. | 2003 | Sh. |
|---|---|---|---|---|
| 31/3 | Sales | 750 | | |

F Williams

| 2003 | | Sh. | 2003 | Sh. |
|---|---|---|---|---|
| 17/3 | Sales | 2890 | | |

Sales a/c

| 2003 | Sh. | 2003 | | Sh. |
|---|---|---|---|---|
| | | | Credit Sales | |

*Purchases Journal*

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

| **Purchase Journal** | | | **Page 15** |
|---|---|---|---|
| DATE 19x 6 | Description/Detail | Folio | Amount |
| 1st May | C.Kelly | PL.10 | 400 |
| 2nd May | L.Smailes | PL.20 | 350 |
| Total | | | 750 |

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

C Kelly

| 19x6 | Sh. | 19x6 | | Sh. |
|---|---|---|---|---|
| | | 1/5 | Purchases | 400 |

Purchases a/c

| 19x6 | | Sh. | 19x6 | Sh. |
|---|---|---|---|---|
| 31/5 | Sundry Creditors | 750 | | |

L Smailes

| 19x6 | Sh. | 19x6 | | Sh. |
|---|---|---|---|---|
| | | 2/5 | Purchases | 250 |

*Returns Inwards Journal*

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

| Returns Inwards Journal | | Page 10 | |
|---|---|---|---|
| Date | Detail | Folio | Amount Sh.) |
| 1st March | S.Spikes | SL.22 | 20 |
| 2nd March | C.Kelly | SL.18 | 18 |
| 5th March | T.Bills | SL.9 | 15 |
| Total | | | 15 |

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

**Sales Ledger** **General Ledger**

S. Spikes a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| | | | 1/3 | Returns In | 20 |

Returns Inwards a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| 31/3 | Sundry Debtors | 53 | | | |

C Kelly a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| | | | 2/3 | Returns In | 18 |

T. Bills a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| | | | 5/3 | Returns In | 15 |

*Returns Outwards Journal*

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

| Returns outwards journal | | | |
|---|---|---|---|
| Date | Detail | Folio | Ampunt(Sh) |
| 2nd May | L.Thompson | PL.15 | 14 |
| 3rd May | M.Hyatt | PL.10 | 12 |
| 4th May | T.Bills | PL.7 | 19 |
| Total | | | 35 |

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

**Purchases Ledger** **General Ledger**

L. Thompson a/c

| | | | | | |
|---|---|---|---|---|---|
| ` | | Sh. | | | Sh. |
| 2/5 | Returns out | 14 | | | |

Returns Outwards a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| | | | 31/5 | sundry creditors | 35 |

M. Hyatt a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| 3/5 | Returns out | 12 | | | |

T. Bills a/c

| | | | | | |
|---|---|---|---|---|---|
| | | Sh. | | | Sh. |
| 4/5 | Returns Out | 19 | | | |

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

*Example 2.3*

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

19x5

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

Study the solution provided:

| Sales Journal | | |
|---|---|---|
| Date | Detail | Amount(Sh) |
| 3rd July | E.Rigby | 510 |
| 3rd July | E.Phillips | 246 |
| 3rd July | F.Thomspson | 356 |
| 8th July | A.Green | 307 |

| | | |
|---|---|---|
| 8th July | H.George | 250 |
| 8 July | J.Ferguson | 185 |
| 20th July | E.Phillips | 188 |
| 20th July | F.Powell | 310 |
| 20th July | E.Lee | 420 |
| Total | | 2,772 |

**Sales Ledger**

E Rigby

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 3/7 | Sales | 510 | 3/7 | Returns Inwards | 30 |

E Phillips

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 3/7 | Sales | 246 | 14/7 | Returns | 18 |
| 20/7 | Sales | 188 | 31/7 | Retuns in | 27 |

F. Thompson

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 3/7 | Sales | 356 | 14/7 | Returns in | 22 |

J. Ferguson

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 8/7 | Sales | 185 | | | |

Green

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 8/7 | Sales | 307 | | | |

F. Powell

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 20/7 | Sales | 310 | | | |

H George

| 19x5 | | | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 8/7 | Sales | 250 | | | |

E Lee

| 19x5 | | Sh. | 19x5 | | Sh. |
|---|---|---|---|---|---|
| 20/7 | Sales | 420 | | | |

| Purchase Journal | | |
|---|---|---|
| Date | Detail | Amount(Sh) |
| 1st July | K.Hill | 380 |
| 1st July | M.Normarn | 500 |
| 1st July | N.Senior | 106 |
| 5th July | R.Mortan | 200 |
| 5th July | J.Cook | 180 |
| 5th July | D.Edwards | 410 |
| 5th July | C.Davies | 66 |

| | | |
|---|---|---|
| 24th July | C.Ferguson | 550 |
| 24th July | K.Ennevor | 900 |
| Total | | 3,292 |

**Purchases Ledger**

N. Senior

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| 12/7 | Returns out | 16 | 1/7 | Purchases | 22 |

M. Norman

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| 30/7 | Returns out | 30 | 1/7 | Purchases | 500 |

J. Cook

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| 31/7 | Returns out | 13 | 5/7 | Purchases | 180 |

C. Davies

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| 31/7 | Returns out | 11 | 5/7 | Purchases | 60 |

K. Hill

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| | | | 1/7 | Purchases | 380 |

R. Morton

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| | | | 5/7 | Purchases | 200 |

D. Edwards

| 1995 | 1995 |
|---|---|

| | | | |
|---|---|---|---|
| | Sh. | | Sh. |
| | | 5/7 Purchases | 410 |

C. Ferguson

| | | | |
|---|---|---|---|
| 1995 | Sh. | 1995 | Sh. |
| | | 27/7 Purchases | 550 |

K. Ennevor

| | | | |
|---|---|---|---|
| 1995 | Sh. | 1995 | Sh. |
| | | 24/7 Purchases | 900 |

| Returns Inwards Journal | | |
|---|---|---|
| Date | Details | Amount |
| 14 July | E. Phillips | 18 |
| 14 July | F. Thompson | 22 |
| 31 July | E. Phillips | 27 |
| 31 July | E. Rigby | 30 |
| | | 97 |

| Returns Outwards Journal | | |
|---|---|---|
| 12 July | M. Norman | 30 |
| 12 July | N. Senior | 16 |
| 31 July | J. Cook | 13 |
| 31 July | C. Davies | 11 |
| | | 70 |

**General Ledger**

Sales a/c

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| | | | 31/7 | Sundry debtors | 2772 |

Purchases a/c

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| 31/7 | Sundry creditors | 3292 | | | |

Returns Inwards a/c

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| 31/7 | Sundry debtors | 97 | | | |

Returns Outwards a/c

| 1995 | | Sh. | 1995 | | Sh. |
|---|---|---|---|---|---|
| | | | 31/7 | Sundry creditors | 70 |

## 3.5 Cash Books

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

There are two types of cashbooks:

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

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

*Two-column cashbook.*

CASH BOOK

| Date | Details | Cash (Sh) | Bank (Sh) | | Date | Details | Cash (Sh) | Bank (Sh) |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |

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

| Date | Details | Discount Allowed | Cash (Sh) | Bank (Sh) | | Date | Discount Receive | Details | Cash (Sh) | Bank (Sh) |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |
| | | | | | | | | | | |
| | | | | | | | | | | |
| | | | | | | | | | | |

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

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

*Example 3.3*

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

2003

| | | |
|---|---|---|
| May | 1 | Started business with capital in cash Sh.1,000. |
| “ | 2 | Paid rent by cash Sh.100. |
| “ | 3 | F Lake lent us Sh.5,000, paid by cheque. |
| “ | 4 | We paid B McKenzie by cheque Sh.650. |
| “ | 5 | Cash sales Sh.980. |
| “ | 7 | N Miller paid us by cheque Sh.620. |
| “ | 9 | We paid B Burton in cash Sh.220. |
| “ | 11 | Cash sales paid direct into the bank Sh.530. |
| “ | 15 | G Moores paid us in cash Sh.650. |

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

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

**Example 4.3**
A three-column cashbook is to be written up from the following details, balanced off, and the relevant discount accounts in the general ledger shown.

19x8
Mar 1 Balances brought forward: Cash Sh.230; Bank Sh.4,756.
“ 2 The following paid their accounts by cheque, in each case deducting 5 percent discounts: R Burton Sh.140; E Taylor Sh.220; R Harris Sh.800.
“ 4 Paid rent by cheque Sh.120.
“ 6 J Cotton lent us Sh.1,000 paying by cheque.
“ 8 We paid the following accounts by cheque in each case deducting a 2 ½ per cent cash discount: N Black Sh.360; P Towers Sh.480; C Rowse Sh.300.
“ 10 Paid motor expenses in cash Sh.44.
“ 12 H Hankins pays his account of Sh.77, by cheque Sh.74, deducting Sh.3 cash discount.
“ 15 Paid wages in cash Sh.160.
“ 18 The following paid their accounts by cheque, in each case deducting 5 per cent cash discount: C Winston Sh.260; R Wilson & Son Sh.340; H Winter Sh.460.
“ 21 Cash withdrawn from the bank Sh.350 for business use.
“ 24 Cash Drawings Sh.120.

“ 25 Paid T Briers his account of Sh.140, by cash Sh.133, having deducted Sh.7 cash discount.
“ 29 Bought fixtures paying by cheque Sh.650.
“ 31 Received commission by cheque Sh.88.

**solution**

**Cash Book**

| | Disct | Cash | Bank | | Disct | Cash | Bank |
|---|---|---|---|---|---|---|---|
| Bank | | | | | | | |
| Bal b/d | | 230 | 4756 | Rent | | | 120 |
| R Burton | 7 | | 133 | N Black | 9 | | 351 |
| E Taylor | 11 | | 209 | P Towers | 12 | | 468 |
| R Harris | 15 | | 285 | C Rowse | 20 | | 780 |
| J Cotton: loan | | | 1000 | Motor expenses | | 44 | |
| H Hankins | 3 | | 74 | Wages | 160 | | |
| C Winston | 13 | | 247 | Cash | | | 350 |
| R Wison & Son | 17 | | 323 | Drawings | | 120 | |
| H Winter | 23 | | 437 | T Briers | 7 | 133 | |
| Bank | | 350 | | Fixtures | | | 650 |
| Commission | | | 88 | Balances c/d | | 123 | 4833 |
| | 89 | 580 | 7552 | | 48 | 580 | 7552 |

Discounts Received

| | | | | | |
|---|---|---|---|---|---|
| | | | 3/1 | Sundry Creditors | 48 |

Discounts Allowed

| | | | | | |
|---|---|---|---|---|---|
| 3/1 | Sundry Debtors | 89 | | | |

*Petty Cash Book and Imprest System of Accounting.*

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

- Postage and stationery

- Traveling
- Cleaning expenses.

The format is as shown:

Petty Cash Book

| Receipts The ledger | Date | Details | Payment Amount | | Expenses | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | Postage | Stationery | Travelling | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |

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

*The Imprest system*

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

This is demonstrated as follows:

| | Sh. | |
|---|---|---|
| Start with (float) | | 1,000 |
| Expenses paid | (720) | |
| Balance | | 280 |
| Reimbursement | | 720 |
| Cash float | 1,000 | |

*Example 5.3*

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

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

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

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

*Solution*

| Receipts | Date | Detail | Payments | Expenses | | | THE LEDGER |
|---|---|---|---|---|---|---|---|
| (Sh.) | | | Amount (Sh.) | Postage (Sh.) | Cleaning (Sh.) | Travel (Sh.) | (Sh.) |
| 2000 | 1/3 | Bal b/d | | | | | |
| | 1/3 | Stamps | 80 | 80 | | | |
| | 2/3 | Bus Fare | 120 | | | 120 | |
| | 2/3 | Cleaning Materials | 240 | | 240 | | |
| | 3/3 | Fuel | 150 | | | 150 | |
| | 3/3 | Cleaning wages | 300 | | 300 | | |
| | 4/3 | Stamps | 200 | 200 | | | |
| | 4/3 | L Thompson | 400 | | | | 400 |
| | 5/3 | Fuel | 150 | . | . | 150 | . |
| | | | 1640 | 280 | 540 | 420 | 400 |
| 1640 | 5/3 | | | | | | |
| | 5/3 | Bal c/d | 2000 | | | | |
| 3640 | | | 3640 | | | | |
| 2000 | 6/3 | Bal b/d | | | | | |

## 3.6 The General Journal

It records information from other correspondence (information that is not recorded in the above books of prime entry). It explains the type of entries that will be made in the ledger accounts giving a reason for these entries.

The type of transactions recorded here are:

i. Writing off of assets from the accounts e.g. bad-debts.
ii. Drawings for goods or other assets from the business by the owner, not cash drawings.
iii. Purchase or sale of non-current assets on credit.

The format is as shown:

**The General Journal**

| General Journal | | | |
|---|---|---|---|
| **Date** | **Detail** | **Debit** | **Credit** |
| $1^{st}$ March | Account to be debit<br>Account to be credited (Narrative) | X | <br>X |

*Example 6.3*

You are to show the journal entries necessary to record the following items:

- 2003 May 1 Bought a motor vehicle on credit from Motors Ltd for Sh.6,790.
- 2003 May 3 A debt of Sh.34 owing from N Smart was written off as a bad debt.
- 2003 May 8 Furniture bought by us for Sh.490 was returned to the supplier Wood
- Offices, as it was unsuitable. Full allowance will be given us.
- 2003 May 12 we are owed Sh.150 by W Hayes. He is declared bankrupt and we received
- Sh.39 in full settlement of the debt.
- 2003 May 14 we take Sh.45 goods out of the business stock without paying for them.
- 2003 May 28 Some time ago we paid an insurance bill thinking that it was all in respect
- of the business. We now discover that Sh.76 of the amount paid was in fact insurance of our private house.
- 2003 May 28 Bought Machinery Sh.980 on credit from Xerox Machines Ltd.

a. Answer

| General Journal | | | |
|---|---|---|---|
| Date | Detail | Debit (Sh.) | Credit |
| $1^{st}$ May | Motor Vehicle<br>Motor Ltd.<br>Motor vehicle bought n credit<br>From Moor Ltd. | 6,790 | <br>6,790 |
| $3^{rd}$ May | Bad debts<br>N Smart-Debtors<br>Amount due from N Smart<br>Written off as bad | 34 | <br>34 |
| $8^{th}$ May | Wood offices | 490 | |

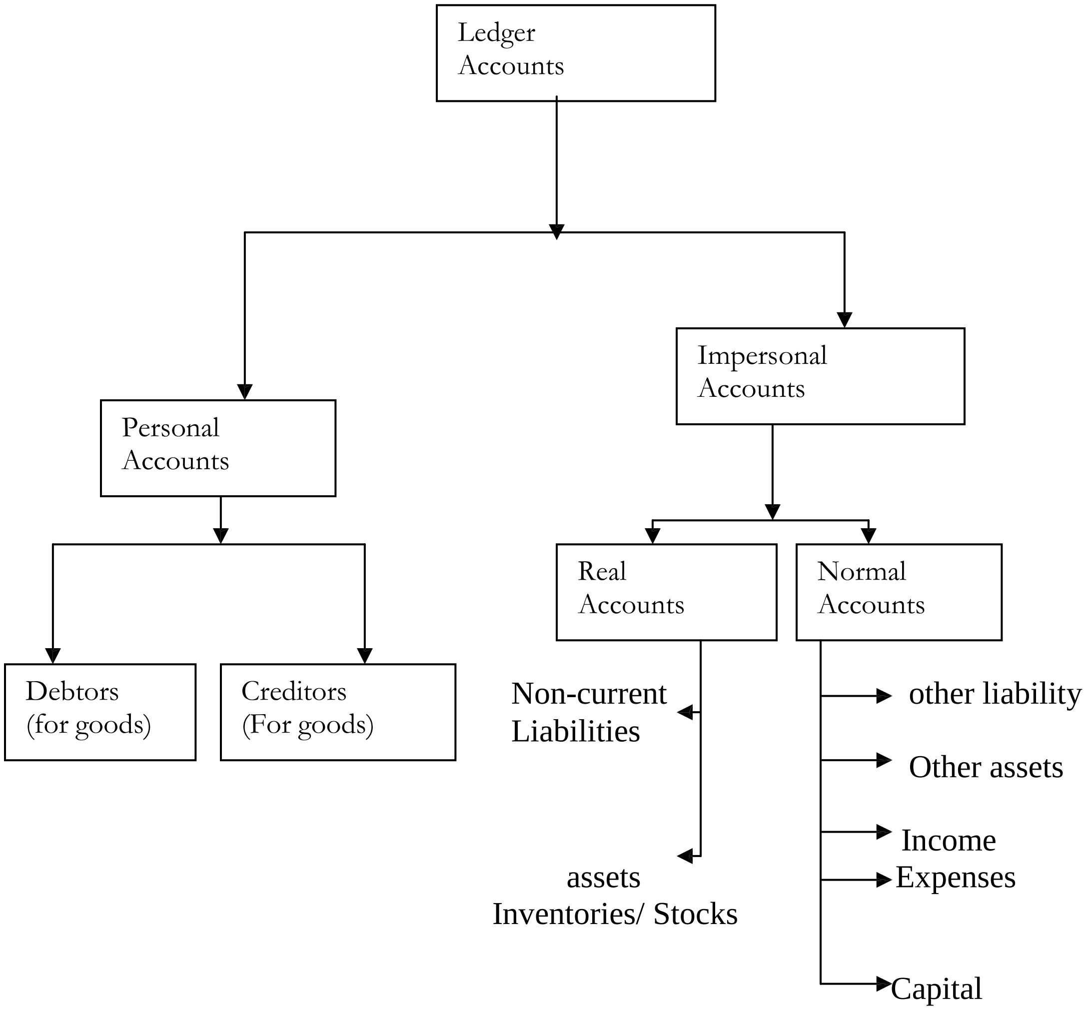
| | | | |
|---|---|---|---|
| | Furniture<br>Office furniture returned to<br>Wood office | | 490 |
| 12th May | Bad debts<br>W.Hayes<br>amount owed now written off as bad debt. | 111 | 111 |
| 14th May | Drawing for goods<br>Purchase<br>Goods taken from the business for personal use. | 45 | 45 |
| 8th May | Drawings<br>Insurance Expe<br>Insurance relating to private house now transferred to drawings. | 76 | 76 |
| 28th May | Machinery<br>Xerox Machines<br>Machinery bought from<br>Xerox Machines | 980 | 980 |

### 3.7 The Ledger

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

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

The ledger accounts can also be classified as follows:




### 3.8 Review Questions

Question One

Mr J Ockey commenced trading as a wholesaler stationer on 1 May 2000 with a capital of Sh.5, 000.00 with which he opened a bank account for his business.

During May the following transactions took place.

May 1 Bought shop fittings and fixtures from store fitments Ltd for Sh.2,000.00
May 2 Purchased goods on credit from Abel Sh.650.00
May 4 Sold goods on credit to Bruce Sh.700.00
May 9 Purchased goods on credit from Green Sh.300.00
May 11 Sold goods on credit to Hill Sh.580.00
May 13 Cash sales paid into bank account Sh.200.00
May 16 Received cheque from Bruce in settlement of his account
May 17 Purchased goods on credit from Kay Sh.800.00

May 18 Sold goods on credit to Nailor Sh.360.00
May 19 Sent Cheque to Abel in settlement of his account
May 20 Paid rent by cheque Sh.200.00
May 21 Paid delivery expenses by cheque Sh.50.00
May 24 Received from Hill Sh.200.00 on account
May 30 Drew cheque for personal expenses Sh.200.00 and assistant wages Sh.320.00
May 31 Settled the account of Green.

**Required**

a) Record the transactions in the books of prime entry.
b) Post the entries in the ledger accounts
c) Balance the ledger accounts where necessary
d) Extract a trial balance as at 31 May 2000.

## 3.9 References


- Wood, Frank, *Business Accounting* (17th Edition), International Thompson. Pages 107-164
- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 49-57
- Heinz and Party,*College Accounting*, (18th Edition).pages 47-52.

# TOPIC 4: CONTROL ACCOUNTS

**Learning Objectives:**
*Upon completion of this topic you will be able to:*

- Define self-balancing ledgers and explain their purpose
- Explain control accounts and prepare debtors and creditors control account

## 4.1 Introduction

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

(i) *Sales ledger control Account* – also called total debtors. The balance on the sales ledger control account should be the same as the total of the balances in the sale ledger.

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

*Example (Sales Ledger Control a/c)*

Sales Ledger Control A/c

| | | | |
|---|---|---|---|
| Sales | 1400 | CashBook | 700 |
| | | Bal C/D | 700 |
| | 1400 | | 1400 |

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

Sales Ledger

Debtor A a/c

| | | | |
|---|---|---|---|
| Sales | 200 | C/B | 50 |
| | | Bal c/d | 150 |
| | 200 | | 200 |

Debtor B a/c

| | | | |
|---|---|---|---|
| Sales | 400 | C/B | 250 |
| | | Bal c/d | 150 |
| | 400 | | 400 |

Debtor C a/c

| | | | |
|---|---|---|---|
| Sales | 300 | C/B | 100 |
| | | Bal c/d | 200 |
| | 300 | | 300 |

Debtor D a/c

| | | | |
|---|---|---|---|
| Sales | 500 | C/B | 300 |
| | | Bal c/d | 200 |
| | 500 | | 500 |

*Example 4.1 Purchases Ledger Control a/c*

Purchases Ledger Control a/c

| | | | |
|---|---|---|---|
| C/B | 1900 | Purchases | 2600 |
| Bal c/d | 700 | | |
| | 2600 | | 2600 |

Purchases Ledger

Creditor A

| | | | |
|---|---|---|---|
| C/B | 400 | Purchases | 600 |
| Bal c/d | 200 | | |
| | 600 | | 600 |

Creditor B

| | | | |
|---|---|---|---|
| C/B | 450 | Purchases | 700 |
| Bal c/d | 250 | | |
| | 700 | | 700 |

Creditor C

| | | | |
|---|---|---|---|
| C/B | 350 | Purchases | 500 |
| Bal c/d | 150 | | |
| | 500 | | 500 |

Creditor D

| | | | |
|---|---|---|---|
| C/B | 700 | Purchases | 800 |
| Bal c/d | 100 | | |
| | 800 | | 800 |

*Purpose of Control Accounts*

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

## 4.2 Format of a Sales Ledger Control

Sales Ledger Control a/c

| | |
|---|---|
| 1. Balance b/d of the total debit balances from previous period | 1. Total credit balances of the sales ledger brought forward |
| 2. Total credit sales for the period (from the sales journal) | 2. Total cash received from credit customers/debtors (from cash book) |
| 3. Refunds to customers (from cashbook) | 3. Total cheques received from credit customers/debtors (from cash book) |
| 4. Dishonored cheques (from cashbook) | 4. Total returns-inwards (returns-inwards journal) |
| 5. Bad debts recovered (from general journal) | 5. Total cash discount allowed to customers (from cash book) |
| | 6. Bad debtors written-off (from general journal) |
| | 7. Cash received from bad debtors recovered (cash book) |
| | 8. Purchases Ledger contra |
| | 9. Allowances to customers (price reduction in excess to discounts allowed) |
| 6. Total credit balances of the sales Ledger carried forward | 10. Total debit balance carried down to the next period – to be derived after posting all those transactions |

*Refunds to Customers*
Sometimes a firm can refund some cash on the customers account. This takes place when there is a credit balance on the debtor's a/c and the customer is not a creditor too.
The entry will be:

Dr. Debtor's a/c
Cr. Cashbook

*Example 4.2*

Debtor A

| | | | |
|---|---|---|---|
| | Sh. | | Sh. |
| Sales | 1000 | Cashbook | 950 |
| (Refunds) C/B | 100 | Discounts | 50 |
| | | Returns | 100 |
| | 1100 | | 1100 |

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

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

*Example:*

Debtor (A)

| | | | |
|---|---|---|---|
| Sales | 2000 | Contra- purchases | 1000 |
| | | Bal c/d | 1000 |
| | 2000 | | 1100 |

Creditor (A)

| | | | |
|---|---|---|---|
| Contra - Debtor | 1000 | Purchases | 1000 |

## 4.3 Format of a Purchases Ledger Control Account

Purchases Ledger Control A/C

| | |
|---|---|
| 1. Total debit balances from purchases ledger brought forward from previous period | 1. Total credit balance brought forward (of purchases ledger from the previous period) |
| 2. Total cash paid to creditors (from cash book) | 2. Total credit purchases for the period (from purchases journal) |
| 3. Total cheques paid to creditors | 3. Refunds from suppliers |

| | |
|---|---|
| (from cash book) | (from cash book) |
| 4. Total cash discounts received (from cash book) | |
| 5. Allowances by suppliers | |
| 6. Sales ledger contra | |
| 7. Total returns outwards (from returns-outwards journal) | |
| 8. Total credit balance (to be derived after posting entries) | 4. Total debit balances (of the purchases ledger carried forward) |

**Notes:**
The following notes should be taken into consideration:

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

*Example 4.3*

The balances and transactions affecting the control accounts of Kopesha Ltd. for the month of November 1997 are listed below:-

| | Sh. | |
|---|---|---|
| Balances on 1 November 1997: | | |
| Sales ledger | 9,123,000 | (debit) |
| | 211,000 | (credit) |
| Purchases ledger | 4,490,000 | (credit) |
| | 88,000 | (debit) |
| Transactions during November 1997: | | |
| Purchases on credit | 18,135,000 | |
| Allowances from suppliers | 629,000 | |
| Receipts from customers by cheques | 27,370,000 | |
| Sale on credit | 36,755,000 | |
| Discount received | 1,105,000 | |
| Payments to creditors by cheques | 15,413,000 | |

| | | |
|---|---|---|
| Contra settlements | 3,046,000 | |
| Bills of exchange receivable | 6,506,000 | |
| Allowances to customers | 1,720,000 | |
| Customers cheques dishonored | 489,000 | |
| Cash received from credit customers | 4,201,000 | |
| Refunds to customers for overpayments | 53,000 | |
| Discounts allowed | 732,000 | |
| Balances on 30 November 1997 | | |
| Sales ledger | 136,000 | (credit) |
| Purchases ledger | 67,000 | (debit) |

**Required:**

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

**Kopesha Ltd**

Sales Ledger Control A/C

| 1997 | | Sh | 1997 | | Sh |
|---|---|---|---|---|---|
| 1/11 | Bal b/d | 9,123,000 | 1/11 | Bal b/d | 211,000 |
| | Sales | 36,755,000 | | Bank | 27,370,000 |
| | Dishonored cheques | 489,000 | | Contra | 3,046,000 |
| | Refunds to customers | 53,000 | | Bills of exchange receivable | 6,506,000 |
| | | | | Allowances | 720,000 |
| | | | | Cash | 4,201,000 |
| | | | | Discounts allowed | 732,000 |
| 30/11 | Bal c/d | 136,000 | 30/11 | Bal c/d | 2,770,000 |
| | | 46,556,000 | | | 46,556,000 |

Purchases Ledger Control A/C

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

## 4.4 Review Questions

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

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

Question two

Prepare a sales ledger control account from the following:

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

## 4.5 References


- Wood, Frank, *Business Accounting* (17th Edition), International Thompson. Pages 334-345

# TOPIC 5: ERRORS AND CORRECTION

**Learning Objectives**

*Upon completion of this topic you should be able to:*

- Discover and correct errors that do not affect the balancing of the trial balance
- Discover and correct errors that affect the balancing of the trial balance

## 5.1 Errors that do not affect the 'balancing' of Trial Balance

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

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

*a) Error of omission*

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

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

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

| | |
|---|---|
| Debiting debtors | Sh.400 |
| Crediting sales | Sh.400 |

*b) Error of Commission*

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

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

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

| | | Sh. |
|---|---|---|
| (i) | Debit T Thompson a/c | 200 |
| (ii) | Credit L Thompson a/c | 200 |

*c) Error of principle*

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

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

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

| | | Sh. |
|---|---|---|
| (i) | Debit Motor vehicles a/c | 400 |
| (ii) | Credit Motor expenses a/c | 400 |

*d) Complete reversal of entries*

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

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

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

The entries will therefore be as follows:

| | | |
|---|---|---|
| (i) | Debit Cash in hand by | Sh.150 |
| | Credit bank by | Sh.150 |

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

| | | |
|---|---|---|
| (ii) | Debit cash by | Sh.150 |
| | Credit bank by | Sh.150 |

To post the entries correctly

*e) Error of Original entry*

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

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

Sh.

| | | |
|---|---|---|
| Debit cash book | | 90 |
| Credit debtors | 90 | |

*f) Compensating Errors*

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

| | Sh. |
|---|---|
| Purchases | 3,980 |
| | 3,890 |
| | (90) |
| | Sh. |
| Fixtures | 4,450 |
| | (4,540) |
| | 90 |

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

*Example 5.1*

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

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

*Solution*

The Journal

| | Debit | Credit |
|---|---|---|
| Sales | 10,000 | |
| Capital | | 10,000 |
| Additional capital passed into sales a/c now transferred to capital a/c | | |
| Drawings | 700 | |
| General expenses | | 700 |
| Drawings debited in general expense now transferred to drawing a/c | | |

| | | |
|---|---|---|
| Drawings | 89 | |
| Insurance | | 89 |
| Private insurance transferred from insurance a/c to drawings a/c | | |
| Purchases | 270 | |
| C Kelly | | 270 |
| Purchases and creditors amount to 857 initially entered as Sh.587 | | |
| Bank | 390 | |
| Cash | | 390 |
| Correct error in posting | | |
| Bank | 390 | |
| Cash | | 390 |
| To post the cash banked correctly | | |
| Bank | 400 | |
| Cash | | 400 |
| Cash drawings correctly started from bank to cash | | |
| J Charlton | 168 | |
| M McCarthy | | |
| Returns in from McCarthy entered in error in J Carlton now transferred to his | | 168 |
| a/c | 1000 | |
| Motor expenses | | 1000 |
| Motor disposal a/c | | |
| To correct error in recording sales proceeds In expense account | | |

**5.2 Errors that affect the 'balancing' of Trial Balance and Suspense Account**

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

1. Transaction is posted on one side of the accounts i.e. only a debit entry or a credit entry. Example cash received from a debtor is debited to the cashbook and no other entry is made in the account, i.e. no credit entry on the debtor's a/c.
2. A transaction is posted on one side of both the accounts i.e. two debits or two credits. Example a payment to a creditor of Sh.300 is credited in the cashbook and also credited in the creditor's accounts.
3. A transaction is posted correctly but different amounts i.e. debit is not the same as the credit. Example – cash received from a debtor of Sh.450 is debited in the cashbook as Sh.450 and credited as Sh.540 in the debtor's a/c.
4. Error on balances of accounts – i.e. understatement or overstatement of an account balance due to mathematical errors.

5. Balance on an account is shown on the wrong side of the account when opening the ledger accounts or when taken up to the trial balance. Example Bal c/d in the cash book for cash at bank of Sh.2000 is shown as a credit i.e. an overdraft, instead of a debit in the trial balance. The balance may also be brought down as an overdraft instead of a debit balance in the trial balance.
6. A balance is omitted from the trial balance on the accounts in total.

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

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

*Example 5.2*

| | DR | CR |
|---|---|---|
| Total | 240 | 200 |
| Suspense | - | 40 |
| | 240 | 240 |

Suspense a/c

| | Sh. | | Sh. |
|---|---|---|---|
| | | Difference as per T/B | 40 |

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

| | DR | CR |
|---|---|---|
| Total | 260 | 300 |
| Suspense | 40 | - |
| | 300 | 300 |

Suspense a/c

| | Sh. | | Sh. |
|---|---|---|---|
| Difference as per T/B | 40 | | |

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

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

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

*Example 5.3*

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

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

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

You are required to:

a) Show the journal entries necessary to correct the errors.
b) Draw up the suspense account after the errors described have been corrected.

Journal Entries

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

Suspense a/c

| | Sh. | | Sh. |
|---|---|---|---|

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

### 5.3 Review Question

Question one

The statement of financial position of N Patel, a sole trader, as at 31 March 2000 was as follows:

| | Sh'000 | Sh'000 | | Sh'000 | Sh'000 |
|---|---|---|---|---|---|
| Capital 1 April 1999 | | 1,890 | Land and buildings (at valuation) | | 1,650 |
| Profit for the year ended 31 March 2000 | 450 | | Machinery (at cost) | 1,200 | |
| Deduct: drawings | 150 | 300 | Deduct: depreciation | 750 | 450 |
| Creditors | | 630 | Stock at cost | 570 | |
| Bank overdraft | | 270 | Debtors | 420 | 990 |
| | | 3,090 | | | 3,090 |

Further investigation reveals the following information:

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

Required:

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

Question two

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

Wanji trial balance as at 31 December 2001

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

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

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

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

Required:

(a) The adjusted trial balance and the correct balance of the suspense account.(6 marks)

(b) Journal entries to correct the errors (Narrations not required) (6 marks)

Suspense account starting with the balance determined in the adjusted trial balance in (a) above. (4 marks)

## 5.4 References

Wood, Frank, *Business Accounting* (17th Edition), International Thompson Pages 346-350

## TOPIC 6: BANK RECONCIALIATION STATEMENT

**Learning Objectives**

*Upon completion of this topic you should be able to:*

- Explain why the bank column of the cashbook may not balance with bank statement
- Explain the importance of bank reconciliation statement
- Prepare a bank reconciliation statement

### 6.1 Introduction

The cashbook for cash at bank records all the transactions taking place at the bank i.e. the movements of the account held with the bank. The bank will send information relating to this account using a bank statement for the firm to compare.

Ideally, the records as per the bank and the cashbook should be the same and therefore the balance carried down in the cashbook should be the same as the balance carried down by the bank in the bank statement.

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

Causes of the differences:

*Items appearing on Cashbook and not reflected on bank statement*.

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

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

Errors made in the cashbook

These include:

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

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

Bank charges: These charges include service, commission or cheques, interest charges on overdrafts.

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

Dishonored cheques

A cheque would be dishonored because:

- Stale cheques
- Post – dated cheques
- Insufficient funds

- Differences in amounts in words and figures.

*Direct credits*
Interest income/dividend incomes

Errors on the Bank Statement (made by the bank).
Such errors include:
- Overstating/understating.
- Deposits
- Withdrawals

## 6.2 Purposes of Bank Reconciliation Statement.

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

*Steps in preparing a bank reconciliation statement*

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

The format is as follows:

*Format 1*
Name:
Bank Reconciliation Statement as at 31/12

| | Sh. | Sh. |
|---|---|---|
| Balance at bank as per cashbook (updated) | | x |
| Add: Un presented cheques | x | |
| Errors on Bank Statement (see note 1) | x | x |
| | | x |
| Less: Uncredited deposits | x | |
| Errors on Bank Statement (see note 2) | x | (x) |
| Balance at bank as per Statement of financial position | | x |

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

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

*Format 2*

Name:
Bank Reconciliation Statement as at 31/12

| | Sh. | Sh. |
|---|---|---|
| Balance at bank as per bank statement | | x |
| Add: Uncredited deposits | x | |
| Add errors on bank statement (note 2) | x | x |
| | | x |
| Less: Unpresented cheques | x | |
| Errors on bank statement (note 1) | x | (x) |
| Balance at bank as per cashbook (updated) | | x |
| | | === |

*Example 6.1*

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

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

*Solution*

Cashbook – Bank

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

Bank Reconciliation as at 31/03/2003

| | Kshs | Kshs |
|---|---|---|
| Balance at bank as per cashbook | | 40,020 |
| Add: Unpresented cheques | | 1,170 |
| | | 41,190 |
| Less: Uncredited deposits | | (6,060) |
| Balance at bank as per Statement of financial position | | 35,130 |
| | | ===== |

*Example 6.2*

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

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

Cashbook

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

*Bank Statement*

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

Cashbook –Bank

| 2002 | | Kshs | 2002 | | Kshs |
|---|---|---|---|---|---|
| 31/12 | Bal b/d | 1,831 | 31/1 | Bank charges | 22 |
| 31/12 | J. Walters (C/T) | 54 | 31/12 | Bal C/D | 1,863 |
| | | 1,885 | | | 1,885 |

J. Richards
Bank Reconciliation Statement as at 31/12/2002

| | | | |
|---|---|---|---|
| | £ | | £ |
| Balance at bank as per cashbook – bank | | | 1,863 |
| Add: Unpresented cheques – (G Small) | | | 115 |
| | | | 1,978 |
| Less: Uncredited deposits | | | |
| K Wood | 249 | | |
| M. Barret | 178 | | (427) |
| Balance at bank as per statement of financial position | | | 1,551 |
| OR: | | | |
| Balance at bank as per statement of financial position | | | 1,551 |
| Add: Uncredited deposits: | | | |
| K. Wood | | 249 | |
| M. Barret | | 178 | |
| | | 1,978 | |
| Less: Unpresented cheques | | (115) | |
| Balance at bank as per cashbook – bank | | | 1,863 |

## 6.3 Review Questions

Question one.

a) Explain the term "bank reconciliation" and state the reasons for its preparation.

(b) Ssemakula, a sole trader received his bank statement for the month of June 2001. At that date the bank balance was Sh. 706,500 whereas his cash book balance was Sh.2, 366,500.

His accountant investigated the matter and discovered the following discrepancies:

1. Bank charges of Sh.3, 000 had not been entered in the cashbook.
2. Cheques drawn by Ssemakula totaling Sh.22, 500 had not yet been presented to the bank.
3. He had not entered receipts of Sh.26, 500 in his cashbook.
4. The bank had not credited Mr Ssemakula with receipts of Sh.98, 500 paid into the bank on 30 June 2001.
5. Standing order payments amounting to Sh.62, 000 had not been entered into the cashbook.
6. In the cashbook Ssemakula had entered a payment of Sh.74, 900 as Sh.79, 400.
7. A cheque for Sh.15, 000 from a debtor had been returned by the bank marked "refer to drawer" but had not been written back into the cashbook.
8. Ssemakula had brought forward the opening cash balance of Sh.329, 250 as a debit balance instead of a credit balance.
9. An old cheque payment amounting to Sh.44, 000 had been written back in the cashbook but the bank had already honored it.

10. Some of Ssemakula's customers had agreed to settle their debts by paying directly into his bank account. Unfortunately, the bank had credited some deposits amounting to Sh.832, 500 to another customer's account. However acting on information from his customers Ssemakula had actually entered the expected receipts from the debtors in is cashbook.

Required:

i. A statement showing Ssemakula's adjusted cashbook balance as at 30 June 2001. reconciliation statement as at 30 June 2001.

Question Two

The cash book of Ramogi stores had adebt balance of sh 24000 on 30th June 2006. On the same date the bank statement had a credit balance of sh 25900. The two documents were compared and the following differences were realized.

i) Acheque of sh 7600 deposited on june 29 had not been evident by the bank.

ii) Cheque no. 003 drawn for sh 5,200 was recorded in the cash book as sh 2500

iii) The bank had collected cheque from debtors worth sh 9700.

iv) The bank charges for the month amounted to sh 1600

v) Acheque issued to a creditor of sh 11,200 was paid bank as sh 12000

vi) Acheque drawn against Runninga stores for sh 6800 was charged in error against Ramogi strores account

vii) A standing order of sh5500 had been paid by the bank

viii) A dividend cheque for sh 9000 had been collected and credited by the bank.

ix) Un represented cheques amounted to sh 15,800.

Required.

a) Prepare an adjustment cash book (5 marks)

b) Bank reconciliation statement

## 6.4 References

Wood, Frank, *Business Accounting* (17th Edition), International Thompson Pages 308-318

# TOPIC 7: FINAL ACCOUNTS

**Learning Objectives**

*Upon completion of this topic you should be able to:*

- Explain the importance of income statement and balance sheet
- Prepare an income statement and balance sheet
- Distinguish between capital and revenue expenditure

## 7.1 Income Statements

(a) Trading Account

The trading account summarises the trading activities (sale and purchase of goods/stocks) of the business and tries to determine the gross profit for the relevant financial period. The gross profit is then taken up in the profit and loss account as part of the income.

Format for the trading account:

Name
Trading Account for the year ended 31 Dec.

| | Sh. | | Sh. | | Sh. |
|---|---|---|---|---|---|
| Sales | | | | | x |
| Less: Returns Inwards | | | | | (x) |
| | | | | | x |
| Less: Cost of Sales | | | | | |
| Opening stock | x | | | | |
| Purchases | x | | | | |
| Add: Carriage Inwards | | x | | | |
| | x | | | | |
| Less: Returns Outwards | | x | | x | |
| Cost of stock available for sale | | | | x | |
| Less: Closing stock | | | x | | (x) |
| Gross Profit | | | | | x |

*Example: 7.1*

From the following details draw up the trading account of Springs for the year ended 31 December 2002, which was his first year in business.

| | Sh. |
|---|---|
| Carriage inwards | 6,700 |
| Returns outwards | 4,950 |
| Returns inwards | 8,900 |
| Sales | 387,420 |
| Purchases | 333,330 |

Stock of goods: 31 December 19x7 74,890

Springs
Trading Account for the year ended 31 Dec 2002

| | Sh. | Sh. |
|---|---|---|
| Sales | | 387,420 |
| Less: Returns Inwards | | 8,900 |
| | | 378,520 |
| Less cost of sales | | |
| Purchases | 333,330 | |
| Add: Carriage Inwards | 6,700 | |
| | 340,030 | |
| Less: Returns outwards | 4,950 | |
| | 335,080 | |
| Less: Closing stock | 74,890 | 260,190 |
| Gross Profit | | 118,330 |

*Example 7.2*

The following details for the year ended 31 March 2003 are available. Draw up the trading account of R Sings for that year.

| | Sh. |
|---|---|
| Stocks: 1 April 2002 | 16,523 |
| Returns inwards | 1,372 |
| Returns outwards | 2,896 |
| Purchases | 53,397 |
| Carriage inwards | 1,122 |
| Sales | 94,600 |
| Stocks: 31 March 2003 | 14323 |

*Solution*

R Sings
Trading Account for the year ended 31 Mar 19x8

| | Sh. | Sh. | Sh. |
|---|---|---|---|
| Sales | | | 94,600 |
| Less: Returns Inwards | | | (1,372) |
| | | | 93,228 |
| **Less: Cost of sales** | | | |
| Opening Stock | | 16,523 | |
| Purchases | 53,397 | | |
| Add: Carriage Inwards | 1,122 | | |
| | 54,519 | | |

| | | | | |
|---|---|---|---|---|
| Less: Returns Outwards | 2,896 | | 51,623 | |
| Cost of goods available for sale | | | 68,146 | |
| Less: Closing stock | | 18,504 | | (49,642) |
| Gross Profit | | | | 43,586 |

*(b) Profit and Loss Account*

It shows the net profit or net loss that the business has made from all the activities during a financial period.

The net profit (or loss) is determined by deducting all the expenses from all the incomes of the same financial period.

In practice, the trading account is combined together with the net profit and loss account into one report called *comprehensive statement of income (formerly, trading, profit and loss account)* . Format is as shown below:

Name

Trading, Profit and Loss Account for the year ended 31/12/19xx

| | Sh. | | Sh. | | Sh. | |
|---|---|---|---|---|---|---|
| Sales | | | | | x | |
| Less: Returns Inwards | | | | | x | |
| | | | | | x | |
| Less: Cost of sales | | | | | | |
| Opening stock | | | x | | | |
| Purchases | x | | | | | |
| Add: Carriage Inwards | | x | | | | |
| | x | | | | | |
| Less: Returns Outwards | | x | | x | | |
| Cost of goods available for sale | | | | x | | |
| Less: Closing stock | | | x | | (x) | |
| Gross Profit | | | | | x | |
| Discount received | | | | | x | |
| Rent received | | | | | x | |
| Interest received | | | | | | x |
| Other incomes | | | | | x | |
| | | | | | x | |
| Less: Expenses | | | | | | |
| Carriage Outwards | | | x | | | |
| Discounts allowed | | | x | | | |
| Postage & stationary | | | x | | | |
| Salaries & wages | | | | x | | |
| Rent paid | | | x | | | |
| Insurance & rates | | | x | | | |

| | | | |
|---|---|---|---|
| Bank charges | x | | |
| Other expenses | x | | (x) |
| Net profit/ (loss) | | x/(x) | |

*Example 7.3*

From the following trial balance of P Boones draw up statement of comprehensive income for the year ended 30 September 2002, and a statement of financial position as at that date.

| | Dr | Cr |
|---|---|---|
| | Sh. | Sh. |
| Stock 1 October 19x8 | 23,680 | |
| Carriage outwards | 2,000 | |
| Carriage inwards | | 3,100 |
| Returns inwards | 2,050 | |
| Returns outwards | | 3,220 |
| Purchases | 118,740 | |
| Sales | | 186,000 |
| Salaries and wages | 38,620 | |
| Rent | 3,040 | |
| Insurance | 780 | |
| Motor expenses | 6,640 | |
| Office expenses | 2,160 | |
| Lighting and heating expenses | 1,660 | |
| General expenses | 3,140 | |
| Premises | 50,000 | |
| Motor vehicles | 18,000 | |
| Fixtures and fittings | 3,500 | |
| Debtors | 38,960 | |
| Creditors | | 17,310 |
| Cash at bank | 4,820 | |
| Drawings | 12,000 | |
| Capital | | 126,360 |
| | 332,890 | 332,890 |

*Solution*

P Boones

Income Statement as at 30 September 2003

| | Sh. | Sh. | Sh. |
|---|---|---|---|
| Sales | | | 186,000 |
| Less: Returns Inwards | | | (2,050) |
| | | | 183,950 |

**Less: Cost of sales**

| | | | |
|---|---|---|---|
| Opening stock | | 23,680 | |
| Purchases | 118,740 | | |
| Add: Carriage inwards | 3,100 | | |
| | 12,1840 | | |
| Less: Returns Outwards | 3,220 | 118,620 | |
| Cost of goods available for sale | | 142,300 | |
| Less: Closing stock | | 29,460 | (11,2840) |
| Gross Profit | | | 71,110 |
| Less Expenses | | | |
| Salaries & wages | | 38,620 | |
| Carriage outwards | | 2,000 | |
| Rent | | 3,040 | |
| Insurance | | 780 | |
| Motor expenses | | 6,640 | |
| Office expenses | | 2,160 | |
| Lighting & heating | | 1,660 | |
| General expenses | | 3,140 | (58,040) |
| Net Profit | | | 13,070 |

### 7.2 Statement of Financial Position/Balance Sheet

This is a simple report that shows the assets and liabilities of the business and the capital of the owner as at a certain point in time. The format is at shown below:

Name
Statement of financial position as at 31/Dec/19xx

| | Sh. | Sh. | Sh. |
|---|---|---|---|
| **Non Current Assets** | | | |
| Land & Buildings | | | x |
| Plant & Machinery | | | x |
| Fixtures, Furniture & Fittings | | | x |
| Motor vehicles | | | x |
| | | | x |
| **Current Assets** | | | |
| Stock/inventories | x | | |
| Debtors – trade | x | | |
| Debtors – others | x | | |
| Cash at bank | x | | |
| Cash at hand | x | | |
| | x | | |
| **Current Liabilities** | | | |
| Bank overdraft | x | | |
| Creditors – trade | x | | |

| | | | |
|---|---|---|---|
| Creditors – others | x | (x) | |
| Net current assets | | x | |
| Net Assets | | x | |
| **Capital** | | | x |
| Add: Net profit | | | x |
| | | x | |
| Less: Drawings | | | (x) |
| | | | x |
| **Non Current Liabilities** | | | |
| Loan (s) | | | x |
| | | | x |

The statement of financial position of P Boones in example 2.3 will be produced as follows:

P Boones
Statement of financial position as at 30 Sept 2002

| | Sh. | Sh. |
|---|---|---|
| **Non Current Assets** | | |
| Premises | | 50,000 |
| Fixtures & fittings | | 3,500 |
| Motor vehicles | | 18,000 |
| | | 71,500 |
| **Current Assets** | | |
| Stock | 29,460 | |
| Debtors | 38,960 | |
| Cash at bank | 4,820 | |
| | 73,240 | |
| **Current Liabilities** | | |
| Creditors | (17,310) | |
| Net Current Assets | | 55,930 |
| Net Assets | | 127,430 |
| **Capital** | | |
| 126,360 | | |
| Add: Net Profit | | |
| 13,070 | | |
| | | 139,430 |
| Less: Drawings | | (12,000) |
| | | 127,430 |

## 7.3 Capital and Revenue Expenditure

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

*Examples of expenses incurred in acquisition:*

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

*Examples of expenses incurred in adding value to an asset:*

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

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

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

## 7.4 Review Questions

Question one

The following trial balance has been drawn up from the accounts of Endpages bookshop.

Endpages Bookshop

Trial balance as at 31 December 2002

| | **Dr** Sh. | **Cr** Sh. |
|---|---|---|
| Sales | | 151,500.00 |
| Purchases | 103,500.00 | |
| Salaries and wages | 18,700.00 | |
| Office expenses | 2,500.00 | |
| Insurance | 1,100.00 | |
| Electricity | 600.00 | |
| Stationery | 2,400.00 | |
| Advertising | 3,500.00 | |

| | | |
|---|---|---|
| Telephone | 800.00 | |
| Rates | 3,000.00 | |
| Discount allowed | 100.00 | |
| Discount received | | 200.00 |
| Rent received | | 2,000.00 |
| Returns inwards | 1,500.00 | |
| Returns outwards | | 3,500.00 |
| Stock at 01 Jan 2001 | 46,000.00 | |
| Premises | 80,000.00 | |
| Stock as at 31 Dec 2001 | 41,000.00 | |
| Fixtures and fittings | 5,000.00 | |
| Debtors and Creditors | 4,800.00 | 7,500.00 |
| Cash in Hand | 200.00 | |
| Cash in bank | | 12,000.00 |
| Capital | | 11,000.00 |
| Drawings | 14,000.00 | |
| Stock as at 31 Dec 2001 | | 41,000.00 |
| | 328,700.00 | 328,700.00 |

Required

Prepare a statement of comprehensive income for the year ended 31 December 2002 and a statement of financial position as at that date. (20 marks)

Question two

The following is the trial balance of KSmooth as at 31 March 2002. Draw up a set of final accounts for the year ended 31 March 2002.

| | **Dr** | **Cr** |
|---|---|---|
| | Sh. | Sh. |
| Stock 1 April 2001 | 1,816,000 | |
| Sales Purchases | | 9,234,000 |
| Carriage inwards | 6,918,500 | |
| Carriage outwards | 42,000 | |
| Returns outwards | 157,000 | |
| Wages and salaries | | 64,000 |
| Rent and rates | 1,024,000 | |
| Communication expenses | 301,500 | |
| Commissions payable | 62,400 | |
| Insurance | 21,600 | |
| Sundry expenses | 40,500 | |
| Buildings | 31,800 | |
| Debtors | 2,000,000 | |
| | 1,432,000 | |

| | | |
|---|---|---|
| Creditors | | 816,000 |
| Fixtures | 285,000 | |
| Cash at bank | 297,000 | |
| Cash in hand | 11,500 | |
| Drawings | 762,000 | |
| Capital | | 5,088,800 |
| | 152,028 | |
| | | 152,028 |

## 7.4 References

Wood, Frank, *Business Accounting* (17th Edition), International Thompson

# TOPIC 8: YEAR END ADJUSTMENTS

**Learning Objectives**

*Upon completion of this topic you should be able to:*

- Explain the reasons for making provision for depreciation on fixed assets
- Explain the methods for calculating provision for depreciation
- Distinguish between accrued revenues and expenses
- Correctly account for accrued revenues and expenses
- Correctly account for prepaid expenses

## 8.1 Depreciation

It is the loss of value of a non-current asset throughout its period of use by the firm. IAS 16 on property, plant and equipment defines depreciation as the allocation of a depreciable amount of a non-current asset over its estimated useful life. Under the matching concept, all incomes or revenues and expenses for a particular period should be reported in the financial statements and because depreciation is an expense of the business therefore, it will be charged in the profit and loss account.

*Causes of Depreciation*

1. *Physical Factors*
   i) Wear and tear: Some non-current assets depreciate or lose value due to use overtime e.g. machinery and motor vehicles.
   ii) Rot/decay/rust: This happens on assets that are not well maintained by the firm e.g. some machines.
2. *Economic Factors*
   i) Inadequacy: Some assets lose value due to them becoming inadequate e.g. when a business grows or expands then some buildings may become inadequate due to space. Also some machines are unable to manufacture a large number of goods.
   ii) Obsolescence: Some assets become obsolete due to change in technology or different methods of production e.g. computers.
3. *Time Factors*
   Some assets have a legal fixed time e.g. properties on lease.
4. *Depletion*
   This occurs when some assets have a wasting character due to extraction of raw materials, minerals or oil. Such assets include mines, oil wells, and quarries.

## 8.2 Methods of Calculating Depreciation

These are the methods developed to assist in estimating the amount of depreciation to be charged in the profit and loss account as an expense. The methods chosen by a firm should be in accordance with the agreed accounting practice, accounting standards and suit the firm's non-current assets. There are two main methods of estimating depreciation and five others that will apply in a firm's situation.

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

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

*The Straight-Line Method*

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

$$\text{Depreciation for year} = \frac{\text{Cost of asset} - \text{Residual Value}}{\text{Estimated useful life}} = \frac{\text{Sh.}100{,}000 - \text{Sh.}20{,}000}{8}$$

$$= \text{Sh.}10{,}000 \text{ per year.}$$

*Cost of Asset – Residual Value*

Estimated useful life of asset.

*Residual Value*

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

*Estimated Useful Life*

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

*Example 8.1*

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

This means for this asset Sh.10, 000 will be charged in the profit and loss account as depreciation expense on the machine.
The straight line method assumes that benefits accruing on use of a non-current asset are spread out evenly over the life of the asset e.g. buildings use straight-line method.
Percentage rate based on cost as opposed to number of years can also be used to calculate the depreciation.

*Reducing Balance Method*

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

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

*Example 8.2*

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

Year 1

| | Sh. | | |
|---|---|---|---|
| Cost | | 100,000 | |
| Depreciation 20% of 100,000 | | (20,000) → | P&L YR 1 |
| Balance to YR 2 | 80,000 | | |
| Year 2 | | | |
| Depreciation 20% of 80,000 | | 80,000 | |
| | | (16,000) → | P&L YR 2 |
| Balance to YR 3 | 64,000 | | |
| Year 3 | | | |
| Depreciation 20 % of 64,000 | | 64,000 | |
| | | (12,800) → | P&L YR 3 |
| Balance to YR 4 | 51,200 | | |

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

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

## 8.3 Accounting Treatment on Depreciation

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

Debit – P&L a/c

Credit – Provision for depreciation a/c
With the amount of depreciation charged for the period.

*Example on straight-line method*

The entries will be as follows:
Debit – P&L a/c with Sh.10, 000
Credit – Provision for depreciation. Machines a/c with Sh.10, 000 being depreciation provided for the machine.

The ledger accounts will be as follows:

**Machinery**

| | Sh. | | Sh. |
|---|---|---|---|
| Cashbook | 100,000 | 31/12 Bal c/d | 100,000 |

**Provision for Depreciation Machinery**

| | Sh. | | Sh. |
|---|---|---|---|
| 31/12 Bal c/d | 10,000 | P&L | 10,000 |

The final accounts extracts will be shown as follows:
(a) Profit And Loss Account (Extract) for the year ended

| Expenses | Sh. | Sh. |
|---|---|---|
| Depreciation: | | |
| Buildings | x | |
| Plant and machinery | 10,000 | |
| Furniture, Fixtures and Fittings | x | |
| Motor vehicles | x | |

**(b)** Statement of financial position (Extract) as at________

| Non Current Assets | Cost Sh. | Total Depreciation (Sh.) | NBV (Net Book Value) Sh. |
|---|---|---|---|
| Land | x | - | x |
| Buildings | x | (x) | x |
| Plant and Machinery | x | (x) | x |
| Furniture, Fixtures & fittings | x | (x) | x |
| Motor vehicles | x | (x) | x |
| | x | x | x |

*Example 8.3*

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

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

Motorcars a/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| | | | | | |
| 1/1 | Cashbook | 24,000 | | | |
| 1/7 | Cashbook | 14,000 | 31/12 | Bal c/d | 38,000 |
| | | 38,000 | | | 38,000 |

Calculation for depreciation

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

= Sh.4, 800 + 1,400 = Sh.6, 200

Provision- Depreciation for Motor cars A/c

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 31/12 | Bal c/d | 6,200 | 31/12 | P&L | 6,200 |

Profit And Loss Account (Extract) for the period.

| Expenses | Sh. | Sh. |
|---|---|---|
| Depreciation: | | |
| Motor vans | 6200 | |

Statement of financial position (Extract) as at 31/12/2002

| Non-current Assets | Cost | Total Depreciation | NBV |
|---|---|---|---|
| Motor vans | 38,000 | (6200) | 31,800 |

*Example 8.4*

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

a. The plant account.
b. The provision for depreciation account.
c. The statement of financial position extracts for each of the years 1999, 2000, 2001, 2002.

The machinery bought was:

| | | |
|---|---|---|
| 1999 | 1 January | 1 plant costing Sh.8, 000 |
| 2000 | 1 July | 2 plant costing Sh.5, 000 each |
| | 1 October | 1 plant costing Sh.6, 000 |
| 2002 | 1 April | 1 plant costing Sh.2, 000 |

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

Plant a/c

| | | | | | |
|---|---|---|---|---|---|
| 1999 | | Sh. | 199 | | Sh. |
| 1/1 | Cashbook | 8000 | 31/12 | Bal c/d | 8000 |
| 2000 | | | 2000 | | |
| 1/1 | Bal b/d | 8000 | | | |
| 1/7 | Cashbook | 10,000 | | | |
| 1/10 | Cashbook | 6,000 | 31/12 | Bal c/d | 24,000 |
| | | 24,000 | | | 24,000 |
| 2001 | | | 2001 | | |
| 1/1 | Bal b/d | 24,000 | 31/12 | Bal c/d | 24,000 |
| 2002 | | | 2002 | | |
| 1/1 | Bal b/d | 24,000 | | | |
| 1/4 | Cashbook | 2,000 | 31/12 | Bal c/d | 26,000 |
| | | 26,000 | | | 26,000 |

Calculation for Depreciation

| | | | |
|---|---|---|---|
| 1999 | Sh. | | Accumulated Depreciation |
| Sh.8,000 x 10/100 x 12/12 | = | 800 | 800 |

2000

| | | | |
|---|---|---|---|
| Sh.10,000 x 10/100 x 6/12 = | 500 | | |
| Sh.6,000 x 10/100 x 3/12 = | 150 | | |
| Sh.8,000 x 10/100 x 12/12 = | 800 | | |
| | 1,450 | | 2,250 |

2001

| | | | |
|---|---|---|---|
| Sh.24,000 x 10/100 x 12/12 | = | 2400 | 4,650 |

2002

| | | | |
|---|---|---|---|
| Sh.24,000 x 10/100 x 12/12 | = | 2400 | |
| Sh.2,000 x 10/100 x 9/12 = | 15 | | |
| | 2,250 | | 7,200 |

Provision – Depreciation Machines

| | | | | | |
|---|---|---|---|---|---|
| 1999 | | Sh. | 1999 | | Sh. |
| 31/12 | Bal c/d | 800 | 31/12 | P&L | 800 |
| 2000 | | Sh. | 2000 | | Sh. |
| | | | 1/1 | Bal b/d | 800 |
| 31/12 | Bal c/d | 2,250 | | P&L | 1,450 |
| | | 2,250 | | | 2,250 |
| 2001 | | Sh. | 2001 | | Sh. |
| | | | 1/1 | Bal b/d | 2,250 |
| 31/12 | Bal c/d | 4,650 | | P&L | 2,400 |
| | | 4650 | | | 4650 |
| 2002 | | Sh. | 2002 | | Sh. |
| | | | 1/1 | Bal b/d | 4,650 |
| 31/12 | Bal c/d | 7,200 | | P&L | 2,550 |
| | | 7,200 | | | 7,200 |

Statement of financial position (Extract) as at 31/12/99 – 31/12/02

| Non Current Assets | Cost | Total Depreciation | NBV |
|---|---|---|---|
| 1999 | | | |
| Motor vans | 8,000 | (800) | 7,200 |

| | | | |
|---|---|---|---|
| 1999 | | | |
| Motor vans | 24,000 | (2,250) | 21,750 |

| | | | |
|---|---|---|---|
| 1999 | | | |
| Motor vans | 24,000 | (4,650) | 19,350 |

| | | | |
|---|---|---|---|
| 1999 | | | |
| Motor vans | 26,000 | (7,200) | 18,800 |

*Disposals of Assets*

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

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

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

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

(a) Debit – asset disposal a/c
Credit – asset a/c
With the cost of the asset being disposed.

(b) Debit – provision for depreciation of asset a/c.
Credit – asset disposal a/c
With the total depreciation provided to date on the asset.

(c) Debit – cashbook.
Credit – asset disposal a/c
With the cash received on disposal.

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

(a) Debit – asset disposal a/c
Credit – asset a/c
With the cost of the asset damaged.

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

(c) Debit – insurance receivable a/c
Credit – asset disposal a/c

With the amount expected from the insurance.

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

Debit – cashbook.
Credit – asset disposal a/c

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

Debit – asset disposal a/c
Credit – asset a/c
With the cost of the asset no longer in use.

Debit – provision for depreciation for asset
Credit – asset disposal a/c
With the total depreciation provided to date.

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

Debit – asset disposal a/c
Credit – P&L a/c
With the balance in the account.

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

*Example 8. 5*

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

Motor vehicle a/c

| | Sh. | | Sh. |
|---|---|---|---|
| Bal b/d | 1,000 | Motor vehicle disposal | 1,000 |
| Disposals | 300 | | |
| Cashbook | 200 | Bal c/d | 500 |
| | 1,500 | | 1,500 |
| | ===== | | ==== |

Motor Vehicle Disposal a/c

| | Sh. | | Sh. |
|---|---|---|---|
| Motor vehicle a/c | 1,000 | Provision for depreciation | 800 |
| P&L | 100 | Motor vehicle | 300 |
| | 1,100 | | 1,100 |

*Journal Entries*

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

In case of a loss,

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

If the firm trades in an old asset for a new one, the following entries will be made in addition to the movements in the asset and depreciation a/c.
Debit – asset a/c (value of the new asset)
Credit – cashbook (cash paid as difference of new value i.e. trade in value of old asset)
Asset disposal a/c (with trade-in value of old asset)

*Example 8. 6*

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

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

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

*Solution*

Plant a/c

| | | | | | |
|---|---|---|---|---|---|
| 1999 | | Sh. | 1999 | | Sh. |
| 1/1 | Cashbook | 900 | | | |
| 1/10 | Cashbook | 600 | 31/12 | Bal c/d | 1,500 |
| | | 1,500 | | | 1,500 |
| 2000 | | Sh. | 2000 | | Sh. |
| 1/1 | Bal b/d | 1,500 | 31/12 | Bal c/d | 1,500 |
| 2001 | | Sh. | 2001 | | Sh. |
| 1/1 | Bal b/d | 1,500 | | | |
| 1/7 | Cashbook | 550 | 31/12 | Bal c/d | 2,050 |
| | | 2,050 | | | 2,050 |
| 2002 | | | 2002 | | |
| 1/1 | Bal b/d | 2,050 | 30/9 | Disposal | 900 |
| | | | 31/12 | Bal c/d | 1,150 |
| | | 2,050 | | | 2,050 |

Plant Provision for Depreciation a/c

| | | | | | |
|---|---|---|---|---|---|
| 1999 | | Sh. | 1999 | | Sh. |
| 31/12 | Bal c/d | 210 | 31/12 | P&L | 210 |
| 2000 | | | 2000 | | |
| | | | 1/1 | Bal b/d | 210 |
| 31/12 | Bal c/d | 510 | | P&L | 300 |
| | | 510 | | | 510 |
| 2001 | | | 2001 | | |
| | | | 1/1 | Bal b/d | 510 |
| 31/12 | Bal c/d | 865 | | P&L | 355 |
| | | 865 | | | 865 |
| 2002 | | | 2002 | | |

| | | | | | |
|---|---|---|---|---|---|
| 31/12 | Disposals | 675 | 1/1 | Bal b/d | 865 |
| | Bal c/d | 555 | | P&L | 365 |
| | | 1,230 | | | 1,230 |

Calculation for Depreciation

| Date | Cost | | Months Depreciation charge | | Sh. |
|---|---|---|---|---|---|
| 1999 | | | | | |
| 1/1 | 900 | 12 | 20/100 x 900 x 12/12 | = | 180 |
| 1/10 | 600 | 3 | 20/100 x 600 x 3/12 | = | 30 |
| | | | | | 210 |
| 2000 | | | | | |
| 1/1 | 1,500 | 12 | 20/100 x 1,500 x 12/12 | = | 300 |
| 2001 | | | | | |
| 1/1 | 1,500 | 12 | 20/100 x 1,500 x 12/12 | = | 300 |
| 1/2 | 550 | 6 | 20/100 x 550 x 6/12 | = | 55 |
| | | | | | 355 |
| 2002 | | | | | |
| 30/9 | 900 | 9 | 20/100 x 900 x 9/12 | = | 135 |
| 31/12 | 550 | 12 | 20/100 x 550 x 12/12 | = | 110 |
| 31/12 | 600 | 12 | 20/100 x 600 x 12/12 | = | 120 |
| | | | | | 365 |

Plant Disposal a/c

| 2002 | Sh. | 2002 | | Sh. |
|---|---|---|---|---|
| Plant a/c | 900 | 30/9 | Provision for depreciation | 675 |
| P&L | 50 | 30/9 | Cashbook | 275 |
| | 950 | | | 950 |

Statement of financial position (Extract)

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

## 8.4 Revenue and Cost Recognition

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

*Accruals*

*Income: Accrued Income*

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

*Example 8.7*

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

The ledger accounts of the firm will be as follows:

Cashbook

| Year 1 | Sh. | | |
|---|---|---|---|
| Feb (rent 4 Jan) | 2,000 | | |
| Mar (rent 4 Feb) | 2,000 | | |
| April (rent 4 Mar) | 2,000 | | |
| May (rent 4 Apr) | 2,000 | | |
| June (rent 4 May) | 2,000 | | |
| July (rent 4 Jun) | 2,000 | | |
| Aug (rent 4 July) | 2,000 | | |
| Sept (rent 4 Aug) | 2,000 | | |
| Oct (rent 4 Sept) | 2,000 | | |
| Nov (rent 4 Oct) | 2,000 | | |
| Dec (rent 4 Nov) | 2,000 | | |
| | 22,000 | | |

Rent – Income

| Year 1 | Sh. | Year 1 | Sh. |
|---|---|---|---|
| | | Jan C/B | 2,000 |
| | | Feb C/B | 2,000 |
| | | Mar C/B | 2,000 |
| | | Apr C/B | 2,000 |
| | | May C/B | 2,000 |
| | | Jun C/B | 2,000 |
| | | July C/B | 2,000 |
| | | Aug C/B | 2,000 |
| | | Sept C/B | 2,000 |
| | | Oct C/B | 2,000 |
| 31/12 P&L | 24,000 | Nov C/B | 2,000 |
| | | Dec Accrued c/f | 2,000 |
| | 24,000 | | 24,000 |

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

*Expenses: Accrued Expenses*

An accrued expense is an expense that is payable or due for payment but has not yet been paid during that period.
An accrued expense should be charged in the P&L account and shown in the statement of financial position as a current liability.
Assume in the above example that the firm is meant to pay the rent, thus it becomes an expense with the facts still the same i.e. Sh.2,000 payable in arrears. The ledger account will be as follows.

Cashbook

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

Rent – Expenses

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

The cashbook shows that the rent for the 11 months was paid for. However in the profit and loss account we should report rent for the full year of Sh.24, 000 and the Sh.2, 000, rent for Dec being the accrued expense will be shown in the statement of financial position as a current liability.

### 8.5 Prepayments

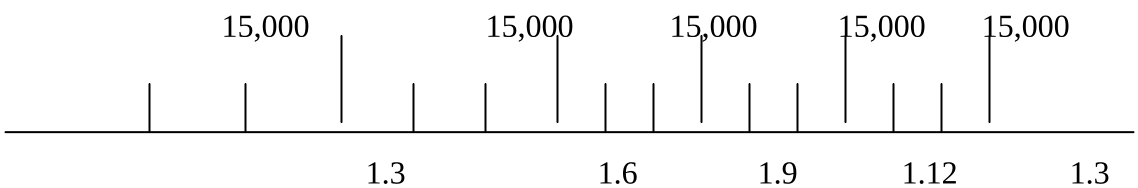
*Prepaid Income*

This is income that is not yet due but cash has been received for it. This happens where an income is payable in advance e.g. Rent payable 3 months in advance.
A prepaid income should not be reported in the current financial period but should be carried forward and reported in the period it relates to.

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

Example 4.2

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




Cashbook

| Year 1 | | Sh. | Year 1 | Sh. |
|---|---|---|---|---|
| 1/3 | Rent | 15,000 | | |
| 1/6 | Rent | 15,000 | | |
| 1/9 | Rent | 15,000 | | |
| 1/12 | Rent | 15,000 | | |

Rent – Income

| Year 1 | | Sh. | Year 1 | | Sh. |
|---|---|---|---|---|---|
| | | | 1/3 | Cashbook | 15,000 |
| | | | 1/6 | Cashbook | 15,000 |
| P&L | (10 x 5,000) | 50,000 | 1/9 | Cashbook | 15,000 |
| 31/12 | Bal c/d | 10,000 | 1/12 | Cashbook | 15,000 |
| | | 60,000 | | | 60,000 |

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

*Prepaid Expenses*

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

*Example 8.8*

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

Cashbook

| Year 1 | Sh. | Year 1 | | Sh. |
|---|---|---|---|---|
| | | 1/3 | Rent | 15,000 |
| | | 1/6 | Rent | 15,000 |
| | | 1/9 | Rent | 15,000 |
| | | 1/12 | Rent | 15,000 |

Rent – Expenses

| Year 1 | | Sh. | Year 1 | | Sh. |
|---|---|---|---|---|---|
| 1/3 | C/B (Mar, April, May) | 15,000 | | | |
| 1/6 | C/B (June, July, Aug) | 15,000 | | | |
| 1/9 | C/B (Sept, Oct, Nov) | 15,000 | P&L | (10 x 5,000) | 50,000 |
| 1/12 | C/B (Dec, Jan, Feb) | 15,000 | 31/12 Bal c/d | (2 x 5,000) | 10,000 |
| | | 60,000 | | | 60,000 |

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

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

P&L

B/Sheet

Accrued - Report as

Current

Income Assets

Income

Prepaid -Not

reported Current

Liability

Accruals/
Prepayments

Accrued - Charge as

Current

an expense

Liability

Expense

Prepaid - Not charged

Current

In P& L Assets

Accrued Incomes and Expenses and Prepaid Incomes and Expenses are shown in the Statement of financial position as follows:

*Statement of financial position Extracts*

| | | | | |
|---|---|---|---|---|
| | | Sh. | | Sh. |
| **Current Assets** | | | | |
| Stock | | | | x |
| Debtors | | | x | |
| Accrued Incomes/Prepaid Expenses | | | | x |
| Cash at bank | | | | x |
| Cash in hand | | | | x |
| | | | | x |
| **Current Liabilities** | | | | |
| Bank overdraft | x | | | |
| Creditors | | x | | |
| Prepaid Incomes/Accrued Expenses | | x | | |
| | | X | | |

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

## 8.7 Bad & Doubtful Debts

Some debtors may not pay up their accounts for various reasons e.g. a debtor may go out of business. When a debtor is not able to pay up his/her account this becomes a bad debt. Therefore the business/firm should write it off from the accounts and thus it becomes an expense that should be charged in the profit & loss account.
In practice a firm may also be unable to collect all the amounts due from debtors. This is because a section of the debtors will not honor their obligations. The problem posed by this situation is that it is difficult to identify the debtors who are unlikely to pay their accounts. Furthermore the amount that will not be collected may also be difficult to ascertain. These debts that the firm may not collect are called doubtful debts. A firm should therefore provide for such debts by charging the provision in the profit and loss account. Provision for doubtful debts maybe specific or general. Specific relate to a debtor whom we can identify and we are doubtful that he may pay the debt (if one of our debtor goes out of business).

*Accounting for bad & doubtful debts.*
*Bad debts*

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

i. Debit bad debts account
   Credit debtors account with the amount owing.
ii. Debit Profit and Loss Account.
   Credit bad – debts account to transfer the balance on the bad – debts account to the Profit and Loss Account.

Doubtful Debts

A provision for doubtful debts can either be for a specific or a general provision. A specific provision is where a debtor is known and chances of recovering the debt are low. The general provision is where a provision is made on the balance of the total debtors i.e. Debtors less Bad debts and specific provision.
The accounting treatment of provision for doubtful debts depends on the year of trading and the entries will be as follows. If it is the 1$^{st}$ year of trading (1$^{st}$ year of making provision):

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

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

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

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

*Example 8.9*

| | |
|---|---|
| Debtors | x |
| Bad debts | (x) |
| | x |
| Specific Provision | (x) |
| | x |
| General Provision | (x) |
| | x |

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

Debtors

| 1999 | Sh. | 1999 | Sh. |
|---|---|---|---|
| Bal B/d | 400,000 | Bad debts | 40,000 |
| | | Bal c/d | 360,000 |
| | 400,000 | | 400,000 |

Provision for doubtful debts

| 1999 | Sh. | 1999 | Sh. |
|---|---|---|---|
| 31/12 Bal c/d | 22,750 | 31/12 P&L | 22,750 |

Bad debts

| 1999 | Sh. | 1999 | Sh. |
|---|---|---|---|
| Debtors | 40,000 | 31/12 P&L | 40,000 |

| | Sh. |
|---|---|
| Debtors | 400,000 |
| Bad debts | (40,000) |
| | 360,000 |
| Specific Provision | (5,000) |
| | 355,000 |
| General Provision (5%) | (17,750) |
| | 337,250 |

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

| | Sh. | Sh. |
|---|---|---|
| **Expenses**: | | |
| Bad debts | 40,000 | |
| Increase in provision for D/debts | 22,750 | |

Statement of financial position (Extract) as at 31/12/99

| | Sh. | Sh. |
|---|---|---|
| **Current Assets** | | |
| Stocks | | x |
| Debtors | 360,000 | |
| Provision for D/debts | (22,750) | 337,250 |
| | 337,250 | 337,250 |

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

| | |
|---|---|
| Debtors | 500,000 |
| Bad debts | (50,000) |
| | 450,000 |
| General Provision (5%) | 22,500 |
| | 427,500 |

Debtors

| 2000 | Sh. | 2000 | Sh. |
|---|---|---|---|
| Bal b\d | 500,000 | Bad Debts | 50,000 |
| | | Bal c\d | 450,000 |
| 500,000 | | 500,000 | |

Provision for Doubtful Debts

| 2000 | Sh. | 2000 | Sh. |
|---|---|---|---|
| P\L | 250 | 1\1 Bal b\d | 22,750 |
| Bal c\d | 22,500 | | |
| 22,750 | | 22,750 | |

Bad Debts

| 2000 | Sh. | 2000 | Sh. |
|---|---|---|---|
| Debtors | 50,000 | 31\12 P& L | 50,000 |

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

| | Sh. | Sh. |
|---|---|---|
| Incomes | | |
| Decrease in provision for D/debts | | 250 |
| *Expenses* | | |
| Bad debts | 50,000 | |

Statement of financial position (Extract) as at 31/12/2002

| | Sh. | Sh. |
|---|---|---|
| **Current Assets** | | |
| Debtors | 450,000 | |
| Provision for bad debts | (22,500) | |
| | | 427,500 |

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

| | Sh. |
|---|---|
| Debtors | 600,000 |
| Bad debts | (50,000) |
| | 550,000 |
| General provision % | (27,500) |
| | 522,500 |

Debtors

| 2001 | Sh. | 2001 | Sh. |
|---|---|---|---|
| Bal | b\ | Bad Debts | 50,000 |
| 600,000 | | | |
| | | Bal c\d | 550,000 |
| 600,000 | | 600,000 | |

Provision for Doubtful Debts

| 2001 | Sh. | 2001 | Sh. |
|---|---|---|---|
| | | 1\1 Bal b\d | 22,500 |
| Bal c\d | 27,500 | P& L | 5,000 |
| 22,500 | | 27,500 | |

Bad Debts

| 2001 | Sh. | 2001 | Sh. |
|---|---|---|---|
| Debtors | 50,000 | 31\12 P& L | 50,000 |

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

| | Sh. | Sh. |
|---|---|---|
| Expenses | | |
| Bad debts | 50,000 | |
| Increase in provision | 5,000 | |

Statement of financial position (Extract) as at 31/12/2001

| | Sh. | Sh. |
|---|---|---|
| **Current Assets** | | |
| Debtors | 550,000 | |
| Less: Provision for Doubtful Debts | (27,500) | 522,500 |

*Example 4.6*

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

| | | |
|---|---|---|
| 30 April | H Gordon | Sh.1,100 |
| 31 August | D Bellamy Ltd | Sh.640 |
| 31 October | J Alderton | Sh.120 |

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

You are required to show:

a. The Bad Debts Account, and the Provision for Doubtful Debts Account.
b. The charge to the Profit and Loss Account.
c. The relevant extracts from the Statement of financial position as at 31 December 2002.

Sh. Bad Debts

Debtors 70,036 2002 Sh.

2002 Sh.

Bad debts (1,860) Bad debts 1860 31/12 P\L

1860

| | | |
|---|---|---|
| | 68,500 | Provision for D/Debt |
| (2,200) | | |
| | 66,300 | |

Provision for doubtful debts

| 2002 | | Sh. | 2002 | | Sh. |
|---|---|---|---|---|---|
| 31/12 | Bal c/d | 2,200 | 31/12 | P&L | 2,200 |

Profit & Loss Account (Extract)

| | Sh. | Sh. |
|---|---|---|
| Expenses | | |
| Bad debts | 1,860 | |
| Increase in provision for Doubtful debts | 2,200 | |

Statement of financial position (Extract)

| | Sh. | Sh. |
|---|---|---|
| **Current Assets** | | |
| Debtor | 8,500 | |
| Less: Provision for D/Debts | (2,200) | |
| | | 6,300 |

*Example 8.10*

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

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

On 31 December 2001 there had been a total of debtors remaining of Sh.405,000. It was decided to make a provision for doubtful debts of Sh.5,500.
On 31 December 2002 there had been a total of debtors remaining of Sh.473,000. It was decided to make a provision for doubtful debts of Sh.6,000.

You are required to show:

i. The Bad Debts Account and the Provision for Doubtful Debts Account for each of the two years.

ii. The relevant extracts from the Statement of financial position as at 31 December 2001 and 2002.

*Solutions*

| | |
|---|---|
| Bad debts = | 2,250 |
| | 405,000 |
| Provision | (5,500) |
| | 399,500 |

Bad Debts

| 2001 | Sh. | 2001 | Sh. |
|---|---|---|---|
| 31\8 W.Best | 850 | | |
| 30\9 S.Aron | 1400 | 31\12 P&L | 2250 |
| 2250 | | 2250 | |

Provision for D/Debts

| 2001 | Sh. | 2001 | Sh. |
|---|---|---|---|
| 31\12 Bal c\d | 550 | 31\12 P&L | 550 |
| | | | |
| 2001 | Sh. | 2001 | Sh. |
| | | 1\1 Bal b\d | 550 |
| 1\1 Bal c\d | 600 | 31\12 P&L | 50 |
| 600 | | | |
| | | 600 | |

Bad Debts

| 2001 | | Sh. | 2001 | | Sh. |
|---|---|---|---|---|---|
| 28/2 | J. Friend | 1,800 | | | |
| 31/8 | N. Kelly | 600 | | | |
| 30/11 | A. Oliver | 2,500 | 31/13 | P&L | 4,900 |
| | | 4,900 | | | 4,900 |

Profit & Loss Account (Extract)

| **19x6** | Sh. | Sh. |
|---|---|---|
| **Expenses** | | |
| Bad debts | 2,250 | |
| Provision for Doubtful Debts | 5,000 | |
| **19x7** | | |
| Bad debts | 4,900 | |
| Increase in provision for D/Debts | 500 | |

Statement of financial position as at 19x6

| | Sh. | Sh. |
|---|---|---|
| **Current Assets** | | |
| Debtors | 405,000 | |
| Less provision | (5,500) | 399,500 |
| 19x7 | | |
| Debtors | 473,000 | |
| Less: provision | (6,000) | 467,000 |

### 8.8 Provision for Discounts Allowable.

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

| | |
|---|---|
| Debtors | x |
| Bad debts | (x) |
| | x |
| Specific provision | (x) |
| | x |
| | (x) |
| | x |
| Provision for discount allowed (on balance) | (x) |
| | x |

**Profit & Loss Account (Extract)**

| | Sh. | Sh. |
|---|---|---|
| **Incomes** | | |
| Decrease in provision for D/Debts | | x |
| Decrease in provision for discounts allowed | | x |
| | | |
| **Expenses** | | |
| Bad debts | x | |
| Increase in provision for D/Debts | x | |
| Increase in provision for discounts allowed | x | |

**Statement of financial position (Extract)**

| **Current Assets** | | Sh. | Sh. |
|---|---|---|---|
| Debtors | | x | |
| Less: provision for Doubtful Debts | (x) | | |
| Less: provision for discounts allowed | (x) | | x |

*Bad Debts Recovered*

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

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

*Example: 8.11*
A firm recovers debts amounting to Sh.10,000 that had been written off in the previous periods. In the same financial period the firm writes off bad debts amounting Sh.30,000. The ledger accounts will be as follows:

Bad debts

| | Sh. | | Sh. |
|---|---|---|---|
| Debtors | 30,000 | Bad Debt Recovered | 10,000 |
| | | P\L | 20,000 |
| 30,000 | | 30,000 | |

Bad debts recovered

| | Sh. | | Sh. |
|---|---|---|---|
| Bad Debt | 10,000 | Debtors | 10,000 |

## 8.9 Revision Questions

Question one

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

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

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

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

Required:

a) Calculate the amount of depreciation charged in the profit and loss account for each of the five years.

b) Prepare the motor vehicle account (at cost).

c) Calculate the profit and loss on disposal of each of the vehicles disposed of by the company.

Question two

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

a) Motor expenses: Paid in 2002 Sh.7,440; Owing at 31 December 2002 Sh.2,800.
b) Insurance: Paid in 2002 Sh.42,000; Prepaid as at 31 December 2002 Sh.3,500.
c) Stationery: Paid during 2002 Sh.18,000; Owing as at 31 December 2001 Sh.25,000; Owing as at 31 December 2002 Sh.49,000.
d) Rates: Paid during 2002 Sh.95,000; Prepaid as at 31 December 2001 Sh.2,200; Prepaid as at 31December 2002 Sh.2,900.
e) Seamers sub-lets part of the premises. Receives Sh.5,500 during the year ended 31 December 2002. Tenant owed Seamers Sh.1,800 on 31 December 2001 and Sh.2,100 on 31 December 2002

Question two

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

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

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

## 8.10 References


- Wood, Frank, *Business Accounting* (17th Edition), International Thompson. Pages 171-189.
- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 143-148

# Mt Kenya University

**UNIVERSITY EXAMINATIONS 2010/2011**

**SCHOOL OF APPLIED SOCIAL SCIENCES**

**DEPARTMENT OF BUSINESS AND SOCIAL STUDIES**

**BACHELOR OF BUSINESS MANAGEMENT**

**UNIT CODE: BAF1101 TITLE: F UNDAMENTALS OF ACCOUNTING I**

**TIME 2HRS**

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**Instructions**

*Answer Question **ONE** which is **Compulsory** and any other **TWO** questions*

**Question One**

(a) Differentiate between the following terms as used in accounting.

(i) A debit entry and credit entry (2 marks)

(ii) Return inwards and return outwards (2 marks)

(iii) An asset account and liability account (2marks)

(iv) An expense account and revenue account (2 marks)

(v) A trail balance and a balance sheet (2 marks)

b) The following is a trial balance of ABC Ltd.

| | Kshs | Kshs |
|---|---|---|
| Stock 1 Jan 2009 | 2,368,000 | |
| Carriage inwards | 200,000 | |
| Carriage outwards | 310,000 | |
| Return outwards | 205,000 | |
| Return outwards | | 322,000 |

| | | |
|---|---|---|
| Purchases | 11,870,000 | |
| Sales | | 18,600,000 |
| Rent | 3,862,000 | |
| Salaries & Wages | 304,000 | |
| Insurance | 78,000 | |
| Motor expenses | 216,000 | |
| Lighting and heating expenses | 166,000 | |
| General expenses | 314,000 | |
| Premises | 500,000 | |
| Motor vehicles | 1,800.000 | |
| Debtors | 3,896,000 | |
| Fixture and fittings | 350,000 | |
| Creditors | | 1,731,000 |
| Cash at Bank | 482,000 | |
| Drawings | 1,200,000 | |
| Capital | | 8,132,000 |
| | 28,785,000 | 28,785,000 |

Stock at 30 December 2009 was Sh. 2,946,000

Required:

Draw up a statement of comprehensive income for the year ended 31st Dec. 2009 and statement of financial position as at 31/12/2009. (20 marks)

**Question Two**

Write a two-column cash book from the following detail and balance off as at the end of the month.

2009

Oct 1: Started business with capital in cash Sh. 1,000,000

Oct 2: Paid rent by cash Sh. 100,000

Oct 3: Loan from Mary- Sh. 500,000, paid by cheque.

Oct 4: Paid B. Peter by cheque Sh. 65,000

Oct 5: Cash sales made Sh. 98,000

Oct 7: Mitter, owe of debtor paid by cash Sh.62, 000

Oct 9: Paid Den (creditor) in cash 22,000

Oct 11: Cash sales paid direct into the bank Sh. 53,000

Oct 15: George (creditor) paid as by cheque Sh. 65,000

Oct 16: Repaid Mary by cheque Sh.100, 000

Oct 19: Took Sh.50, 000 out of the cash till and paid it into the bank accounts.

Oct 22: Paid motor expenses by cheque Sh. 12,000

Oct 26: Withdrew Sh. 100,000 cash from the bank for business use.

Oct 31: Paid wages in cash Sh. 97,000.

**Question Three**

The following transaction to Best Sales (K) Ltd for the month of March 2009.

March 1: Started business with Sh. 800,000 in the bank.

March 2: Bought goods on credit from the following persons

Ndichu- Sh. 76,000

Omolo- Sh. 27,000

Tina- Sh. 56,000

March 5: Cash sales Sh. 87,000

March 6: Paid wages in cash Sh. 14,000

March 7: Sold goods on credits to

Emma-Sh.35, 000

Jane- Sh. 42,000

Juma- Sh. 72,000

March 9: Bought goods for cash Sh. 46,000

March 10: Bought goods on Credits from

Omolo- Sh. 57,000

Ndebu-Sh. 98,000

March 12: Paid wages in cash Sh.465, 000

March 13: Sold on credit to: Jane- Sh. 32,000

Juma- Sh. 23,000

March 15: Bought fix tires on credit from Beta Ltd Sh. 50,000

March 17: Paid Omolo by cheque Sh. 84,000

March 18: Returned goods to Ndebu Sh.20, 000

March 24: Jane returned some of goods sold to her Sh.11, 000

March 31: Bought a motor van paying by cheque Sh. 400,000

**Required:**

Record the above transaction in the ledger of Best Sales Ltd and balance off the account; hence forth, extract a trial balance as at 31 March 2009.

**Question Four**

(a) Define the following terms as used in Business.

(i) Business transactions (2 marks)

(ii) Credit transaction (2 marks)

(iii) Initial capital (2 marks)

(iv) Final capital (2 marks)

(v) Drawings (2 marks)

(b) Outline 4 circumstances under which the capital of a business may change (4 marks)

(c) The following information was extracted from the book of LIMA Ltd. For the year 2006.

(i) Initial capital as at 1/01/2006 – Sh.200,000

(ii) Made a net loss of Sh. 50,000

(iii) The proprietor invested into the business from her personal saving Sh. 600,000

(iv) The proprietor withdraw in cash for her personal use Sh. 250,000

**Required:**

Using the final capital formula, determine the final capital as at 31/12/06 **(**4 marks)

**Question Five**

Write notes on any 5 basic accounting concepts (20 marks)

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**UNIT CODE: BAF1101 TITLE: F UNDAMENTALS OF ACCOUNTING I**

**TIME 2HRS**

---

**Instructions**

*Answer Question **ONE** which is **Compulsory** and any other **TWO** questions*

**Question One**

a) Outline and explain any five (5) users of accounting information. (5 marks)

b) What are purposes of control accounts (5 marks)

c) David a sole trader has prepared the following balance as at 31 March 2010.

| | Sh. |
|---|---|
| Sales | 378,500.00 |
| Discount Received | 2,400.00 |
| Rent Received | 7,500.00 |
| Returns outwards | 7,700.00 |
| Creditors | 18,700.00 |
| Bank Overdraft | 30,000.00 |
| Capital | 287,500.00 |
| Purchases | 261,700.00 |
| Salaries and Wages | 45,700.00 |
| Office expenses | 8,400.00 |
| Insurance premiums | 3,100.00 |
| Electricity | 1,600.00 |
| Stationery | 6,200.00 |
| Advertising | 8,400.00 |
| Telephone | 2,100.00 |

| | |
|---|---|
| Business Rates | 7,500.00 |
| Discounts allowed | 600.00 |
| Returns Inwards | 4,100.00 |
| Stocks as at 1 April 2000 | 120,600.00 |
| Warehouse, shop and office | 210,000.00 |
| Fixtures and fittings | 12,800.00 |
| Debtors | 13,000.00 |
| Cash in till | 500.00 |
| Drawings | 26,000.00 |

The following further information was obtained:

- Closing stock was Sh.102,500.00
- Electricity charges accrued Sh.700.00
- Advertising expenses accrued Sh.500.00
- Insurance premiums paid in advance Sh.900.00
- Business rates prepaid Sh.1,500.00

**Required:**

Prepare statement of comprehensive income for the year ended 31 March 2001 and statement of financial position as at that date. (10 marks).

**Question Two**

a) Explain the term "bank reconciliation" and state the reasons for its preparation.

(b) Makula, a sole trader received his bank statement for the month of June 2001. At that date the bank balance was Sh. 706,500 whereas his cash book balance was Sh.2, 366,500.

His accountant investigated the matter and discovered the following discrepancies:

11. Bank charges of Sh.3, 000 had not been entered in the cashbook.
12. Cheques drawn by Makula totaling Sh.22, 500 had not yet been presented to the bank.
13. He had not entered receipts of Sh.26, 500 in his cashbook.
14. The bank had not credited Mr Makula with receipts of Sh.98, 500 paid into the bank on 30 June 2001.
15. Standing order payments amounting to Sh.62, 000 had not been entered into the cashbook.
16. In the cashbook Makula had entered a payment of Sh.74, 900 as Sh.79, 400.
17. A cheque for Sh.15, 000 from a debtor had been returned by the bank marked "refer to drawer" but had not been written back into the cashbook.
18. Makula had brought forward the opening cash balance of Sh.329, 250 as a debit balance instead of a credit balance.
19. An old cheque payment amounting to Sh.44, 000 had been written back in the cashbook but the bank had already honored it.
20. Some of Makula's customers had agreed to settle their debts by paying directly into his bank account. Unfortunately, the bank had credited some deposits amounting to Sh.832, 500 to another customer's account. However

**Required:**

ii. A statement showing Makula's adjusted cashbook balance as at 30 June 2001.

iii. A bank reconciliation statement as at 30 June 2001. ( 20 marks)

**Question Three**

A bookkeeper extracted a trial balance on 31 December 2002 that failed to agree by Sh.3, 300 a shortage on the credit side of the trial balance. A suspense account was opened for the difference.
In January 2003 the following errors made in 2003 were found:

(vi) Sales daybook had been under cast by Sh.1, 000.
(vii) Sales of Sh.2, 500 to J Church had been debited in error to J Chane account.
(viii) Rent account had been undercast by Sh.700.
(ix) Discounts received account had been under cast by Sh.3, 000.
(x) The sale of a motor vehicle at book value had been credited in error to Sales account Sh.3, 600.

*Required:*

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

**Question Four**

.a) Write shorts notes on the following source documents.

i) Debit

ii) Credit note

iii) Purchase note

iv Sales invoice
v) receipt (10 marks)

b) Write short notes on the following books of prime entry.

i) Sales journal

ii) Purchase journal

iii) Return inward journal .

iv) Return out ward journal

v) General journal.

**Question Five**

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

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

Required:

Construct a trial balance, from the above list of balances. (20 marks)

## Answers model paper 1. (Suggested)

**Question one**

(i) Debit entry –an entry made on the debit side of an account.

Credit entry- an entry made on the credit side of an account.

(ii) Return inwards-also called sales returns. Goods returned to the business by their customers.

Return outwards also called purchase returns Goods returned to suppliers by the business.

(iii) An asset account - An account having a resource of a business. E.g. motor vehicle accounts, debtor account.

(iv) An expense account- An account having what the business has incurred when running business e.g salary account, electricity account

Revenue account – An account having an income to the business. E.g. p&l account, discount received account.

(v) Trial balance- This is a list of debit and credit balance of a business for particular date.

Has a column, title of accounts, the debit column and credit column.

(vi) Balance sheet- A statement showing the assets and liabilities of a business at a particular date.

Also called, statement of financial position.

b) **ABC Ltd.**

**Statement of comprehensive income for the few ende l 31/ 12/2009**

| | Sh (000) | Sh (000) |
|---|---|---|
| Sales (net) (w1) | | 18,385 |
| Cost of sales (w2) | | 11170 |
| Gross profit | | 7225 |
| | | |
| Operator expenses | | |
| Carrying outwards | | 310 |
| Rent | | 3,862 |
| Salaries & wages | | 304 |

| | | |
|---|---|---|
| Insurance | 78 | |
| Motor expenses | | 664 |
| Office expenses | | 216 |
| Lighting and heating expenses | | 116 |
| General expenses | 314 | |
| Operating profit | | **1,361** |

**ABC ltd Statement of financial position as at 31/Dec/2009**

| | | |
|---|---|---|
| Non-current Asset: | | |
| Promises | 500 | |
| Motor vehicles | 1,800 | |
| Fixture & fitting | 350 | |
| | 2,650 | |
| **Current Assets** | | |
| Stock | 2,946 | |
| Debtors | 3,896 | |
| Cash at Bank | 482 | |
| | 7,324 | |
| **Total Assets** | 10,024 | |
| **Equity & Reserves** | | |
| Capital | 8,132 | |
| Drawing | | (1,200) |
| Profit | 1,361 | |
| | 8,293 | |
| Current liabilities | 1,731 | |
| Creditors | | |
| Total | 10,024 | |

*Workings*

| | | | |
|---|---|---|---|
| | | 18,600 | |
| W1 sales | | 205 | |
| Return inwards | | | 18,395 |

W2 cost of sales

| | Sh 000 | Sh 000 | |
|---|---|---|---|
| Opening stock | | 2,368 | |
| Purchases | 11,870 | | |
| Carriage inwards | 200 | | |
| | 12,070 | | |
| Return outwards | 322 | 11,748 | |
| Goods available for sale | | | 14,116 |
| Closing stock | | 2,946 | |
| Cost of sales | | 11,170 | |

**Question Two**

**Cash book**

| **2009** | **Cash** | **Bank** | | **Cash** | **Sales** |
|---|---|---|---|---|---|
| | Sh.000 | Sh.000 | 2009 | Sh.000 | Sh.000 |
| Oct. Capital A/C | 1000 | | Oct 2 rent A/C | 100 | |
| Oct Loan A/C | | 500 | Oct 4 B. Peter A/c | | 65 |
| Oct 5 Sales A/C | 98 | | | 62 | |
| Oct 7 Debtors | 62 | | Oct 9 Creditors A/C | 22 | |
| Oct 1 sales | | 53 | | | |
| | | | Oct 15 Creditors | | 65 |
| | | | Oct 16 May A/C | | 100 |
| Oct 19 C1 | 50 | | Oct 19 C1 | 50 | |
| | | | Oct 22 motor expenses A/C | | 12 |
| | | | Oct 26 Business A/C | 100 | |

| | | | | | |
|---|---|---|---|---|---|
| | | | Oct 31 wages A/C | 97 | |
| | | | Oct Bal A/C | 779 | 311 |
| | **1,210** | **553** | | **1,210** | **553** |

**Question Three**

**Bank A/C**

2009 Sh '000' 2009 Sh '000'

Sh '000'

Mar 1 capital 800 Mar 6 wages A/C 14

Mar 5 statement 87 Mar 9 purchase 46

A/C 800

Mar 12 wages 14

Mar 17 creditors 84

Mar 24 motor A/c 400

Mar 31 bal c\d 329

887 887

**Capital A/C**

2009 Sh'000' 2009

Mar 1

Mar 31 Bal A/C 800 Bank

**Purchase A/C**

2009 Sh 2009 Sh

Sh

Mar 2 Creditors A/C 159

76

27

56

Mar 2: Bank A/C 46 bal c\d360

Mar 9 Creditors A/C- Omolo 57

- Ndebu 98

57

**Creditors A/C**

2009 Sh 2009

Mar 2Mar 18 Bank Bal 84 Ndichu

Omolo

Tina

Mar 18 R/out 20 Mar 10

bal c\d 210 Omolo

Ndebu ____

98

| | | | |
|---|---|---|---|
| **360** | **360** | **314** | **314** |

**Sales A/C**

| 2009 | Sh | 2009 | Sh |
|---|---|---|---|
| Sh | | | |
| | | Bank A/C | 87 |
| Bal c\d | 291 | Nov 7 Emma | 35 |
| 28 | | | |
| | | Jane | 42 |
| | | Jane | 72 |
| | | Nov 13: Jane | 32 |
| | | Juma | 23 |
| | **291** | | **291** |

**Wages A/C**

| 2009 | Sh | 2009 | |
|---|---|---|---|
| Nov 6 Bank A/C | 14 | | |
| Nov 2 Bank A/C | 14 | Bal c\d | |
| | **28** | | **28** |

**Debtors A/C**

| 2009 | Sh | 2009 | Sh |
|---|---|---|---|
| Nov 7: Emma | 35 | Nov 24 R/inward | |
| : Jane | 42 | Jane A/C | |
| : Juma | 72 | | |
| Nov 13 – Jane | 32 | Bal c\d | 193 |
| - Juma | 23 | | |
| | **204** | | **204** |

**Fixture A/C**

| 2009 | Sh | 2009 | Sh |
|---|---|---|---|
| Nov 15 | | | |
| Beta Ltd | 50 | Bal c\d | 50 |

**Beta Ltd**

| 2009 | Sh ‘000’ | 2009 | Sh ‘000’ |
|---|---|---|---|
| Bal c\d | 50 | March 15 Beta Ltd | 50 |

**Returns outwards A/C**

| 2009 | Sh ‘000’ | 2009 | Sh ‘000’ |
|---|---|---|---|

| | | | |
|---|---|---|---|
| | | March 15 creditors | |
| Bal c\d | 20 | | Ndebu A/c 20 |

**Return Inwards A/C**

| 2009 | Sh. ‘000’ | 2009 | | Sh ‘000’ |
|---|---|---|---|---|
| Mary 24 Debtors | 11 | Bal c\d | 11 | |
| Jane | | | | |

**Motor vehicle**

| 2009 | sh ‘000’ | 2009 | Sh ‘000’ |
|---|---|---|---|
| .31 Bal A/C | 400 | Bal c\d | 400 |

**Best Sales Ltd**

**Trail Balance**

| | Debit | credit |
|---|---|---|
| | Sh ‘000’ | Sh ‘000’ |
| Bank | 329 | |
| Capital | | 800 |
| Purchase | 360 | |
| Creditors | | 210 |
| Sales | | 291 |
| Wages | 28 | |
| Debtors | 193 | |
| Fixtures | 50 | |
| Beta | | 50 |
| R/ outwards | | 20 |
| R/ inwards | | |
| Motor vehicle | 400 | |
| **Total** | **1,371** | **1,371** |

Question four

(i) Business transaction – Exchange of goods and services for payment

Business receives payment in the form of money or goods and services

(ii) Credit transaction- Exchange of goods and services where payments are made at a future date.

(iii) Cash transaction – Immediate payment for goods and service at the time when the transaction takes place in the form of cash, cheques and other forms of money.

(iv) Initial capital- terms used to describe any funds and other assets invested into the business by the owner at the beginning of the trading period

(v) Final capital – business capital at the end of the trading period

(vi) Drawings- money or other assets taken from the business by the owner for personal use

(b) -Additional investment

- Drawings from the business
- Profit making
- Loss making

(c) F.C = I.C + I+ P-L-D

Therefore = Sh 200,000 + Sh.600, 000- Sh. 50,000 – 250,000

= Sh. 500,000

**Question Five**

1. Cost concept – Means that assets are normally shown/ recorded at cost price. This is the basic for valuation
2. Money measurement concept – accounting is concerned only with the facts which
   a) Can be measured in money
   b) Most people will agree to the money value of the transaction
3. Going concern concept – resources that business will continue for along time
4. Business entity concept – items recorded in a business book are limited to the transaction which affect the firm as a business infinity
5. Realization concept – profit is said to be earned at the time when:

(a) goods or service are passed to the customer

(b) when the customer pays for the goods

6. Dual aspect concept – statement that there are two aspect of accountancy- one represented by the assets of the business and the other by the claims against them

There are two aspect are always equal to each other

7. Actual concept – Net profit is the difference between revenue and expenses
8. others include- time interval concept

   Materiality Prudence

   Consistency

   Substance over form