'O' LEVEL

ACCOUNTS Study Pack

Preface

THIS STUDY PACK COVERS ALL AREAS OF THE SYLLABUS THOROUGHLY GIVING DETAILED COVERAGE OF ALL TOPICS. THE EXAMPLES GIVE THE STUDENTS PLENTY OF PRACTICE AT THE VARIOUS, ACCOUNTING TECHNIQUES INVOLVED BUILDING FROM SIMPLE CONCEPTS AND EXAMPLES TO QUESTIONS OF EXAMINATION STANDARD. THIS TEXT IS INTENDED TO ACCOMMODATE BOTH NEW STUDENTS TO ACCOUNTING AND THOSE WHO DID IT AT J.C. LEVEL HENCE THE FIRST TWO CHAPTERS OF THIS BOOK ARE DEDICATED TO THE INTRODUCTION TO ACCOUNTING.

APART FROM THOSE SITTING FOR THEIR "O" LEVEL EXAMINATION, STUDENTS STUDYING FINANCIAL ACCOUNTING AT IT'S ELEMENTARY LEVEL IN ANY OF THE FOLLOWING COURSES ARE RECOMMENDED TO MAKE USE OF THIS BOOK.

- THE INSTITUTE OF CHARTERED SECRETARIES AND ADMINISTRATORS
- THE ASSOCIATION OF ACCOUNTING TECHNICIANS
- THE INSTITUTE OF CREDIT MANAGEMENT
- THE INSTITUTE OF BANKERS
- BACHELOR OF COMMERCE DEGREES
- THE INSTITUTE OF ADMINISTRATION AND COMMERCE

- LONDON CHAMBER OF INDUSTRY AND COMMERCE

1. INTRODUCTION TO FINANCIAL ACCOUNTING

1.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Define the terms 'Accounting' and 'transaction'.*
- *Explain the accounting process.*
- *Understand the need for businesses accounts.*
- *State the purposes of calculating business profit and loss*
- *Identify business assets and liabilities and show awareness of the importance of the difference between them.*
- *State the accounting equation.*
- *Recognize and understand the forms of accounting statement which show profits and losses (Statement of comprehensive income) and assets and liabilities (Statement of financial position)*

1.2 Financial accounting

Andrew Thomas defines accounting as a **process** of designing and operating an information system for collecting, measuring and recording business transactions, and summarizing and communicating the results of these transactions to users to facilitate financial / economic decisions.

1.3 The Accounting process

The process of accounting starts with collecting and recording transactions in the **books of prime entry**, using source documents. Posting to the **Ledger accounts**, extracting a **Trial Balance**, making adjustments for accruals, prepayments and other year-end adjustments will then follow, before preparing **Financial Statements** and communicating them to users.
This process can be shown below:

TRANSACTIONS

↓

SOURCE DOCUMENTS

↓

BOOKS OF ORIGINAL ENTRY

↓

LEDGER *(balance off)*

TRIAL BALANCE

ADJUSTMENTS

↓

FINANCIAL STATEMENTS

(E.g. Statement of comprehensive income and statement of financial position)

Note: The above process will be used when preparing year-end accounts as well as management accounts. Let us now look at the details of the above process.

1.4 Transactions

A transaction is an activity involving the exchange of money or anything with an ascertainable money value e.g. sale or purchases of goods on cash or credit. There are of two types, Cash transactions and Credit transactions.
Each transaction will result in two different accounts being affected. Whenever there is a transaction, one account is either gaining or the other one is losing. The one, which is gaining, should be debited and the one, which is losing, should be credited.

Illustration

Consider the following information, which was extracted from the books L. Ncube for the month of January 2012:

January 1. L. Ncube started business with a capital of $100 000 in cash.
January 2. Purchased goods worth $40 000 for resale on credit from National Wholesales.
January 3. Sold goods on cash for $35 000.

From each of the above transactions we should identify two accounts as follows being affected and then determine which one is gaining and which one is losing.

	Gain *(Debit)*	Lose *(Credit)*
January 1.	Cash	Capital
January 2.	Purchases	National Wholesales
January 3.	Cash	Sales

1.5 Source documents

As the organisation conducts its business on a daily basis, it generates documents, which are used by the accountant to record transactions in the books of accounts. These documents are known as Source Documents in accounting. The examples of these documents include: receipt, invoice, credit note, debit note, cheque counterfoil, petty cash voucher and statement of account

1.6 Books of original entry

These are the first books of accounts were transactions are recorded before posted to the ledger. These books include: sales journal, sales returns journal, purchases journal, purchases returns journal, cash book and general journal.

1.7 The ledger

A ledger is a main book of accounts. This is because all the other books of original entry are posted to the ledger at the end of each period for example at the end of every month.

1.8 The trial balance

It is a list of all ledger balances at the end of a particular period. Each ledger account is balanced at the end of the month and the total transferred to the trial.

1.9 Adjustments to the financial statements

These are items which added as additional information to the trial balance. They include closing inventory, other payments (accruals), other receivables (prepayments), inventory taken by the owner for personal use, depreciation, provision for doubtful debts and others.

1.10 Financial Statement

Financial statements are final accounts which are prepared at the end of each financial year. They are used to assess the financial performance of the business (Statement of comprehensive income) and the financial status (Statement of financial position).

Key Accounting terms

1.1 Capital (Equity)

Capital is money or other assets put into the business by the owner. When someone starts a business he usually puts money into the business. Only Capital in the form of cash is debited to the cash / bank account and credited to the Capital account. Capital in other forms is debited to the respective asset accounts and credited to the capital account.

1.2 Drawings

This is anything that is taken by the owner from the business for his or her private use. Drawings may be in the form of cash, cheque or goods. A drawings account should be debited because it is either receiving money or goods. The effects of a drawing account are that it reduces the owners' capital. In the Statement of financial position, drawings should be subtracted from capital.

1.3 Asset

This is resource which belongs to the business. We have got two classes of assets, which are non-current assets and current assets.

1.3.1 Non-current assets (Fixed assets)

Those are assets with a useful life of more than 1 year which are intended to be used to generate revenue for the business. They can be further classified as tangible or intangible. Tangible assets are those that can be touched and seen while intangible cannot be touched.

Examples of Non-current assets

The following are example of non-current /fixed assets:

1. **Premises** ***(tangible)***
   These include land and buildings. These assets are not subject to depreciation as they appreciate in value.
2. **Fixtures and fittings** ***(tangible)***
   It refers to anything that is fitted on the building to add its value for example air conditioner, sockets, plugs etc.
3. **Equipment** ***(tangible)***
   Equipment includes computers, printers, type writers and other peripheral devises which used by an enterprise.
4. **Furniture** ***(tangible)***
   For example chairs, tables and desks.
5. **Motor vehicles** ***(tangible)***
6. **Machinery** ***(tangible)***
7. **Goodwill** ***(intangible)***
   Goodwill is the difference between the value of the business as a whole and the value if it's separate assets.

1.3.2 Current assets

These are assets with a useful life of less than 1 year. The following are examples of current assets and should be listed in their order of liquidity starting with the least liquid assets i.e. the one which cannot easily be converted into cash:

Examples of Current assets

1. **Inventory (Stock)**
   Inventory refers to raw materials to be transformed into finished goods, semi-finished goods and/or goods awaiting sale.
2. **Trade receivables (Debtors)**
   These are credit customers who owe the business money for the value of goods sold on credit.
3. **Other receivables (Expenses paid in advance)**
   These are expenses which are paid in advance or before their due dates for example salaries prepaid, rent paid in advance etc.
4. **Cash at bank**
   Cash at bank is money deposited into the business bank account.
5. **Cash on hand**
   This is money on hand or at the disposal of the company.

6. **Petty cash**
   Cash held for the payment of the small value items.

1.4 Liabilities

A liability represents an amount being owed by the business to other people or businesses. A liability is either current or non-current.

2.4.1 Current assets

A current liability is a debt, which is due or payable within the next twelve months. The following are examples of current liabilities:

1. **Trade payables (Creditors)**
   These are credit customers to whom the business the business owes money for the value of goods bought on credit.
2. **Other payables (Expenses accrued)**
   Other payables are expenses outstanding or unpaid at the end of the financial period.
3. **Bank overdraft**
   A bank overdraft is the excess of withdrawal over the amount deposited.
4. **Short-term loan**
   A short term loan is a loan which is payable by the business within the next twelve months.

2.4.2 Non-current liability (Long term liability)

Long term liability is a debt which is payable by the business after one year.
Following are examples of long term liabilities:

1. **Loan from a bank**
   A loan obtained by the business which is payable after one year. For this loan to be granted, the bank will request for collateral security.
2. **Mortgage**
   This special loan is issued by the building society for the acquisition of immovable property like a house. The property acquired is then used as collateral security and therefore remains the asset of the bank until the payment of the last instalment by the borrower.
3. **Loan from an individual**
   Instead of borrowing money from the bank or other business, an enterprise can also obtain a loan from an individual.

1.5 Expenses

These are costs incurred by the business in its dad-to-day operation.

Examples of expenses

1. Wages and salaries
2. Rent and rates

3. electricity
4. Bad debts
5. Insurance
6. Depreciation
7. Telephone/cell phone charges

1.6 Income

This refers to revenue generated by a business in its normal course of running the business.

Examples of Income

1. Revenue/sales
2. Rent received
3. Commission received
4. Discount received

1.7 Purchases

These are goods bought by the business for resale.

1.8 Accounting Equation

The Accounting equation is stated as follows:

1. Assets - Liabilities = Capital

This equation can also be expressed as follows:

2. Assets = Capital + Liabilities
3. Assets – Capital = Liabilities

<u>Revision question</u>

Tshepo is a sole trader making machine tools. His financial year ends on 30 November each. On 30 November 2011 he furnishes you with the following information:

	$		**$**
Premises	20 000	Equipment	25 000
Trade receivables	10 000	Trade payables	7 500
Cash in hand	1 000	Bank overdraft	2 500
Inventory	8 000	Other receivables	1 500
Other payables	1 000	Short term loan	4 500
Bank loan – payable after 5 years	10 500		

You are required to answer the following questions

a) i) State the Accounting equation

ii) Define the term working capital

b) Calculate the following:

i) Total non-current assets
ii) Total current assets
iii) Total current liabilities
iv) Working capital

1.9 The double entry rule

This rule states that for every debit entry, there should be a corresponding credit entry and for every credit entry there should be a corresponding debit entry. The receiving account should be debited whilst the paying account should be credited. A transaction will result in one account receiving or gaining, whilst the other account is losing. The rule to be observed when entering transactions in the books of accounts is **that each transaction should be entered in two accounts**, in one on the **debit** side and in another on the **credit** side. Thus the debit entry on the water account below is not complete until and unless the corresponding credit entry is made in the Cash account.

An example is the following Account for Water Expenditure of $900 paid by cash. The complete Double entry is shown below:

Dr Cash Account Cr.

2011			2011		$
			Jan 15	Water **	900

Dr Water Account Cr.

2011		$			
Jan 15	Cash***	900			

The arrow that we inserted explains that the amount is entered on **opposite sides**. Please make sure you understand this: -

** The narrative on the **credit** side of the cash account (i.e. Water**) means that the corresponding **debit** entry is in the water account.
The narrative on the **debit** side of the water account (i.e. Cash) means that the corresponding **credit entry** is in the Cash Account.

Recording of financial transactions using the double entry system

What is Double Entry Book-keeping?	• It is a system of accounting in which every financial transaction gives rise to "two equal accounting entries", a debit and credit. • Every financial transaction affects two aspects e.g. giving and receiving. This dual aspect of a giving and a receiving is recorded in two ledger accounts as a debit and a credit entry. This way of recording of a transaction is called double entry system of book-keeping.
State basic rules of double entry system	(i) Every transaction must be recorded in **two accounts (**because of twofold aspects of it e.g. giving and receiving.) (ii) For every **debit entry** there must be a **credit entry**. (iii) The amount of debit entry must be **equal** to the amount of credit entry.

Effect of an entry made in an account	• Every entry that is made in an account results in increase or decrease in value. • This increase or decrease in value because of an entry depends on the **type of account** in which the entry is made.
Classification of Accounts	• Asset Account • Liability Account • Revenue (Income) Account • Expenses (Loss) Account

Effect of a debit or credit entry in different types of accounts	
Asset Account	• A **debit entry** in the asset account **increases** its value • A **credit entry** in the asset account **decreases** its value
Liability Account	• A **credit entry** in the liability account **increases** amount owing • A **debit entry** in the liability account **decreases** amount owing
Revenue Account	• A **credit entry** in the revenue account **increases** the value • A **debit entry** in the revenue account **decreases** the value
Expenses Account	• A **debit entry** in an expenses account **increases** the value • A **credit entry** in the expenses account **decreases** the value

Dr. (+) Asset Account Cr.(-)

	Asset Received	xxx		Asset Given out	xxx

Dr. (-) Liability Account Cr.(+)

	Payment/ Returns	xxx		Owing	xxx

Dr. (+) Expense Account Cr.(-)

	Services Received	xxx			

Dr. (-) Revenue Account Cr.(+)

				Services Rendered	xxx

1.10 ILLUSTRATIONS TO SHOW DOUBLE ENTRIES FOR VARIOUS TRANSACTIONS

1.10.1 I CASH TRANSACTIONS

1. Bought goods for $700 paying by cash

Dr. Purchases Account Cr.

		$			
	Cash	700			

Dr. Cash Account Cr

					$
				Purchases	700

2. Bought goods for $800 paying by cheque

Dr. Purchases Account Cr.

		$			
	Bank	800			

Dr. Bank Account Cr

					$
				Purchases	800

3. Bought Equipment for $1000 paying by cash

Dr. Equipment Account Cr.

		$			
	Cash	1000			

Dr. Cash Account Cr

					$
				Equipment	1000

4. Bought Motor Van for $9000 paying by cheque

Dr. Motor Van Account Cr.

		$			
	Bank	9000			

Dr. Bank Account Cr

					$
				Motor Van	9000

5. Paid $650 cash for wages

Dr. Wages Account Cr.

		$			
	Cash	650			

Dr. Cash Account Cr

					$
				wages	650

6. Paid $380 by cheque for rent

Dr. Rent Account Cr.

		$			
	Cash	380			

Dr. Bank Account Cr

					$
				Rent	380

7. Received $320 cash for commission

Dr. Cash Account Cr.

		$			
	Commission	320			

Dr. Commission Received Account Cr

					$

	received									Cash	320

8 Sold goods for cash $590

Dr.	Cash Account				Cr.	Dr.	Sales Account				Cr
	Sales	$ 590								Cash	$ 590

9. Sold goods for $730 and received a cheque for the amount.

Dr.	Bank Account				Cr.	Dr.	Sales Account				Cr
	Sales	$ 730								Bank	$ 730

10. Sold old furniture for cash $880

Dr.	Cash Account				Cr.	Dr.	Furniture Account				Cr
	Furniture	$ 880								Cash	$ 880

1.10.2 II CREDIT TRANSACTIONS

11. Bought goods on credit from M. Huro for $1100

Dr.	Purchases Account				Cr.	Dr.	M. Huro Account				Cr
	M. Huro	$ 1100								Purchases	$ 1100

12. Bought Machinery on credit from Sarah Company for $8400

Dr.	Machinery Account				Cr.	Dr.	Sarah Company Account				Cr
	Sarah Company	$ 8400								Machinery	$ 8400

13. Sold goods on credit to T. Chirwa for $5500

Dr.	T. Chirwa Account				Cr.	Dr.	Sales Account				Cr
	Sales	$ 5500								T. Chirwa	$ 5500

14. Sold Office Equipment on credit to J. Moeng for $3000

Dr.	J. Moeng Account	Cr.	Dr.	Office Equipment Account	Cr

	Office Equipment	$ 3000			

				J. Moeng	$ 3000

1.10.3 III PROPRIETORS' TRANSACTIONS

15. Sabina. Abdullah started a business investing $10 000 cash

Dr.	Cash Account				Cr.
	Capital	$ 10000			

Dr.	Capital Account				Cr
				Cash	$ 10000

16. N. Tajbay commenced a business contributing $9000 into the business bank account

Dr.	Bank Account				Cr.
	Capital	$ 9000			

Dr.	Capital Account				Cr
				Bank	$ 9000

17. The proprietor, A. Muvindi has taken $500 cash from business for his private use

Dr.	Drawings Account				Cr.
	Cash	$ 500			

Dr.	Cash Account				Cr
				Drawings	$ 500

18, The proprietor has drawn $700 from business bank account for his personal use

Dr.	Drawings Account				Cr.
	Bank	$ 700			

Dr.	Bank Account				Cr
				Drawings	$ 700

1.10.4 IV. TRANSACTIONS WITH BANK – Cash Deposit and Withdrawal of Money

20. Deposited $800 cash into business bank account

Dr.	Bank Account				Cr.
	Cash	$ 800			

Dr.	Cash Account				Cr
				Bank	$ 800

21. Withdraw $1600 cash from bank for business use

Dr.	Cash Account				Cr.
	Bank	$ 1600			

Dr.	Bank Account				Cr
				Cash	$ 1600

1.10.5 V. Loan Transactions – Borrowing a Loan

22. Borrowed $4000 by cheque from T. Mubika.

Dr. Bank Account Cr.

		$			
	T. Mubika (Loan)	4000			

Dr. T. Mubika (Loan) Account Cr

					$
				Bank	4000

Revision question
Complete the following table showing which accounts are to be debited and which to be credited.
January 4.

No.	Transaction	Account to be debited	Account to be credited
(a)	Paid salary for staff by cash		
(b)	Bought goods on credit from J Smith		
(c)	Received Rent by cheque from a tenant		
(d)	Goods returned to J Smith, the supplier		
(e)	Bought stationery paying by cash		
(f)	Paid insurance by cheque		
(g)	Sold goods on credit to N Franklin		
(h)	Paid J Smith, the supplier, by cheque		
(i)	Sold old computer for cash		
(j)	Goods returned by N Franklin to us		
(k)	Received commission by cash		
(l)	Bought machines on credit from K Lowe		

2. SOURCE DOCUMENTS

2.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Explain the stages of accounting system*
- *Understand and use original business source documents (Invoice, Credit/Debit notes, cheque counterfoils, receipt and statements).*
- *State the contents of each of the business documents.*
- *Explain the type of discounts offered by business and distinguish between them.*
- *Explain the purposes of both the cash discount and trade discount.*

2.2 Introduction

The following are the major source documents used in business and the books of first entry in which they are entered.

Source Document	**Book of Prime Entry**	
For Cash transactions		
Cash Receipts/ Till slips issued	cashbook	Cash column
Cheque Stubs/ Requisition forms	Cash Book	Bank column
Deposit books/Slips	Cash Book	Bank column
Cash Receipts or Till slips received	Cash Book	Cash column
Bank statement	Cash Book	Bank column
For Credit transactions		
To customers…		
Credit /Account sales invoices and debit notes	Sales daybook	
Credit notes issued	Sales Return Journal	
From suppliers…		
Credit /Account purchases invoices and debit notes	Purchases daybook	
Credit notes received	Purchases return Journal	
Others…		
Invoices for fixed assets bought on credit	The Journal	

2.3 Invoice

An invoice is a business document which is used for all credit transactions. It applies when the business acquires or sells assets on credit for example the purchase of goods on credit, acquisition of equipment on credit, purchase of delivery van on credit etc.

2.3.1 Contents of the Invoice

- **i)** Name of the supplier which is often recorded on top of the invoice.
- **ii)** The name of the customer which is normally written at the bottom of the invoice.
- **iii)** A full description of the merchandise sold as well as the quantity for each.
- **iv)** The unit price of the goods supplied and the totals thereof.
- **v)** The percentage and the amount of trade discount deducted.
- **vi)** Conditions relating to cash discount for, for example 5% cash discount if paid within 28 days.
- **vii)** The date which the goods were supplied.
- **viii)** The invoice number which is supposed to be sequenced for accountability and recording.
- **ix)** The addresses of both the supplier and the customer
- **x)** The order number for each invoice.

2.3.2 Worked example about the invoice

Study the invoice shown below and answer the questions which follow:

ABC LIMITED

<u>INVOICE</u>

Tel. 50006

Head Office
Unit 20 Palmolive Avenue
Gaborone

Invoice No. 43897
Date 14 February, 2011
Order No. K/507890

Description	**Quantity**	**Unit Price $**	**Total $**
1 Cement(50kgs)	40	90	i
2 Doors	30	ii	600
3 Window frames	50	20	iii
Total			iv
Less Trade Discount of 10%			v
Amount to be paid			vi

XYZ LTD
467 High Street
Highlands

Cash discount of 5% if the account is paid within 21 days.

Required

a) What is the name of the business sending the invoice?
b) State the name of the customer.
c) Give the supplier's invoice number.

d) Name the customer's order number.
e) State the name of the town in which the customer is located.
f) Calculate the missing amounts i, ii, iii, iv, v, and vi on the invoice and enter these in the boxes above. Show your workings.
g) State 3 products which are sold by the supplier.
h) Complete the sentences below to show the prime (original) entry book where the invoice details are entered.

1. By the business sending the invoice.
2. By the business receiving the invoice.

i) The amount owing was unpaid on 28 February 2011. In the seller's books, does the business owe this amount a debtor or a creditor?

Suggested solutions

a) ABC LIMITED
b) XYZ LTD
c) 43897
d) K/507890
e) Highlands
f) i) 40 * $90 = $3 600 ii) $600/30 = $20 iii) 50 * $20 = $1 000
iv) $3 600 + $600 + $1 000 = $5 200 v) 10% $5 200 = $520
vi) $5 200 - $520 = $4 680
h) Cement, Doors and window frames.
i) 1. Sales journal
2. Purchases journal
j) A debtor

3.1.3 Trade discount

A trade discount is an allowance given by one business to another in the same line of business. Businesses are said to be in the same line of operation if they belong to one industry for example wholesalers like Jaggers and supermarkets.

Purposes of the trade discount

1. It encourages customers to buy goods in bulk. This is because the more the quantity purchased the more is the amount of trade discount.
2. It also encouraged trade relations with other businesses.

Note
A trade discount is not recorded in the books of accounts but should be deducted and only the net goods total recorded. Net goods total is the amount after deducting the trade discount.

3.1.4 Cash discount

A cash discount is a deduction given to customers for payments made by them within the time limit set by the supplier. Cash discount does not only apply to cash transactions but to all prompt payments.

Cash discount is shown on an invoice as note i.e. it is not deductible on this document. See the invoice above. However, this allowance is deductible on the receipt and statement and **must** always be shown on the ledger account.

Purposes of the cash discount
Cash discount is given to customers to encourage them to pay their accounts promptly (with delay). This has an advantage to the business as the money can be utilised on other investment projects. By the same vein, the customer will pay less than due implying that it is an advantage to both parties.

Worked example
On 6 July 2011, Tatenda bought goods with a list price of $10 000 from Anesu & Co. Anesu & Co. allows Tatenda trade discount of 20% on the goods sold and a cash discount of 5% if the payment is made within 14 days from the date of the invoice.

Required
Calculate the amount paid by Tatenda to Anesu & Co. if the payment of the invoice is made on 17 July 2011. Show your workings with appropriate narratives.

Suggested solutions
List price is the amount shown on the catalogue being inclusive of both the trade discount and the cash discount.

		$
List price of goods sold		10 000
Less Trade discount (20% of $10 000)		2 000
Net goods total		8 000
Less Cash discount (5% of $8 000)	400	
Amount paid by Tatenda		7 600

Note
Students are advised not to add the trade and cash discounts but to calculate them separately as above.

2.4 Debit note

This document is issued by the customer to the supplier when returning goods. It is also used to report any shortages, overcharges or damages goods.

Note
A debit note can also be issued by the supplier to the customer when the goods have been undercharged that is to correct an undercharge.

2.4.1 Contents of the debit note

- Name of the customer
- Name of the supplier
- Date of the document

- Reason for the return
- Addresses of both the customer and the supplier.
- A full description of the items returned.
- Percentage of trade discount and the amount of the discount.

2.4.2 The example of a Debit note

On 19 December 2011 Wells Retailers returned two bags of cement to Techno limited because they were damaged.

Well Retailers
DEBIT NOTE

Tel. 349660

Head Office Plot number 767 Ascort Bulawayo	Debit note No. 261 Date 19 December 2011

Description	Quantity	Unit Price $	Total $
Items returned			
Cement(50kgs)	2	60	120
Less trade discount (20%*120)			24
Net goods total			96
Reason for the return: damaged			

Techno Limited
Plot 196 Donnington
Bulawayo

3.3 Credit note

A credit note is issued by the supplier to the customer to correct an overcharge. It is also used by the supplier to reduce the amount owed by the customer especially when the supplier does not have the right quality and/ quantity to replace the goods returned.

3.3.1 Contents of the Credit note

- Name of the customer
- Name of the supplier
- Date of the document
- Reason for the return
- Addresses of both the supplier and the customer.
- A full description of the items returned.
- Percentage of trade discount and the amount of the discount.

3.3.2 The example of a Credit note

On 19 December 2011 Wells Retailers returned two bags of cement to Techno limited because they were damaged.

Techno Limited
CREDIT NOTE

Tel. 3055490

Plot 196 Donnington
Bulawayo

Credit note Number 333
Date 23 December 2011

Description	**Quantity**	**Unit Price $**	**Total $**
Items returned			
Cement(50kgs)	*2*	*60*	*120*
*Less trade discount (20%*120)*			*24*
Net goods total			*96*
Reason for the credit: *damaged*			

Wells Retailers
Plot 767 Ascot
Bulawayo

2.5 Statement of account (Statement)

A statement is issued by the supplier to the customer at the end of each month to show the transactions for that period.

3.3.1 Purpose of the statement of account

The document is issued to remind the customer to pay the amount due.

3.3.2 Contents of the Statement of account

i) Invoices issued by a business
ii) Total sales for the month
ii) Total returns for the month
iv) Date for each transaction recorded.
v) Addresses of both the supplier and the customer
vi) The business name of the supplier and the customer
vii) Cash and cheques received from the customer
viii) Any cash discount allowed to customers
ix) Amount due and its due date
x) Terms of payments

3.3.3 Points to note about the Statement

The statement of account has three different columns as follows:

i) **Debit (Dr)** -Which increases the balance owing as more goods are sold credit to customers.

ii) **Credit (Cr)** -Which reduces the balance as customers will be either be paying the business or returning goods to it.

iii) **Balance column** -Which shows the net effect of given entries on the statement.

3.3.4 Worked example about the Statement

Study the statement of account received by Wells Retailers from Techno Limited and answer the questions which follow:

Techno Limited
Statement of account

Plot 457
Donnington
Bulawayo

Statement number: 609
Date: 2 January 2012
Telephone number 3055490

To: Wells Retailers
Plot 767
Ascort
Bulawayo

Account number: SM970

Date 2011	**Details**	**Debit $**	**Credit $**	**Balance $**
Dec 1	Balance brought forward			4 000Dr.
6	Invoice number MN003	3 360		7 360Dr.
23	Credit note number CR167		96	(i)
28	Cheque number 37822		(ii)	
	Discount		370	2950Dr.
30	Invoice number MN006	1 840		(iii)

Required

a) Calculate the missing figures on the statement and enter them in the boxes (i) to (iii) above. Show your workings.

b) State one reason suppliers should sent statements to their customers.

c) Name the type of discount shown in the statement on 31 December 2011.

d) On 31 December 2011, Wells Retailers paid Techno Limited for invoice number MN003 by a cheque, deducting 5% discount.

   (i) Calculate the amount of discount. Show your workings.
   (ii) Calculate the amount of the cheque.

Suggested solutions

a) (i) $7 360 – $96 = $7 264 (ii) $7 264 - $2 950 -$370 = $3 944

(iii) $2 950 + $1 840 = $4 790

b) To remind customers to pay the amount due.

c) Cash discount

d) 5/100 * $3 360 = $168

e)

	$
Amount due	3 360
Less Cash discount	168
Amount of the cheque	3 192

2.6 Examination type questions

3. THE CASH BOOK

3.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Describe the process of recording transactions in the double-column cash book.*
- *Draw up the double-column cash book and balance it off at the end of the month.*
- *Explain the concept of contra-entries and outline its relevance to the cash books.*
- *Apply the principle of duality in drawing up the double-column and three-column cash book.*
- *Balance the cash book at the end of the month.*
- *Post the transactions from the cash book to the nominal ledger, sales ledger and purchases ledger.*
- *Post the transactions from the cash book to the nominal ledger, sales ledger and purchases ledger.*
- *Explain what is meant by the imprest system in relation to petty cash books.*
- *Write up the petty cash book to record the given transactions.*
- *Balance the cash book at the end of the month and carry down the balance.*
- *Make an entry to restore the petty cash imprest amount.*
- *Explain how the double entry is completed for items recorded in the analysis columns of a petty cash book.*

3.2 Introduction

All Cash and cheque transactions are entered in the **cashbook** and that is the sole purpose of the Cashbook. Bank transactions are also classified as cash transaction because there is an immediate cash flow. These are the simplest transactions to enter in the General Ledger because the entry in the Cashbook is easy to determine (**see next paragraph).** The corresponding entry is also no problem since it simply goes to the opposite side of the account for which cash is paid or from which cash is received. The easy way, yet the backbone of double entry of all cash transactions is explained below

1. When Cash is received (either through the bank or as hard Cash) the **Cash book** is **DEBITED**
2. When Cash is paid (e.g. using a Cheque, Bank Notes and Coins, Stop order or credit Card payment) the **Cashbook** is **CREDITED.**

The following is a list of some **CASH TRANSACTIONS.**

CASH BOOK

RECEIPTS	***PAYMENTS***
$	**$**

From Customers	- Cash Sales - Account Settlement	**To Suppliers**	- Cash Purchases - Account Settlement
From tenants	-Rent received	**for expenses**	- Rent, Salaries etc
From Investments	-Interest received -Dividends received	**To investors'**	-Interest paid -Dividends paid
From Investments	-Disposal of fixed assets -Disposal of investments	**For Investments**	-Purchase of fixed assets -Purchase of investments

NB It is not necessary to open more than one cash account but individual accounts for cash payments and receipts should be opened for different types of transactions. The Cashbook is balanced off as well as the other accounts to determine the closing balance.

3.3 Balancing off an account

After all the transactions have been posted to their relevant ledger accounts, at the end of each accounting period, the ledger accounts need to be balanced off. Balancing an accounting is a process that is used to determine the difference between the debit and the credit side of an account. Any balance remaining at the end of the period should be carried forward to the next accounting period. If an account is said to be having a debit balance, after balancing it off, it means that the debit side of that account is greater than the credit side of the same account. And an account with a credit balance, it means that the credit side is greater than the debit side. A list of all debit balances and credit, which is known as the trial balance, should agree.

Consider the following information, which was extracted from the books of S. Moyo for the month of February 2011:

February 1. S. Moyo started business with a capital of $200 000 cash
February 2. Purchased goods on cash $160 000.
February 3. Sold goods on cash $35 000
February 4. Sold goods on cash $45 000

You are required to post and balance the above transactions to their relative ledger accounts.

Each of the above transactions should result in two accounts being affected as explained above. A cash account is prepare as follows

Cash account

2011		$	2011		$
February 1	Capital	200 000	February 2	Purchases	160 000
February 3	Sales	35 000	February 29	Balance c/d	120 000
February 4	Sales	45 000			
		280 000			280 000
March 1	Balance b/d	120 000			

From the above example, it is clear that the balance remaining in the cash account is carried forward to the next accounting period, which is March. The $120 000 can be reduced or increased in that period. Please note that the other accounts have been prepared under normal circumstances, as follows.

Capital account

2011		$	2011		$
February 28	Balance c/d	200 000	February 1	Cash	200 000
			March 1	Balance b/d	200 000

Purchases account

2011		$	2011		$
February 2	Cash	160 000	February 28	Balance c/d	160 000
		160 000			160 000
March 1	Balance b/d	160 000			

Sales account

2011		$	2011		$
February 28	Balance c/d	80 000	February 3	Cash	35 000
			February 4	Cash	45 000
		80 000			80 000
			March 1	Balance b/d	80 000

3.4 The Single- column cash book

A single column cash book involves transactions relating to the bank or cash separately. Any cash or cheque received is debited to this account while cash or cheque paid is credited to the same account.

Worked example

Enter the following cash transaction into their relevant accounts for the month of January 2012.

On 1 January 2012, A. Moyo started business with $20 000, which he deposited into the bank account specifically opened for the business. Consider the other transactions that passed through the bank.

Jan 2	Paid rent	$ 5 000
Jan 3	Bought goods for resale	$20 000
Jan 4	Paid Wages	$2 000
Jan 7	Bought Stationery	$500
Jan 9	Sold goods for	$32 000
Jan 13	Bought a motor car for	$22 000
Jan 15	Paid Water	$900

SOLUTION

Cashbook (Bank columns only)

Date	**Details**	**Amount ($)**	**Date**	**Details**	**Amount ($)**	
Jan 1	Capital	20 000	Jan 2	Rent	5 000	
Jan 9	Sales	32 00	" 3	Purchases	20 000	
			" 4	Wages		2 000
			" 7	Stationery	500	
			" 13	Motor car	22 000	
			" 15	Water		900
			Jan 31	Bal. c/d		1 600
		52 000			**52 000**	
Feb 1	Bal. b/d	1 600				

There has been an inflow into the Bank Account and the business owes the owner **$20 000**. Thus the **Bank is debited** and the **Capital credited** as shown above.

Capital A/C

2012		$	2012		$
Jan. 31	Bal. c/d	20 000	Jan 1	Bank	20 000
			1 Feb.	Bal. b/d	20 000

The Nominal [general] ledger

Rent a/c

2012		$	2012		$
Jan 2	Cash	5 000	Jan 31	Bal. c/d	5 000
Feb 1	Bal. b/d	5 000			

Purchases a/c

2012		$	2012		$
Jan 3	Cash	20 000	Jan 31	Bal. c/d	20 000

Feb 1 Bal. b/d		20 000

Wages a/c

2012		$	2012		$
Jan 4	Cash	2 000	Jan 31	Bal. c/d	2 000
Feb 1	Bal. b/d	2 000			

Stationery a/c

2012		$	2012		$
Jan 7	Cash	500	Jan 31	Bal. c/d	500
Feb 1	Bal. b/d	500			

Sales a/c

2012		$	2012		$
Jan 31	Bal. c/d	32 000 Jan 9		Cash 32 000	
			Feb 1	Bal. c/d	32 000

Motor vehicle a/c

2012		$	2012		$
Jan 13	Cash	22 000	Jan 31	Bal. c/d	22 000
Feb 1	Bal. b/d	22 000			

Water account

2012		$	2012		$
Jan 15	Bank	900	Jan 31	Bal. c/d 900	
Feb 1	Bal. b/d	900			

Please note that in all **Ledger Accounts,** the other account involved in the transaction has been shown as a narrative. For example in the detail column of the Bank Account we wrote ‘Capital’ against the figure $20 000 to indicate that the other account involved in the transaction is the Capital account. In the details column of the capital account we have the word ‘bank’ meaning that the debit entry is in the Bank Account. **This cross-reference must always be adhered to.**

3.5 Double column cash book

This cash book has two columns, one for recording cash transactions and the other one to record bank transactions. The application of the concept of duality is just the same with that of a single column cash book where cash received is debited in the cash column and cash expended is credited in the cash column. Cheques received are debited in the bank column while cheques issued are credited in the bank column.

Worked example

Write up the Two-Column Cash Book for M Haffejee from the following details, and balance it off at the end of the month:

2011	June	1	Started business with capital in cash $2 000 and bank $5 000.
	June	3	Cash purchases $1 200.
	June	4	Received a cheque from S Hassan $4 100.
	June	7	Bought equipment using cheque $1 300.
	June	9	Withdrew $ 800 from the bank for business use.
	June	10	Cash sales $3 300.
	June	13	G White lent us $5 000, paid by cheque.
	June	17	We paid M Issa by cheque $2 700.
	June	23	Bought machinery by cheque $3 600.
	June	27	Paid salaries in cash $1 900.
	June	28	Took cash, $1 800 from the till and deposited it in the business bank account.
	June	29	Bought stationery by cheque $1 500.

M Haffejee

Dr **Cash Book** **Cr**

Date	**Details**	**Cash**	**Bank**	**Date**	**Details**	**Cash**	**Bank**
2011		**$**	**$**	**2011**		**$**	**$**
Jun 1	Capital	2 000	5 000	June 3	Purchases	1 200	
4	S. Hassan		4 100	7	Equipment		1 300
8	Bank c	800		8	Cash c		800
10	Cash sales	3 300		17	M. Issa		2 700
13	G. White		5 000	23	Machinery		3 600
28	Cash c		1 800	27	Salaries	1 900	

				28	Bank c	1 800	
				29	Stationery		1 500
				30	Balance c/d	1 200	6 000
		6 100	**15 900**			**6 100**	**15 900**
Jul 1	Balance b/d	1 200	6 000				

3.6 Contra entry

It is a transaction that is both debited and credited on the same cash book.

Examples of contra entries

1. Cash is withdrawn from the business bank account for business/office use. This transaction is debited on the cash column as it is receiving money and credited in the bank column. From the above question, transaction on 9 June 2011 is typical of this example.
2. Cash is taken from the till and deposited into the business bank account. It is debited in the bank column and credited in the cash book and the typical example is a transaction on 28 June.

3.7 Three column cash book

This cash book has three columns, cash column, bank column and discounts column. The discount allowed is always debited in this cash book and discount received is credited.

Worked example 3

James is a sole trader who keeps full double entry accounting records including a three column cash book. All cheques received are banked on the same day.

On 1 October 2011 balances in his books included the following:

	$
Debtors	
M Jones	1000
S Belt	900
W Man	740
Creditors	
J Ruth	500
N Marumo	800
Cash	400
Bank	3100

James's transactions for the month of October 2011 included the following:

		$
October 2	M Jones paid the amount he owed by cheque after deducting cash discount of $50.	
6	Cash was withdrawn from the bank for office use	400
9	Paid J Ruth by cheque after deducting $30 cash discount.	
13	Paid salaries in cash	600
16	S Belt paid amount he owed by cheque after deducting cash	

discount of $40.

18 Paid N Marumo by cheque after deducting cash discount of $15.
20 Cash sales 450
24 W Man paid the amount he owed by cheque.
26 Paid wages in cash 200
30 Paid electricity bill by cheque 650

Enter the transactions shown on the next page in James's cash book provided (the cash and bank balances have already been entered for you).

Balance the cash book at 31 October 20 and bring down the balances on 1 November 2011.

James

Debit Cash book Credit

Date			Discount	Cash	Bank	Date		Discount	Cash	Bank
2008			$	$	$	2008		$	$	$
Oct	1	Balance b/d		400	3 100	Oct 6	Cash			400
	2	M Jones	50		950	9	J Ruth	30		470
	6	Bank		400		13	Salaries		600	
	16	S Belt	40		860	18	N Marumo	15		785
	20	Cash Sales		450		26	Wages		200	
	24	W Man			740	30	Electricity			650
						31	Balance c/d		450	3345
			90	1250	5650			45	1250	5650
Nov	1	Balance c/d	450	3345						

3.8 The petty cash book

Business has to make payments for various purposes like payment to suppliers of goods and services. Among those payments, there are many transactions, which only involve a small amount of cash payments and these are recorded in the petty cash book.
Following are the examples of small cash payments usually made by businesses on daily basis:

- Postage expenses
- Travelling/ Motor expenses
- Cleaning expenses
- Wages to casual labour
- Stationery
- Refreshments
- Ledger accounts

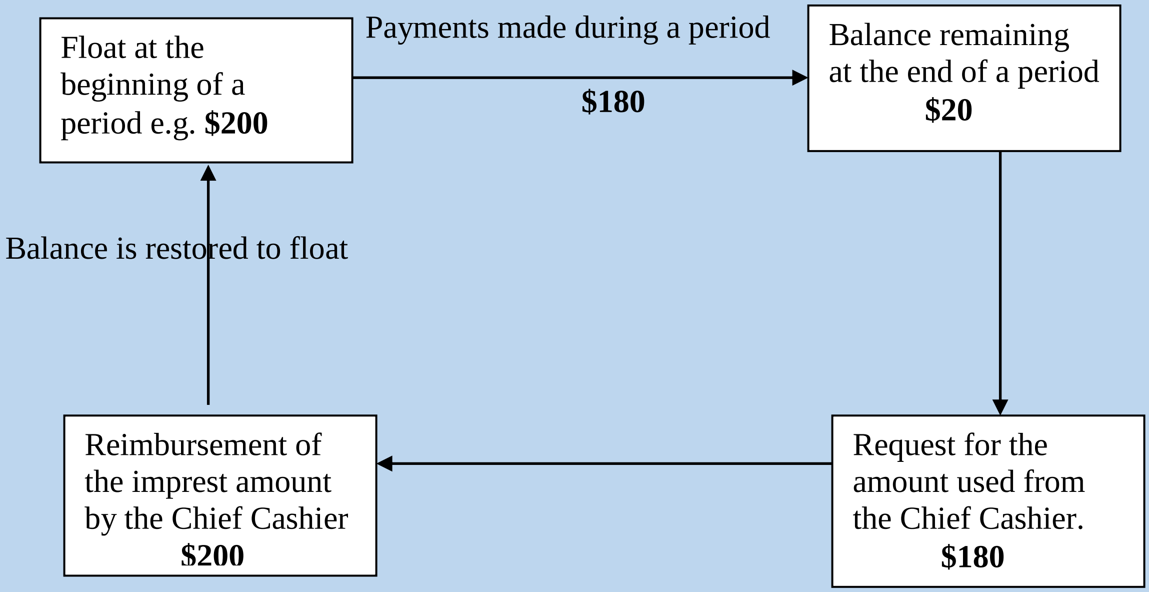
Important Points:

- Petty cash book is a sub-division of main Cash Book (Two/Three Columns)
- The task of handling these small cash payments is delegated to a member of staff known as the Petty Cashier.
- Petty cash payments are made against a Petty Cash Voucher, which indicates the expense.
- Petty Cash Voucher requires the signature of the person to whom the payment has been made.
- A receipt obtained for payment of expenses should be attached to the petty cash voucher while claiming the reimbursement against it.
- The petty cash voucher with receipt will act as **proof** of the expenditure.
- Petty cash payments are recorded in Analytical Petty Cash Book in the appropriate columns.
- The totals of each type of expense are then posted to the respective Expenses Account periodically, e.g. monthly in the nominal ledger.
- This system of posting only the total of an expense on monthly basis reduces the number of entries in the ledger account.

Important Terms:

1. **Imprest Amount / Cash Float**: A **fixed sum** that is given to petty cashier by the chief cashier in order to make cash payments for small business expenses.
2. **Reimbursement:** The process where the imprest amount is **restored** to the cash float in order to bring the total imprest amount same as in the beginning of a period.

3. **Imprest System**: It is a system whereby a petty cashier is given a fixed sum of money, called imprest amount, in order to make payments for small expenses. At the month end, he is reimbursed with the amount that he spent during the month (the amount equal to what he spent during the month) so as to restore same fixed imprest amount that is required for next month's payment.



Worked example 4

Tatenda is a sole trader who keeps a Petty Cash Book on the imprest system. The book has four analysis columns such as Travelling, Stationery, Cleaning and Postage and the imprest amount is $200. Tatenda's transactions for the month of March 2011 were as follows:

2011			$
March	3	Travelling expenses	18
March	6	Office stationery	14
March	12	Cleaner's wages	30
March	14	Envelopes	10
March	17	Window cleaning	12
March	19	Bus fares	15
March	21	Registered post	15
March	24	Wood polish	16
March	26	Postage stamps	8
March	29	Travelling expenses	20
March	31	Restored imprest amount in cash	

<u>Required</u>

a) Write up Tatenda's Petty Cash Book to record her transactions for the month of March 2011. The imprest amount of $200 was restored on 1 March 2011.

b) Make the entry on 31 March 2011 to restore the Petty Cash imprest amount.

c) Balance the Petty Cash Book on 31 March 2011 and carry down the balance.

d) Post the totals from the analysis columns to the nominal ledger.

solutions

a), b) and c)

Dr Tatenda Petty Cash Book Cr

Date	Details	Total Received	Date	Details	Voucher number	Total Paid	Stationery	Staff Travelling expenses	Cleaning expenses	Postage
2011		$	2011			$	$	$	$	$
Mar 1	Cash Book	200	Mar 3	Travelling Expenses	1	18		18		
			6	Office Stationery	2	14	14			
			12	Cleaner's Wages	3	30			30	
			14	Envelopes	4	10	10			
			17	Window Cleaning	5	12			12	
			19	Bus fares	6	15		15		
			21	Registered post	7	15				15
			24	Wood Polish	8	16			16	
			26	Postage Stamps	9	8				8
			29	Travelling Expenses	10	20		20		
						158	**24**	**53**	**58**	**23**

31	Cash Book	158	31	Bal c/d		200				
		358				**358**				
Apr 1	Bal b/d	200								

d) **Nominal ledger**

Stationery account

2011		$	
March 31	Petty cash	24	

Staff travelling expenses account

2011		$	
March 31	Petty cash	53	

Cleaning expenses account

2011		$	
March 31	Petty cash	58	

Postages account

2011		$	
March 31	Petty cash	23	

3.1 Examination type questions

4. THE BOOKS OF ORIGINAL ENTRY

4.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Record the accounting data in the Books of Prime Entry using the information from the source documents:*
  1. *Sales Journal*
  2. *Sales Returns Journal*
  3. *Purchases Journal*
  4. *Purchases Returns Journal*
  5. *General journal*
- *State the uses of journal entries*
- *In connection with journal entries explain what is meant by the term 'narrative'*

4.2 Introduction

The books of prime entries are also known as the **books of first or original entry.** These books are written from source documents collected by the accounts department from the whole business process. All books of prime entry except the cashbook are not part of the double entry system. In the cashbook, the **discount columns** are not part of the double entry system. Transactions are entered in the books of prime entry before their totals are posted to the ledger.

As discussed earlier, transactions are of two types i.e. credit and cash transactions. Cash transactions are entered in the cashbook while credit transactions are entered in other books of prime entry. The following is list of books of prime entries.

1. Cash Book (incorporating both the Bank Account and the Petty-Cashbook)
2. Sales Day Book **OR** Sales Journal
3. Sales Returns Journal **OR** Returns Inwards Journal
4. Purchases Day Book **OR** Purchases Journal
5. Purchase Returns Day Book **OR** Returns Outwards Journal
6. General Journal

Credit Transactions

4.3 The sales daybook

It is used to record sales on credit for goods initially bought for resale. It is written from the credit sales invoices and debit notes issued to customers. The amount to be entered should be after deducting trade discount. The amount of each invoice and debit note is debited to the **Individual Debtors Account** in the **Sales/Debtors' ledger**. At the end of each period, the total of the sales daybook is credited to **Sales Account** in the **General Ledger.**

Example

Musa Masuku an indigenous miller sold goods on credit during the month of January 2000 as follows: -

Date		**Customer**	**Invoice No.**	**Amount**
2012				$
Jan	1	T. Moyo	1011	35 000
	5	S. Mlambo	1012	28 000 *less 20% Trade discount*
	9	S. Siziba	1013	20 000
	21	S. Mlambo	1014	5 700

Required: -

a) Write up the sales daybook for the month of January 2000 and

b) Post totals to the: -

i. Sales ledger

ii. Nominal [General ledger]

Solution

The Sales daybook

DATE		**DETAILS**	**INVOICE No.**	**$**
2012				
Jan	1	T. Moyo	1011	35 000
	5	S. Mlambo	1012	22 400
	9	S. Siziba	1013	20 000
	21	S. Mlambo	1014	5 700
	31	Balance posted to the sales a/c in the General Ledger		83 100

General ledger

Sales Account

2012		$	2012		$
Jan 31 Bal. c/d	83 100		Jan 31	Debtors	83 100
			Feb 1	Bal. b/d	83 100

SALES LEDGER

T. Moyo account

2012		$	2012		$
Jan. 1	Sales	35 000	Jan. 31	Bal. c/d	35 000
		35 000			35 000
Feb. 1	Bal. b/d	35 000			

S. Mlambo account

2012		$	2012		$
Jan. 5	Sales	22 400			
Jan. 21	Sales	5 700	Jan. 31	Bal. c/d	28 100
		28 100			28 100
Feb. 1	Bal. b/d	28 100			

S. Siziba account

2012		$	2012		$
Jan. 9	Sales	20 000	Jan. 31	Bal. c/d	20 000
		20 000			20 000
Feb. 1	Bal. b/d	20 000			

4.4 The purchases day book

This book is used to record purchases on credit for goods bought for resale. It is written from suppliers' credit invoices and debit notes. The amount entered should be after deducting trade discount. The amount of each invoice and debit note is debited to the **Individual Creditor's Account** in the **Purchases or Creditors ledger**. At the end of the period the total of this book is debited to the **Purchases Account** in the **General Ledger.**

Example

M. Tapera a retailer purchased goods on credit from the following suppliers: -

		Creditor	**Invoice No.**	**$**
Jan	2	J. Smith	85	10 000
	10	P. Dube	1621	30 000
	15	M. Nyandoro	759	15 000 *less 10 % trade discount*
	20	S. Shoko	286	5 000

Required: -

Prepare the daybook and post the necessary entries to the General Ledger & Purchases Ledgers

SOLUTION

Purchases Day Book

Date	**Details**	**Invoice No.**	**Amount ($)**
2012			

Jan 2	J. Smith	85	10 000
10	P. Dube	1621	30 000
15	M. Nyandoro	759	13 500
20	S. Shoko	286	5 000
Jan 31	Balance posted to purchases account in nominal ledger		58 500

General Ledger

Purchases account

2012		$	2012		$
Jan. 31	Creditors	58 500	Jan. 31	Bal. c/d	58 500
		58 500			58 500
Feb. 1	Bal. b/d	58 500			

Purchases Ledger

J. Smith account

2012		$	2012		$
Jan. 31	Bal. c/d	10 000	Jan. 2	Purchases	10 000
		10 000			10 000
			Feb. 1	Bal. b/d	10 000

P. Dube account

2012		$	2012		$
Jan. 31	Bal. c/d	30 000	Jan. 10	Purchases	30 000
		30 000			30 000
			Feb. 1	Bal. b/d	30 000

M. Nyandoro account

2012		$	2012		$
Jan. 31	Bal. c/d	13 500	Jan. 15	Purchases	13 500
		13 500			13 500
			Feb. 1	Bal. b/d	13 500

S. Shoko account

2012		$	2012		$
Jan. 31	Bal. c/d	5 000	Jan. 20	Purchases	5 000
		5 000			5 000
			Feb. 1	Bal. b/d	5 000

4.5 Sales returns day book

It is also known as the Returns Inwards Journal. This book is used to record credit notes issued when customers return goods or when they have been overcharged. The amount entered is after trade discount. At the end of the period, the total of the sales returns book is debited to the sales returns account in the General ledger and the amount of each credit note is credited to the individual Debtors accounts in the Debtors` ledger.

Example – sales returns daybook

The following information was extracted from the books of Nice Foods Ltd a food manufacturer sent credit notes to the following customers: -

2012			
Jan	2	Sold goods on credit to M. Nyathi	$10 000
	5	Sold goods on credit to S. Ndou	$35 000
	10	Sold goods on credit to S. Nkiwane	$30 000
	19	M. Nyathi returned goods worth	$5 000
	23	S. Nkiwane returned goods worth	$1 500

You are required to prepare the:
1. Sales Returns Journal
2. Sales day book
3. Relevant ledger accounts

Sales Returns Journal

Date	Details	Amount ($)
Jan 19	M. Nyathi	5 000
23	S. Nkiwane	1 500
Jan 31	Balance posted to Sales Returns in nominal ledger	6 500

General Ledger

Sales returns account

2012		$	2012		$
Jan. 31	Debtors	6 500	Jan. 31	Bal. c/d	6 500
		6 500			6 500
Feb. 1	Bal. b/d	6 500			

Sales Ledger/ Debtors ledger

M. Nyathi account

2012		$	2012		$
Jan. 2	Sales	10 000	Jan. 19	Sales returns	5 000
			Jan. 31	Bal. c/d	5 000
		10 000			10 000
Feb. 1	Bal. b/d	5 000			

S. Ndou account

2012		$	2012		$
Jan. 2	Sales	35 000	Jan. 31	Bal. c/d	35 000
Feb. 1	Bal. b/d	35 000			

S. Nkiwane account

2012		$	2012		$
Jan. 2	Sales	30 000	Jan. 19	Sales returns	1 500
			Jan. 31	Bal. c/d	28 500
		30 000			30 000
Feb. 1	Bal. b/d	28 500			

4.6 Purchases returns daybook

It is also known as the returns outwards book. It is used to record credit notes received from suppliers relating to goods that were initially bought for resale now returned back to suppliers. The net amount after trade discount is recorded. At the end of the period, the total of the journal is credited to the purchases returns account in the General Ledger and the amount on each credit note is debited to the individual creditor's account in the Purchases Ledger.

Example – purchases returns daybook

The following information was extracted from the books of S. Dziva for the month of January 2012

Purchased goods on credit from the following individuals

			$
Jan.	1	M. Ndoro	15 000
Jan.	3	B. Ncube	12 000
Jan.	5	S. Mutasa	10 000

Received credit notes from the following suppliers on goods returned:

			$
Jan	14	M. Ndoro	900
	25	S. Mutasa	1 200

Required: -

Prepare the Purchases daybook, the purchases returns book and post totals to the two Ledgers.

Purchases Day Book

Date	**Details**	**Amount ($)**
Jan 1	M. Ndoro	15 000
3	B. Ncube	12 000

5	S. Mutasa	10 000
Jan 31	Balance posted to purchases account in nominal ledger	37 000

Purchases returns Book

Date	Details	Amount ($)
Jan 14	M. Ndoro	900
25	S . Mutasa	1 200
Jan 31	Balance posted to the purchases returns account in General Ledger	2 100

General Ledger

Purchases account

2012		$	2012		$
Jan. 31	Creditors	37 000	Jan. 31	Bal. c/d	37 000
		37 000			37 000
Feb. 1	Bal. b/d	37 000			

Purchases returns account

2012		$	2012		$
Jan. 31	Bal. c/d	2 100	Jan. 14	M. Ndoro	900
			Jan. 25	S. Mutasa	1 200
		2 100			2 100
			Feb. 1	Bal. b/d	2 100

Purchases /Creditors Ledger

M. Ndoro account

2012		$	2012		$
Jan. 14	Purchases returns	900	Jan. 1	Purchases	15 000
Jan. 31	Bal. c/d	14 100			
		15 000			15 000
			Feb. 1	Bal. b/d	14 100

B. Ncube account

2012		$	2012		$
Jan. 31	Bal. c/d	12000	Jan. 1	Purchases	12 000
		12000			12 000
			Feb. 1	Bal. b/d	12 000

S. Mutasa account

2012		$	2012		$
Jan. 14	Purchases returns	1 200	Jan. 1	Purchases	10 000
Jan. 31	Bal. c/d	8 800			
		10 000			10 000
			Feb. 1	Bal. b/d	8 800

4.7 The journal (General Journal)

It is used to record the following transactions:

a) Opening entries

b) Accounting adjustment e.g. corrections of errors and yearend adjustments.

c) Transfer between Ledger accounts.

d) It is also used to record transactions that are not appropriate to any other book of prime entry e.g. the Purchase or sale of non-current assets on credit. It has both a credit and a debit column. It is not part of the double entry in the ledger. It is used to indicate what two entries (double entry) are going to be made in the ledger in respect of a given transaction or adjustment.

Narrative

Catherine Coucom defined a narrative as a brief explanation of why an entry is being made.

N.B. A narrative should accompany all journal entries unless stipulated otherwise by the examiner. This is because of the great variety of transactions being made in the books.

<u>Examples</u>

1. Recording of opening entries

Opening entries apply when the business is preparing the financial statements for the first time.

M. Nyambi commenced trading two years ago but has not prepared the financial statements during this period.
His assets on 1 January 2012 included the following:
Equipment $10 000, fixtures and fittings $7 000, trade receivables $6 400, cash at bank $1 200 and cash on hand $600.
On the same day its liabilities encompassed the following:
Trade payables $4 400 and bank loan $9 000.

Required

Draw up M. Nyambi's opening entries as at 1 January 2012.

Suggested solution

	Debit	Credit
	$	**$**
Equipment	10 000	
Fixtures and fittings	7 000	
Trade receivables	6 400	
Cash at bank	1 200	
Cash on hand	600	
Trade payables		4 400
Bank loan		9 000
Capital ***		11 800
	25 200	**25 200**

N.B Capital*** is a balancing figure which makes the debit equals the credit side.

2. Correction of errors

Lindiwe Mkosana prepared her trial balance on 31 December 2011 which failed to agree. Subsequently, the following errors were identified:

a). Sales were overcast by $800

b). Discount allowed of $500 was credited to the discount received account.

Required

Draw up the journal entries to correct the above errors.

Suggested solution

	Details	Debit	Credit
		$	**$**
a)	Sales account Suspense account **Sales overcast, now corrected**	800	 800
b)	Suspense account Discount allowed Discount received **Discount allowed credited in error to the discount received**.	1 000	 500 500

3. Purchase of non-current assets on credit.

It has both a credit and a debit entry. It is not part of the double entry in the ledger. It is used to indicate what two entries (double entry) are.

G. Mutero purchased plant and equipment on credit from Z. Dziti for $14 000 on 8 January 2012.

	Details	Debit	Credit
2012		**$**	**$**
Jan 8	Plant & Equipment Z. Dziti Being the purchase of plant and equipment on credit	14 000	 14 000

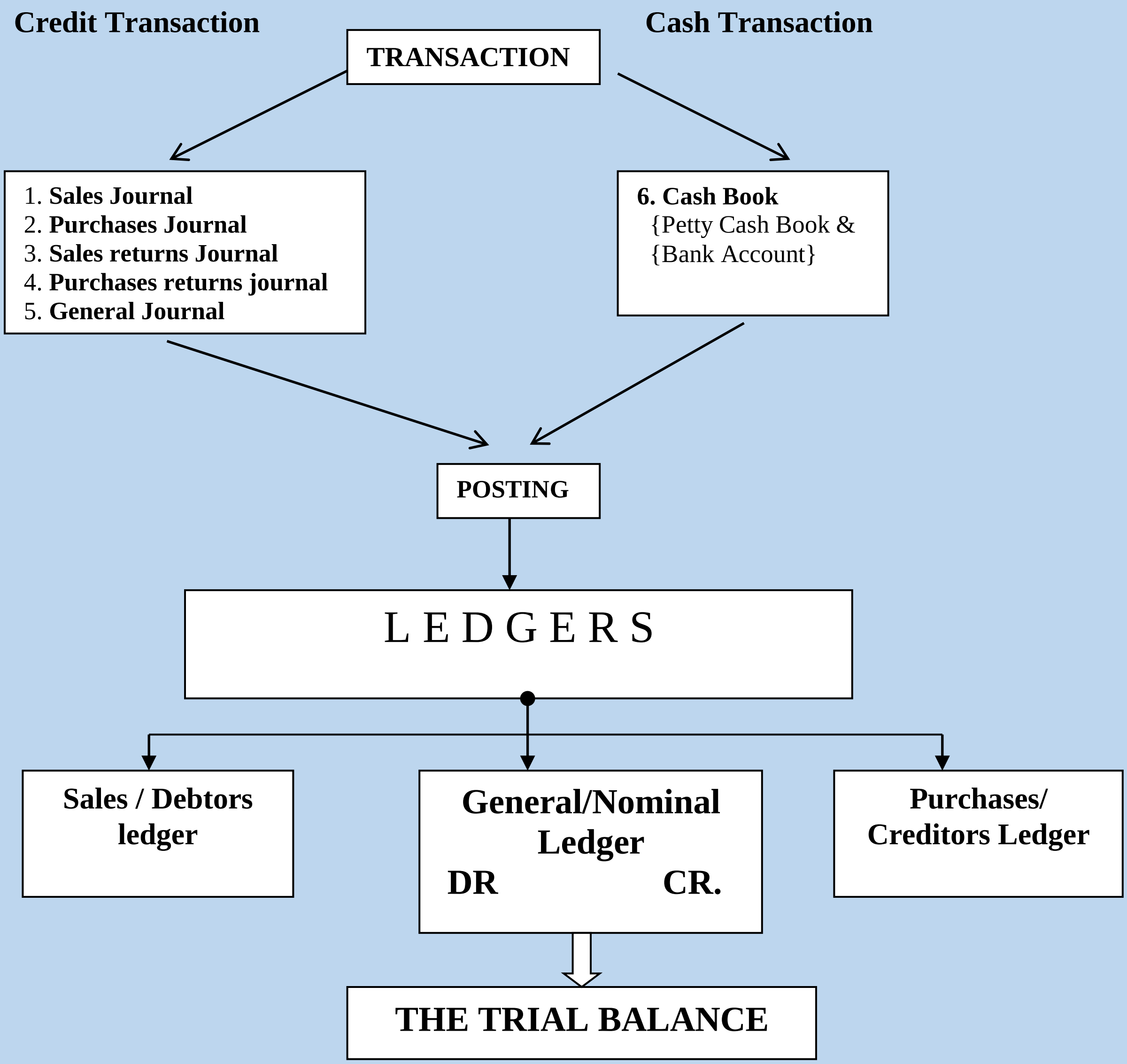
Note

1. The debit entry is recorded on top whilst the credit is recorded below and aligned to the right
2. Z. Dziti is a Creditor but not a trade creditor. Therefore his balance is not part of the Purchases/ Credit Ledger but is an independent account in the Nominal/General Ledger.

Summary: Transactions, Source documents, and the books of prime entry in which transactions are recorded.

	Financial Transactions	**Source Document Received or Issued**	**Books of Prime Entry where the transaction is recorded**
1	Purchase of goods on ***credit*** from supplier	Invoice Received / Purchases Invoice	Purchases Journal / Purchases Day Book
2	Goods returned to supplier	Credit Note Received / Debit Note Issued	Purchases Return Journal / Returns Outward Book
3	Sale of goods on ***credit*** to customer	Invoice Issued / Sales Invoice	Sales Journal / Sales Day Book
4	Goods returned by customer	Credit Note Issued	Sales Returns Journal / Returns Inward Book
5	All Receipts and Payments by cash or cheque	Receipt, Statement, Cheque counter foils	Cash Book (Two/Three columns) & Petty Cash Book
6	Un-usual, Special, or Rare transactions	Invoice, minutes, accounting policy, court notice etc.	General Journal

The following diagram shows a detailed process of accounting up to the Trial balance



4.8 Examination type questions

Question 1

Steady Ndogwedu is a wholesaler who sells goods on credit to retail customers.
The following transactions relates to the month of November 2011.

Transaction number	Date 2011	Transaction
1.	Nov. 3	Steady bought goods on credit from Big Supplies
2.	Nov. 6	Steady sold goods on credit to Munashe Supermarket
3.	Nov. 12	Steady returned some of the damaged goods to Big Supplies
4.	Nov. 14	Munashe Supermarket returned some faulty goods to Steady
5.	Nov. 19	Steady bought equipment on credit from Tanatswa limited
6.	Nov. 25	Steady sold goods and received cash
7.	Nov. 30	Munashe Supermarket sent a cheque to Steady for the amount owing.

Required

For each of the items 1 to 6, complete the table below to show:

1. The business document from which Steady writes up his accounting records.
2. The book of prime entry in which the items appear.

Number	**Date**	**Name of business document**	**Book of prime entry**
1.	Nov. 3		
2.	Nov. 6		
3.	Nov. 12		
4.	Nov. 14		
5.	Nov. 19		
6.	Nov. 25		
7.	Nov. 30		

Question 2

The following account, prepared by an inexperienced book- keeper, appeared in the ledger of Zimuto.

S. SORRY'S A/C

2011				2011			
April	1 Balance b/d	250		April	10	Bank	245
	21 Goods		333		10	Discount	5
	21 Delivery charge		9		25	Returns	17
					30	Balance c/d	325
			592				592
2011							
May 1	Balance b/d		325				

REQUIRED:

Explain each entry in S. Sorry's account as it appears in the ledger of Zimuto and state where the double entry is completed for each item.

Question 3

Mrs. Chad sells goods to Batista and the following transactions are available;

2011

May 1	Batista owed $400 to Chad
May 5	Chad sold goods on credit to Barista for $600 less 25% trade discount
May 10	Batista sent a cheque for $380 in settlement of the amount owing on 1 May.
May 13	Batista was sent a credit note for returned goods, list price, $100; they formed part of the 5 May transaction.

REQUIRED:

Write up the ledger account of Batista in Mrs Chad's books and balance the account on 31 May 2011. Pay particular attention to dates and details.

5. THE LEDGER

5.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Understand the division of the ledger into specialist areas:*
  - *Sales (Debtors) Ledger*
  - *Purchases (Creditors) Ledger*
  - *Nominal (General) Ledger*
- *Record financial transactions using double-entry in the ledger books systematically*
- *State the advantages of dividing the ledger into sales, purchases and nominal.*
- *Post entries to ledger accounts from the books of prime entry:*
  - *Purchases Journal*
  - *Purchases Returns Journal*
  - *Sales Journal*
  - *Sales Returns Journal*
  - *Cash Book*
- *Carry out balancing process in the ledgers accounts.*
- *Post entries to ledger accounts from the books of prime entry:*

5.2 Introduction

A ledger is the main book of accounts. Transactions are entered in the accounts using the concept of double entry system from books of prime entry. The double entry concept states that every transaction should be entered twice in the books of accounts. A transaction should first be entered in the books of prime entry before it is entered in the ledger. Only business transactions are entered in the books of accounts. An account is a summary of related transactions. Every account has a debit (i.e. DR) side, which is the left-hand side, and a credit (i.e. CR.), which is the right-hand side.

5.3 The division of the ledger

After transactions are entered in the books of prime entry they are posted to any of the three ledgers.

(a) **The General Ledger** that contains real accounts (assets & liabilities accounts) and Nominal accounts (income & expenditure accounts).
(b) **The Sales / Debtors' Ledger** which contains the personal accounts of credit customers.
(c) **The Purchases / Creditors' ledger** which contains personal accounts of credit suppliers.

NB. The **General Ledger is the main book,** it is the backbone of every accounting system and it is from it that we extract the Trial Balance and produce the final account of a Business. A Ledger account looks like this;

DR			**Name of account**		CR.
Date	Details	Amount	Date	Details	Amount
2011		$	2011		$

5.4 The advantages of dividing the ledger

1. It enables the accounting work to be shared among several people for example one clerk specialising in preparing the nominal ledger, the other one on the sales ledger while the third one on the purchases ledger.
2. It makes it easier to install accounting and internal control systems.
3. It also reduces the chances of errors through internal checking procedures.

5.5 Fully worked examples with solutions

5.5.1 Example 1

The following information relates to the business of A. Nyathi.

2012

Jan 1. Commenced Business with a capital of $70 000 in cash.
1. Opened a business bank current account with $1 000.
2. Paid Rent $ 2 500 cash
3. Bought stationery $ 500 cash
4. Purchased goods for resale $10 000 paying in cash
5. Sold goods for $30 000 payment received by cheque.
6. Paid wages $ 5 000 cash
7. Bought goods on credit from the following:
   M. Shava $25 000
   S. Mudzingwa $19 000
   L. Kusano $8 000 less 10% trade discount.
8. Purchased furniture for $8 000 paying by cash
9. Paid transport $1 200 by cheque
10. Paid M. Shava $23 750 by cheque having deducted 5% cash discount from the purchase made on 7 January.
11. Paid water $ 200 by cheque
12. Paid telephone $1 900 by cheque
13. Paid wages $ 5 000 by cheque
14. Sold goods on credit to: - W. Cliffs $42 000 *less 20% trade discount*
    S. Ndlovu $ 8 000
    M. Zakeo $ 3 000
15. Paid electricity $1 300 cash
16. Paid L. Kusano $6 840 in full settlement of his account by cheque.
17. Returned goods to S. Mudzingwa worth $3 000.
18. The following returned goods: M. Zakeo $ 500
    S. Ndlovu $1 000
19. Received cheques for payment of account from the following: -
    W. Cliffs $31 920 in full settlement
    M. Zakeo $1 900 in full settlement
20. Paid stationery $300 by cheque
21. Paid wages $500 by cheque
22. Withdrew $500 cash from the bank for personal use.
23. Received a loan of $28 000 by cheque from the Bank of People (B.O.P.).
30. Purchased equipment for $30 000 cash.
31. Bought a motor vehicle from J.B. Motors for $50 000 on account.

Closing stock was valued at $15 700

Required: -

(a) Enter the above transactions in the books of prime entry
(b) Post to the following ledgers: -
    i. General ledger
    ii. Sales ledger
    iii. Purchases ledger and
(c) Extract a trial balance.
(d) Prepare the financial statements (without the statement of cash flows)

Solution.

(a) i.

The cash book

Date	Details	Disc.	Cash	Bank	Date	Details	Disc	Cash	Bank

Date	Details	$	$	$	Date	Details	$	$	$
2012		$	$	$	2012		$	$	$
Jan 1	Capital		70000		Jan 1	Bank C		1 000	
1	Cash C			1 000	2	Rent		2 500	
5	Sales			30 000	3	Stationery		500	
	W. Cliffs	1 680		31 920	4	Purchases		10000	
19									
	M. Zakeo	600		1 900	6	Wages		5 000	
23	Loan– B.O.P.			28 000	8	Furniture		8 000	
					9	Transport			1 200
					10	M. Shava	1250		23 750
					11	Water			200
					12	Telephone			1 900
					13	Wages			5 000
					15	Electricity		1 300	
					16	L. Kusano	360		6 840
					20	Stationery			300
					21	Wages			500
					22	Drawings			500
					30	Equipment		30000	
					31	Bal. c/d		11700	52 630
		2 280	70000	92 820			600	70000	92 820
Feb 1	Bal. b/d		11700	52 630					

(a) ii. **Purchases Journal/Purchases daybook**

Date	Details	Invoice No.	Amount ($)
Jan 7	M. Shava		25 000
	S. Mudzingwa		19 000
	L. Kusano		7 200
Jan 31	Total posted to the General Ledger		51 200

iii. **Sales Journal/Sales daybook**

Date	Details	Invoice No.	Amount ($)
Jan 14	W. Cliffs		33 600
	S. Ndlovu		8 000
	M. Zakeo		3 000
Total posted to the General Ledger			44 600

iv. **Purchases Returns Journal**

Date	**Details**	**Invoice**	**Amount ($)**
Jan 17	S. Mudzingwa		3 000
	Total posted to the General ledger		**3 000**

v. **Sales returns Journal**

Date	Details	Invoices No.	Amount ($)
Jan 18	M. Zakeo		500
" "	S. Ndlovu		1 000
	Balance posted to the General Ledger		1 500

Vi **General Journal**

	Dr $	Cr. $
Motor Vehicle	50 000	
J B Motors		50 000

b)i. **General Ledger**

Rent account

2012		$	2012		$
Jan. 2	Cash	2 500	Jan. 31	Bal. c/d	2 500
		2 500			2 500
Feb. 1	Bal. b/d	2 500			

Stationery account

2012		$	2012		$
Jan. 2	Cash	500	Jan. 31	Bal. c/d	800
Jan. 20	Bank	300			
		800			800
Feb. 1	Bal. b/d	800			

Purchases account

2012		$	2012		$
Jan. 4	Cash	10 000	Jan. 31	Bal. c/d	61 200
Jan. 31	Creditors	51 200			
		61 200			61 200
Feb. 1	Bal. b/d	61 200			

Wages account

2012		$	2012		$
Jan. 6	Cash	5 000	Jan. 31	Bal. c/d	10 500
Jan. 13	Bank	5 000			
Jan. 21	Bank	500			
		10 500			10 500
Feb. 1	Bal. b/d	10 500			

Furniture account

2012		$	2012		$
Jan. 8	Cash	8 000	Jan. 31	Bal. c/d	8 000
		8 000			8 000
Feb. 1	Bal. b/d	8 000			

Transport account

2012		$	2012		$
Jan. 9	Bank	1 200	Jan. 31	Bal. c/d	1 200
		1 200			1 200
Feb. 1	Bal. b/d	1 200			

Water account

2012		$	2012		$
Jan. 11	Bank	200	Jan. 31	Bal. c/d	200
		200			200
Feb. 1	Bal. b/d	200			

Telephone account

2012		$	2012		$
Jan. 12	Bank	1 900	Jan. 31	Bal. c/d	1 900
		1 900			1 900
Feb. 1	Bal. b/d	1 900			

Electricity account

2012		$	2012		$
Jan. 15	Cash	1 300	Jan. 31	Bal. c/d	1 300
		1 300			1 300
Feb. 1	Bal. b/d	1 300			

Drawings account

2012		$	2012		$
Jan. 22	Bank	500	Jan. 31	Bal. c/d	500
		500			500
Feb. 1	Bal. b/d	500			

Capital account

2012		$	2012		$
Jan. 31	Bal. c/d	70 000	Jan. 1	Cash	70 000
		70 000			70 000
			Feb. 1	Bal. b/d	70 000

Loan account – The Bank of People

2012		$	2012		$
Jan. 31	Bal. c/d	28 000	Jan. 23	Cash	28 000
		28 000			28 000
			Feb. 1	Bal. b/d	28 000

Sales account

2012		$	2012		$
Jan. 31	Bal. c/d	74 600	Jan. 5	Bank	30 000
			Jan. 31	Debtors	44 600
		74 600			74 600
			Feb. 1	Bal. b/d	74 600

Sales returns account

2012		$	2012		$
Jan. 31	Debtors	1 500	Jan. 31	Bal. c/d	1 500
		1 500			1 500
Feb. 1	Bal. b/d	1 500			

Purchases returns account

2012		$	2012		$
Jan. 31	Bal. c/d	3 000	Jan. 9	Creditors	3 000
		3 000			3 000
			Feb. 1	Bal. b/d	3 000

Motor vehicle account

2012		$	2012		$
Jan. 31	J.B. Motors	50 000	Jan. 31	Bal. c/d	50 000
		50 000			50 000
Feb. 1	Bal. b/d	50 000			

J.B. Motors account

2012		$	2012		$
Jan. 31	Bal. c/d	50 000	Jan. 31	Cash	50 000
		50 000			50 000
			Feb. 1	Bal. b/d	50 000

Discount allowed account

2012		$	2012		$
Jan. 31	Debtors	2 280	Jan. 31	Bal. c/d	2 280
		2 280			2 280
Feb. 1	Bal. b/d	2 280			

Discount received account

2012		$	2012		$
Jan. 31	Bal. c/d	1 610	Jan. 31	Creditors	1 610
		1 610			1 610
			Feb. 1	Bal. b/d	1 610

c) ii. **SALES LEDGER**

W. Cliffs account

2012		$	2012		$
Jan. 14	Sales	33 600	Jan. 19	Bank	31 920
			Jan. 19	Discount	1 680
		33 600			33 600

S. Ndlovu account

2012		$	2012		$
Jan. 14	Sales	8 000	Jan. 18	Returns	1 000
			Jan. 31	Bal. c/d	7 000
		8 000			8 000
Feb. 1	Bal. b/d	7 000			

M. Zakeo account

2012		$	2012		$
Jan. 14	Sales	3 000	Jan. 18	Returns	500
			Jan. 19	Bank	1 900
			Jan. 19	Discount	600
		3 000			3 000

B) iii. **Purchases ledger**

M. Shava account

2012		$	2012		$
Jan. 10	Discount	1 250	Jan. 7	Purchases	25 000
Jan. 10	Bank	23 750			

		25 000			25 000

S. Mudzigwa account

2012		$	2012		$
Jan. 17	Returns	3 000	Jan. 7	Purchases	19 000
Jan. 31	Bal. c/d	16 000			
		19 000			19 000
			Feb. 1	Bal. b/d	16 000

L. Kusano account

2012		$	2012		$
Jan. 16	Discount	360	Jan. 7	Purchases	7 200
Jan. 16	Bank	6 840			
		7 200			7 200

Debtors are determined by adding all customers in the Sales Ledger with outstanding balances (i.e. those with balance brought down). And in this example total debtors figure is equal to $7 000 for S. Ndlovu as there were no outstanding balances for W. Chivengere and M. Zakeo. The same procedure is used in determining the creditors' figure which, in this example is equal to $16 000 of S. Mudzingwa.

5.6 End of chapter questions

Question 1 Enter the following transactions in the books of Nyaradzo Madzingira:

2011

Sept.	01	Nyaradzo started a business by investing $15 000 cash
	02	Bought Motor Vehicle for cash $9 000
	03	Bought Fixtures for cash $4 600
	04	Bought goods for cash $2 400
	05	Bought stationary for cash $340
	06	Sold goods for cash $4 520
	10	Bought goods on credit from C Camel for $8 100
	12	Paid $760 cash for motor running expenses
	13	Sold goods on credit to R Bernard for $2 300
	16	Returned goods to C Came for $1 780
	18	Sold goods for cash $2 640
	20	R Bernard returned goods costing $140
	24	Paid wages by cash $800
	25	Paid Rent by cash $3 700
	26	Received cash from R Bernard $2 000
	30	Paid cash to C Camel P7 050

Question 2 Enter the following transactions in the books of a trader V Chirwa:

2011

May	01	V Chirwa started a business with $30 000 in the bank
	02	Bought the following assets paying by cheques:

		Office Equipment \$7 600; Delivery Van for \$17 000
	05	Bought goods on credit from T Apulia for \$2 650
	06	Paid insurance by cheque \$600
	07	Goods sold on credit to S Magahi for P940
	11	Goods returned to T Apulia \$430
	12	Paid Motor expenses by cheque \$740
	14	Goods returned by S Magahi \$240
	17	Sold goods on credit to K Masada \$1 220
	22	Bought goods on credit from H Senga for \$3 780
		Paid T Apulia by cheque \$2 150
	24	Received a cheque of \$4 200 from S Magahi
	27	Goods returned by K Masada for \$550
	28	Paid Salaries by cheque \$2 760
	31	Paid Rent by cheque \$1 300

Question 6. N Smart started a retail business on 1 October 2001. He carried out the following transactions during the month:

2011		
Oct.	01	N Smart contributed by \$16 000 cash as his capital
	02	He deposited \$12 500 cash into business bank account
	03	Bought motor van paying by cheque \$11 000
	04	Bought furniture paying by cash \$1 000.
	07	Bought goods paying by cash \$1 500.
	09	Sold goods for cash \$800.
	13	bought goods on credit from G. Salem \$1 700.
	18	Sold goods on credit to D. Dhliwayo for \$3 200.
	22	Wages paid by cash P400
	26	Received a cheque from D Bernard P1 500
	30	Paid a cheque to T. Mano for \$1 450

Required:

(a) Enter the above transactions in the ledger books following Double entry system

(b) Balance off these ledger accounts at the month end of October 2001.

6. THE TRIAL BALANCE

6.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Define the following terms: assets, liabilities, drawings, operating expenses, income and equity.*
- *Define the trial balance.*
- *Prepare a Trial Balance from a given list of balances*
- *Understand the reasons for the preparation of the Trial balance*
- *Explain the errors which are not revealed by the Trial balance.*

6.2 The trial balance

It is a list of all ledger balances at the end of a particular period. It is not part of the double entry system. The main purpose of preparing the trial balance is to check the mathematical accuracy of the ledger clerks involved in the preparation of various ledgers.

6.3 Procedures for preparing a trial balance

All accounts with a debit balance are entered on the debit side of the trial balance and all accounts with credit balance are entered on the credit side of the trial balance and add all figures on each side, the total should be the same.

The following is a trial balance of A. Moyo as at 31 January 2012

	DR $	CR. $
Bank	1 600	
Equity (Capital)		20 000
Motor car	22 000	
Rent	5 000	
Purchases	20 000	
Wages	2 000	
Stationery	500	
Revenue		32 000
Water	900	
	52 000	52 000

Sometimes in an examination, students are required to prepare a trial balance from a list of mixed up ledger balances. For the student to prepare such a trial balance, he/she must understand the type of accounts that should be credited and those that should be debited. The following is a summary of items that are debited and those that are credited.

Details	**Dr.**	**Cr.**
Equity (Capital)		✓
Revenue (Sales)		✓
Purchases	✓	
Drawings	✓	
All expenses e.g. rent payable, salaries, insurance	✓	
All assets e.g. machinery, inventory, trade receivables	✓	
All liabilities e.g. trade payables, loan		✓
Returns outwards/ purchases returns		✓
Discount received		✓
Rent received		✓
Insurance received		✓
All provisions e.g. for deprecation, for bad debts		✓

6.4 Fully worked examples with solutions

6.4.1 Example 1

From the following list of ledger balances, you are required to prepare the trial balance of B. Brown as at 31 December 2011.

	$
Equity (Capital)	500 000
Land and buildings	150 000
Purchases	200 000
Revenue (Sales)	350 000
Rent	55 000
Salaries and wages	100 000
Electricity	25 000
Motor vehicles	120 000
Carriage inwards	15 000
Carriage outwards	23 000
Sales returns (Returns inwards)	4 500
Purchases returns (Returns outwards)	4 000
Cash balance at bank	137 500
Trade receivables (Debtors)	26 000
Trade payables (Creditors)	16 000
Drawings	14 000

Trial balance of B. Brown as at 31 December 2011

	Dr. $	Cr. $
Equity (Capital)		500 000
Land and buildings	150 000	
Purchases	200 000	
Revenue (Sales)		350 000
Rent	55 000	
Salaries and wages	100 000	

Electricity	25 000	
Motor vehicles	120 000	
Carriage inwards	15 000	
Carriage outwards	23 000	
Sales returns (Returns inwards)	4 500	
Purchases returns (Returns outwards)		4 000
Cash balance at bank	137 500	
Trade receivables (Debtors)	26 000	
Trade payables (Creditors)		16 000
Drawings	14 000	
	870 000	870 000

6.4.2 Example 2

The following trial balance was extracted from the books of Joseph Mazura by a trainee accounts clerk after the accountant resigned without notice.
Trial balance as at 30 September 2011

	Dr. $	Cr. $
Provision for depreciation	13 680	
Equity (Capital)		29 800
Revenue (Sales)		90 000
Purchases	64 000	
Discount received	1 020	
Carriage outwards		100
Purchases returns (Returns outwards)	3 000	
Sales returns (Returns inwards)		1 000
Bank	18 900	
Motor vehicle	38 000	
Trade payables	21 600	
Trade receivables		15 100
Opening inventory	2 800	
Drawings	19 200	
Suspense		6 200
	182 200	182 200

You are required to prepare a corrected trial balance as at 30 September 2011.

<u>Solution</u>
Corrected trial balance as at 30 September 2011

Dr. Cr.

	$	$
Equity (Capital)		29 800
Revenue		90 000
Purchases	64 000	
Discount received		1 020
Carriage outwards	100	
Purchases returns		3 000
Sales returns	1 000	
Bank	18 900	
Motor vehicle	38 000	
Provision for depreciation on vehicle		13 680
Trade payables		21 600
Trade receivables	15 100	
Opening inventory	2 800	
Drawings	19 200	
	159 100	159 100

6.5 Errors that do not affect the trial balance

These are errors which do not affect the agreement of the trial balance that is even if they are made the trial balance will still balance.

6.5.1 Error of omission

It occurs when a transaction has not been recorded in the books of accounts. The entry will not be in the ledger thus it will not also be in the trial balance. For example a sale on credit of $4 000 to a customer is completely omitted from the books of accounts. Both the sales account and the trade receivables' account will be falling short by $4 000.

6.5.2 Error of principle

This occurs as a result of failure to distinguish between the classes of the accounts.
Examples of the errors of principle

i) The purchase of a non-current asset recorded as purchases
ii) Income is credited to a liability account in error (or vice versa).
iii) Repairs to machine recorded machinery account.

6.5.3 Error of commission

It occurs when an entry has been recorded correctly but in a wrong person's account.
For example cheque received from M. Moyo a debtor is credited to C. Moyo.

6.5.4 Error of original entry

It occurs when the figure on the source document is not the same as that recorded in the books of accounts. For example sales on credit of $400 recorded as $4000 both in the individual account in the sales ledger and in the sales account.

6.5.5 Complete reversal of entries

It occurs when an entry has been recorded on the wrong side in the subsidiary book, but posted correctly to the ledger. It applies when the double entry system has not been followed, that is, the account that should have been debited is credited and vice versa e.g. a cheque payment to H. Mutero is debited to Bank and credited to Mutero's Account in error.

6.5.6 Compensating errors

This is when two or more errors cancel each other out e.g. wages is overcast by $200 and telephone under cast by $200 or sales under cast by $500 and purchases under cast by $500. These errors will cancel each other so that the trial balance will still balance.

6.5.7 Transposition errors

This occurs when the digits of a figure has been interchanged. Thus the figure on the document will be different from the one in the books of accounts.
For example purchases on credit of $491 recorded as $419 both in the individual account in the purchases ledger and in the purchases account.

6.6 Purposes of the trial balance

i) The trial balance is mainly used to check the arithmetical accuracy of the double entry bookkeeping.
ii) The trial balance is used in the preparation of the financial statement
iii) It is also used to detect errors if it fails to balance.

6.7 Examination type questions

Question 1
State the type of error in the following:

(a) A sale of goods to B. Bonzo for $900 was entered in Bosso.
(b) The purchase of Machinery for $2 000 was entered in the Machinery repairs account.
(c) A purchase of goods on credit from Nyore Nyore for $690 was entered in the books as $960.
(d) A payment by cheque to M. Moyo for $15 000 was debited to the bank account and credited in Moyo's account.
(e) The interest earned account was under cast by $200 and also the interest payable account was under cast by the same amount.
(f) A return of goods previously bought on credit from Nyore Nyore was completely omitted from the books.

(a) State any 4 errors that are not revealed by a Trial Balance.
(b) Give 2 errors affecting the agreement of a Trial Balance.
(c) State one purpose of preparing a trial balance.
(d) The following trial balance at 30 April 1997 has some errors.

Question 2

TRIAL BALANCE FOR THE YEAR ENDED 30 APRIL 2011

	DEBIT	**CREDIT**
Capital at 1 May 1996		20 000
Drawings	2 000	
Sales		60 525
Purchases	29 900	
Stock at 1 May 1996	8 750	
Stock at 30 April 1997		7 300
Administration expenses	15 017	
Discounts allowed		1 100
Discounts received	930	
Equipment	25 000	
Cash in Hand		200
Bank (CR)	1 760	
Trade debtors	3 588	
Provision for doubtful debts		140
Trade creditors		2 200
Suspense account	<u>4520</u>	
	<u>91 465</u>	<u>91 465</u>

<u>REQUIRED:</u>

Re – write the Trial Balance to correct the errors.

7. THE STATEMENT OF COMPREHENSIVE INCOME

7.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *State the purpose of preparing the Statement of comprehensive income*
- *Define and calculate 'cost of goods sold'*
- *Define 'gross profit' and 'net profit'*
- *Prepare simple Statement of comprehensive income in vertical format showing clearly:*
  - *Turnover*
  - *Cost of sales*
  - *Gross profit*
  - *Operating expenses*
  - *Net Profit*
- *Enter the missing words and figures in the boxes on the Statement of comprehensive income.*

7.2 Introduction

The Statement of comprehensive income is an account, which shows all the expenses and income of the business as well as the net profit or loss for the period. Previously this statement was being referred to as the profit and loss account. Net profit arises if income is more than expenses and net loss when expenses are more than income for a particular period. The trading account is used to calculate the gross profit, whilst the profit and loss account is used to calculate the net profit of the business.

7.3 The format of the Statement of comprehensive income

The following is a pro-forma of a Statement of comprehensive income using the vertical format, which is recommended by your syllabus:

	$	$	$
Revenue			xxx
Less sales returns			<u>xxx</u>
Net sales/turnover			xxx
<u>Less cost of sales</u>			
Opening inventory		xxx	
Add Purchases	xxx		
Add Import duty	xxx		
Add carriage inwards	<u>xxx</u>		
	xxx		
Less purchases returns	<u>xxx</u>	<u>xxx</u>	
Cost of goods available for sale		xxx	
Less closing inventory		<u>xxx</u>	<u>xxx</u>
Gross profit/ loss			xxx
Add rent received			xxx
Add bad debts recovered			xxx
Add Decrease in provision for bad debts			<u>xxx</u>
			xxx
<u>*Less* trading expenses</u>			

Rent	xxx	
Carriage outwards	xxx	
Wages and salaries, e.t.c.	xxx	xxx
Net profit/ loss		**xxx**

Please note that closing stock represents the part of the goods purchased for resale but not sold at the end of the accounting period.

7.3.1 Example 1

The following is a Statement of comprehensive income of Mr. A. Moyo. The trial balance is given on page …of the previous chapter and all goods purchased were sold

A Moyo's Statement of comprehensive income for the month of January 2012

	$	$	
Revenue			32 000
Less cost of goods sold			
Purchases		20 000	
Gross profit		12 000	
Less expenses			
Rent	5 000		
Wages	2 000		
Stationery	500		
Water	900	8 400	
Net profit		3 600	

7.4 Fully worked examples with solutions

7.4.1 Example 2

The following information was extracted from the books of Mc Author for the month of January 2012

- Revenue $90 000
- Returns inwards $600
- Purchases $60 000
- Returns outwards $800
- Carriage inwards $1 000
- Opening inventory $15 000
- Closing inventory $16 000
- Trading expenses $24 500

Required

Prepare the Statement of comprehensive income of Mc Author for the month of January 2012

Suggested Solution

Statement of comprehensive income of Mc Author for the month of January 2012

	$	$	$	
Revenue			90 000	
Less returns inwards			600	
Net sales			89 400	
Less cost of sales				
Opening inventory		15 000		
Add purchases	60 000			
Add carriage inwards	1 000			
	61 000			
Less returns outwards	800	60 200		
		75 200		
Less closing inventory		16 000		59 200
Gross profit				30 200
Less trading expenses				24 500
Net profit				5 700

P**lease note that opening stock is referring to goods which remained unsold for the previous accounting period and closing stock is referring to goods not sold by the end of the current accounting yea**r. In its first year of trading, the business will not be having opening inventory. In example 1 above, there is no opening inventory because the business was in its first year of trading and the absence of closing inventory is based on the assumption that all goods purchased are sold by the end of the accounting date. However, in practice, there will always be closing inventory at the end of the accounting period, which will be opening stock for the next accounting period for the following reasons:

a) To avoid losing revenue when all the goods in stock have been sold.
b) All goods purchased cannot be sold.

7.4.2 Example 3

The following trial balance was extracted from the books of Musa Mohammed for the financial year ending 30 June 2011 after the preparation of the trading account.

	Dr. $	Cr. $
Capital		41 000
Gross profit		21 000
Closing inventory[1]	20 000	
Rent	1 000	
Electricity	6 000	
Wages and salaries	1 600	
Sundry expenses	2 300	
Cash at bank	2 000	
Motor vehicles	13 000	
Equipment	15 000	
Trade receivables	2 900	

Trade payables		1 800
	63 800	63 800

Required

Prepare the Statement of comprehensive income of Musa Mohammed for the year ended 30 June 2011.

Note

[1] If either gross profit or net profit figure is appearing in the trial balance, the stock figure in that trial balance will be for closing stock not opening stock. This is because the opening stock figure has already been accounted for in the calculation of either the net or gross profit figure.

Suggested Solution

Statement of comprehensive income of Musa Mohammed for the year ended 30 June 2011

	$	$
Gross profit		21 000
Less trading expenses		
Rent	1 000	
Electricity	6 000	
Wages and salaries	1 600	
Sundry expenses	2 300	10 900
Net profit		10 100

This solution will be used to prepare the Statement of financial position in the next chapter.

7.5 End of chapter questions

7.5.1 Question 1

From the following list of balances you are required to prepare a Statement of comprehensive income for the year ended 31 December 2011. *(A Statement of financial position is not required)*

	Debit	Credit

	$	$
Capital		120 000
Revenue		160 000
Purchases	100 000	
Opening inventory	25 000	
Carriage inwards	12 000	
Purchases outwards		1 300
Returns inwards	1 800	
Wages and salaries	5 000	
Factory rent	10 000	
Electricity	6 500	
Miscellaneous expenses	1 000	
Machinery	59 800	
Motor vehicles	40 000	
Cash at bank	16 000	
Trade receivables	26 000	
Trade payables		20 000
	303 100	303 100

Additional information

Closing inventory was valued at $16 000

7.5.2 Question 2

Andy Jim started business on the 1st of February 2011. The following transactions relate to his business during the first month of trading.

February 1	Started business with $200 000 in the bank.
2	Bought goods on credit from A &A Wholesalers for $100 000.
4	Sold goods for $60 000 and received cash.
6	Bought machinery for $50 000 paying by cheque.
9	Returned goods worth $10 000 to A & A Wholesalers.
10	Paid $12 000 out of the bank for various business expenses.
12	Paid A & A. Wholesalers their total amount by cheque.
14	Withdrew $500 cash from the bank for business use.
17	Bought office stationery by cheque, $4 000.
19	Sold goods worth $40 000 on cash, which was promptly deposited into the bank account.
20	Bought goods for $20 000 paying by cheque.
21	Withdrew cash, $12 000 from the bank for personal use
22	Paid rent by cheque $22 000.
28	Sold goods on credit to D. Williams for $25 000.
	Closing stock was valued at $17 300

From the above information you are required to:

(a) Prepare the journals, post the necessary entries to the ledger and balance the accounts.
(b) Extract a trial balance
(c) Prepare the Statement of comprehensive income for the end of the period.

7.5.3 Question 3

In an attempt to ascertain his profit for the year, D. Wales prepared the following statement for the year ended 31 December 2011. He approached you to check if the trading account has been prepared in a good manner.

	$		$	
Revenue			400 000	
Add carriage outwards			1 000	
			401 000	
Less returns inwards		2 500		
			398 500	
Less cost of goods sold				
Opening inventory		15 000		
Add purchases	345 600			
Add carriage inwards	3 400			
Add returns outwards	4 200			
	368 200			
Less closing inventory	16 000		352 200	
Gross profit			46 300	
Less expenses				
Wages and salaries		5 000		
Rent and rates	6 000			
Fittings and furniture	10 000			
Discount allowed		1 000		
Sundry office expenses		5 500	27 500	
Net profit				18 800

You are required to prepare the Statement of comprehensive income using the vertical format for the year ended 31 December 2011.

7.6 Examination type questions

7.6.1 From the following information, you are required to:

(a) Enter the transactions in the books of accounts and post to the ledger of T. Tsuro.
(b) Extract a trial balance as at 31 March 2011.
(c) Prepare the Statement of comprehensive income for the year ended 31 March 2011.

2011		
March	1	Started business with capital of $250 and $5750 in the bank.
	2	Bought goods on credit from C. Gama for $15 600 and from S. Dube for $22 100.
	4	Sold goods on credit from to N. Chibaya for $29 900 and to J. Matambo for $36 400.
	6	Paid rent by cheque $1 200.
	8	Sold goods for cash and deposited the money in the business bank account, $3 610.
	10	Returned goods to S. Dube for $800.
	11	J. Matambo returned goods worth $900.

12 N. Chibaya returned goods worth $1 300.
13 Returned goods to C. Gama for $550.
14 Bought goods and paid by cheque $2 770.
15 Paid for shop furniture by cheque $3 100.
16 Paid cash for stationery $60.
17 Paid wages and salaries by cheque $2 800.
18 Bought motor vehicle and paid by cheque $13 600.
19 Sold goods for cash and deposited $4 450.
20 Paid electricity and water by cheque $1 760.
21 Paid cash for telephone $130.
22 Received cheque from N. Chabaya for $15 700 and allowed him $200 discount.
23 Sent a cheque to C. Gama for $10 200 and received $180 discount.
24 J. Matambo paid by cheque $18 600 and allowed a discount of $400.
26 Paid S. Dube by cheque $10 900 and received $100 discount.
28 Withdrew from the bank for private use$1 000.
29 Paid salaries and wages by Cheque $3 300.

8. THE STATEMENT OF FINANCIAL POSITION

8.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *State the accounting equation*
- *State the purpose of preparing Statement of financial position*
- *Classify assets and liabilities*
- *Prepare the simple Statement of financial position in a vertical format showing clearly:*
  - *Non-current assets*
  - *Current assets*
  - *Working capital / Net current assets*
  - *Non-current liabilities and Current liabilities*
  - *Financed by (Owner's Equity*
- *Define the term 'working capital'*
- *State the effect on working capital of given transactions.*

8.2 Introduction

The Statement of financial position is a list of ledger balances remaining after the preparation of the Statement of comprehensive income. It shows the financial status (financial position) of a business that is the availability of assets to pay for business liabilities. Previously this was being referred to as the balance sheet. An asset is a resource that belongs to the business, e.g. inventory, machinery and trade receivables (debtors) e.t.c. An asset can be classified either as non-current or current asset. Current assets are those assets with a useful life of less than one year whilst non-current assets are those assets with a useful life of more than one year. Liabilities are items that the business owes to outsiders. The following is the Statement of financial position equation and a pro-forma of the Statement of financial position.

Assets = Capital + liabilities or Assets – Liabilities = Capital

8.3 The format of the Statement of financial position

Non-current assets			
Land and buildings			xxx
Motor vehicles			xxx
Machinery			xxx
			xxx
Current assets			
Inventory		xxx	
Trade receivables		xxx	
Other receivables		xxx	
Cash		xxx	
		xxx	
***Less* current liabilities**			
Trade payable	xxx		
Other payables	xxx		
Bank overdraft	xxx		
Working capital		xxx	
Employment of capital		xxx	

Financed by:

Opening Capital	xxx
Add net profit	xxx
	Xxx
Less drawings	xxx
Closing Capital	xxx

The following is the Statement of financial position of A. Moyo whose books of accounts were prepared in the previous chapters.

Statement of financial position of A. Moyo as at 31 January 2001

	$
Assets	
Non-current: Motor vehicle	22 000
Current assets: Inventory	2 000
:Bank	1 600
	25 600
Financed by:	
Capital	20 000
Net profit	5 600
	25 600

8.4 Working capital

This is the difference between current assets and current liabilities. The following are the major components of working capital.

Current assets: Inventory
- Trade receivables
- Other receivables
- Bank
- Cash

Current liabilities: Trade payables
- Bank overdraft
- Other payables

It is important to note that a transaction which increases one of the current assets items will increase working capital and vice – versa and items that increases current liabilities will reduce working capital and vice versa. A transaction that decreases one current asset and increases another current asset does not have an effect on working capital. For example, a payment by a debtor by cheque or cash.

We also have some transactions that decrease a current liability and decrease a current asset. Such items do not have an effect on the working capital of a business. For example, a payment to a creditor by cheque or bank.

A transaction, which increases a current liability and increases a current asset, will have no effect on working capital. E.g. purchases of stock on credit.

Example

State the effect (increase or decrease) if any, on working capital, of each of the following transactions. If a transaction does not have an effect, state no effect.

(a) Bought goods on credit from J. Links
(b) Paid wages and salaries in arrears by cheque
(c) Paid for electricity expenses
(d) Sold a motor vehicle on credit
(e) Payment received from a debtor
(f) Withdraw stocks for personal use
(g) Withdraw cash from the bank for office use
(h) Returned damaged goods to the supplier
(i) Sold goods and received cash
(j) Received a bank loan by cheque and to be repaid in 4 year time
(k) Purchased an office equipment by cheque
(l) Sold some office equipment for cash

Solution

Transaction	Effect on working capital
(a) Bought goods on credit from J. Links	No effect
(b) Paid wages and salaries in arrears by cheque	No effect
(c) Paid for electricity expenses	Decrease
(d) Sold a motor vehicle on credit	Increase
(e) Payment received from a debtor	No effect
(f) Withdraw stocks for personal use	Decrease
(g) Withdraw cash from the bank for office use	Decrease
(h) Returned damaged goods to the supplier	No effect
(i) Sold goods and received cash	No effect
(j) Received a bank loan by cheque and to be repaid in 4 year time	Increase
(k) Purchased an office equipment by cheque	Decrease
(l) Sold some office equipment for cash	Increase

Example 2

A. Nyathi commenced business on 1 February 2011 supplying automobile spare parts. The following is his Trial balance as at 31 January 2012

	Debit	Credit
	$	$
Sales Returns	1 500	
Rent	2 500	
Bank	52 630	

Stationery	800	
Purchases	61 200	
Wages	10 500	
Cash on hand	11 700	
Furniture	8 000	
Discount received		1 610
Transport	1 200	
Water	200	
Telephone	1 900	
Electricity	1 300	
Drawings	500	
Capital		70 000
Loan		28 000
Revenue		74 600
Loan- The Bank of People		50 000
Motor Vehicle	50 000	
Discount Allowed	2 280	
Trade receivables	7 000	
Trade payables		16 000
Purchases Returns		3 000
Office equipment	30 000	
	243 210	**243 210**

Additional information

Closing inventory was valued at $15 700.

You are required to prepare the Statement of comprehensive income of A. Nyathi for the year ended 31 January 2002, and a Statement of financial position as at that date.

Solution

Statement of comprehensive income of A. Nyathi for the month ending 31 January 2002

	$	**$**
Revenue		74 600
Less sales return		1 500
Net sales/Turnover		73 100
Less Cost of sales		
Purchases	61 200	
Less returns	3 000	

	58 200	
less closing inventory	15 700	42 500
Gross profit		30 600
Add income received		
Discount received		1 610
		32 210
Less expenses		
Rent	2 500	
Stationery	800	
Wages	10 500	
Transport	1 200	
Water	200	
Telephone	1 900	
Electricity	1 300	
Discount allowed	2 280	20 680
Net profit		11 530

Statement of financial position of A. Nyathi as at 31 January 2002

	$	$	$
Non-current assets			
Motor vehicle			50 000
Office equipment			30 000
Furniture			8 000
			88 000
Current assets			
Stock		15 700	
Debtors		7 000	
Bank		52 630	
Cash		11 700	

		87 030	
***Less* Current liabilities**: Creditors	16 000		
J.B. Motors	50 000	66 000	
Working capital			21 030
			109 030
Long-term liabilities			
The Bank of people			28 000
			81 030
Financed by:			
Opening Capital			70 000
Less net loss			11 530
			81 530
Less drawings		500	
Closing capital			81 030

8.4.1 Example 2

The Statement of financial position of Musa Mohammed from the previous chapter is prepared as follows.

Statement of financial position of Musa Mohammed as at 30 June 2011

	$	$
Non-current assets		
Motor vehicles		13 000
Equipment		15 000
		28 000
Current assets		
Inventory	20 000	
Trade receivables	2 900	
Cash at bank	2 000	
	24 900	
Less: trade payables	1 800	23 100

		51 100
Financed by:		
Capital	41 000	
Add net profit		10 100
		51 100

8.5 Examination type questions

8.5.1 Question 1

From the following information you are required to:

(a) Open, post and balance the relevant accounts in the ledger of R. Duncan for the period ending 31 January 2008.
(b) Extract a trial balance as at 31 January 2008.
(c) Prepare the Statement of comprehensive income for the year ended 31 January 2008.

January 1	Started business with a capital of $200 000 in cash, which was all used to open a business bank account with a commercial bank.
2	Bought goods for resale for $55 000
3	Sold goods on cash for $25 600. The full amount was immediately deposited into the business bank account
5	Purchased goods on credit from Tswana Trading for $65 000
7	Sold goods on credit to R. Greedy for $46 000
10	Bought a motor vehicle for $30 900 paying by cheque
11	Returned goods worth $5 000 to Tswana Trading
15	R. Greedy settled his account in full by cheque after allowing him a discount of $2 500.
21	Purchased goods $65 000 by cheque.
22	Sold good for cash $120 000, which was immediately deposited in the bank.
25	Received loan from a commercial bank $100 000
28	Paid Tswana Trading the full amount by cheque.
29	Bought machinery paying by cheque $60 000
30	Paid $30 000 for wages and salaries.
31	Paid $12 000 for rent
31	Paid $8 000 for electricity
	Closing stock was valued at $15 000

8.5.2 Question 2

The following trial balance was extracted from the books of J. Banda for the year ended 30 June 2010

	Dr. $	Cr. $
Capital		500 000
Purchase and Revenue	156 000	354 000
Rent	35 000	
Discount allowed	12 000	
Discount received		3 500

Sales returns	14 000	
Carriage inwards	23 000	
Motor vehicles	390 000	
Computers	80 000	
Machinery	85 000	
Trade receivables and trade payables	56 000	45 000
Salaries and wages	50 000	
Inventory at 1 July 2009	16 000	
Sundry expenses	1 500	
Carriage outwards	6 000	
General repairs	12 000	
Bank overdraft		23 000
Cash	14 000	
Drawings	15 000	
Loan from a bank- payable in 2020		40 000
	965 500	965 500

Additional information
Inventory on 30 June 2010 was valued at $26 500.

You are required to:

(a) Prepare the Statement of comprehensive income for the year ended 30 June 2010 and
(b) The statement of financial position as at that date.

8.5.3 The following trial balance was extracted from the books of C. Karambe on 30 June 2011.

	Dr. $	Cr. $
Capital		41 390
Purchase and revenue	36 750	63 330
Rent and rates	1 440	
Discount allowed	650	
Discount received		1 280
Sales returns	630	
Cash in hand	860	
Motor vehicles	15 250	
Furniture and fittings	10 500	
Premises	40 000	

Trade receivables and trade payables	12 960	13 710
Salaries and wages	9 300	
Inventory on I July 2010	4 950	
Electricity and water	3 910	
Bank	1 750	
Purchases returns		980
Drawings	6 740	
Loan from a bank		41 390
	145 690	145 690

Additional information
Inventory on 30 June 2011 was $4 050

Required

(a) Prepare the Statement of comprehensive income for the year ended 30 June 2011.
(b) Draw up a Statement of financial position as at 30 June 2011.

9. ADJUSTMENTS TO FINANCIAL STATEMENTS

9.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Define the terms 'Accruals' and 'Prepayments'.*
- *State where the accrued expenses and prepaid expenses are recorded in the Statement of financial position.*
- *State the accounting principles applied when adjusting for accruals and prepayments.*
- *Record the given transactions in the appropriate accounts for income and expenses, showing the amounts transferred to the Statement of comprehensive income at the end of the financial period.*
- *Explain each entry in the ledger accounts for expenses and income.*
- *Distinguish between capital expenditure and revenue expenditure.*

9.2 Introduction

At the end of the accounting period, some adjustments are required to be made to the trial balance figures before the preparation of final accounts and these consist of: -

a) Accrued expenses and income
b) Prepaid expenses and income
c) Drawings made in the form of stock
d) Closing stock
e) Stock of stationery and packaging material, stock of spare parts etc.
f) Provision for depreciation
g) Provision for bad debts
h) Correction of errors

In this chapter we are going to look at items a) to item e) only as the other items are covered in detail in the other chapters.

9.3 Other payables (Accrued Expenses)

These are expenses incurred during the financial year but not yet paid for by the period end. The opening balance is brought down on the credit side of the account as shown below. What was paid during the year is debited to the expense account and credited to the bank account. Any balance unpaid at the end of the period is debited to the expenses account and shown in the Statement of financial position as a current liability. The adjustment is made as follows:

Expense Account

Bank / cash	xxx	Bal. b/d	xxx
Bal. c/d	xxx	Profit and loss (Bal figure)	xxx

		xxx			**xxx**
				Balance b/d	xxx

9.4 Other receivables (Prepaid expenses)

These are expenses that have been paid in advance in the current financial year for the coming period. The opening balance is brought down on the debit side. What was paid during the year is debited to the expense account and credited to the bank account. Any balance paid in advance at the end of the period is credited to the expense account and shown in the Statement of financial position as a current asset. The adjustment is made as follows:

Expenses Account

Year		$	Year		$
	Balance b/d	xxx		profit and loss	xxx
	Bank / cash	xxx		Balance c/d	xxx
		xxx			**xxx**
	Balance b/d	xxx			

9.4.1 Example of both accrued and prepaid expenses

The ledger account for Mutero showed the following account balances:

	1 Jan 2011	**31 December 2011**
Rent prepaid	$500	$700
Electricity accrued	$900	$470

During the year ended 31 December 2011 these expense were paid as follows:

Rent	$ 6 500
Electricity	$12 100

Required:

Post and balance the rent and electricity accounts for the year ended 31 December 2011 clearly showing amount to be transferred to Statement of comprehensive income.

Solution

Rent account

2011		$	2011		$
Jan. 1	Bal. b/d	500	Dec. 31	Profit & loss	6 300

Dec. 31	Bank	6 500	Dec. 31	Bal. c/d	700
		7 000			**7 000**
2012					
Jan. 1	Bal. b/d	700			

Electricity account

2011		$	2011		$
Dec. 31	Bank	12 100	Dec. 31	Bal. B/d	900
Dec. 31	Bal. c/d	4 70	Dec. 31	Statement of comprehensive income	11 670
		12570			**12 570**
			2012		
			Jan. 1	Bal. c/d	470

9.5 Accrued Revenue

This is income owing to the account at the beginning and at the end of the financial period e.g. rent receivable, commission receivable etc., other than sales. When it owes at the beginning, it is debited to the revenue account and when it is owes at the end it is credited to this revenue account. In the Statement of financial position income accrued is a current asset. Any income received during the year is debited to the bank account and credited to the revenue account.

Format

Revenue A/c

Balance b/d	xxx	Bank	xxx
Profit & loss	xxx	Bal. c/d	xxx
	xxx		**xxx**
Balance b/d	xxx		

9.6 Prepaid income

This is income paid in advance to the account at the beginning and at the end of the financial period e.g. rent receivable, commission receivable etc., other than sales. When it is received in advance at the beginning, it is credited to the revenue account and when it owes at the end it is debited to this revenue account. In the Statement of financial position income received in advance is a current liability. Any income received during the year is debited to the bank account and credited to the revenue account.

9.6.1 Example of both prepaid and accrued income.

The ledger balances of Wellington showed the following:

	1 January 1999	31 December 1999
Commission receivable *(prepaid)*	$2 000	$3 500
Rent receivable *(accrued)*	$400	$700

During the year, amounts received in respect of the above were as follows

Rent	$9 600
Commission	$6 200

Required: -

Post and balance these accounts for the year ended 31 December 1999 clearly showing the amounts to be transferred to Statement of comprehensive income.

Rent Receivable

Bal. b/d	400	Bank	9 600
Profit and loss *(difference)*	9 900	Bal. c/d	700
	10 300		**10 300**
Bal. b/d	700		

Commission received

Profit and loss*(difference)*	4 700	Bal. b/d	2 000
Bal. c/d	3 500	Bank	6 200
	8 200		**8 200**
		Bal. b/d	3 500

9.7 Drawings

Drawings are anything of value taken from the business for personal use. They are in various forms e.g.

a) Cash taken from the business for personal use, we debited drawings and credit cash / bank Account.

b) Stock taken from business for personal use we debit drawings account and credit purchases account {at cost price}.

9.8 Fully worked examples with solutions

9.8.1 Example 1

The following is a trial balance of C. Mlambo as at 31 December 2011.

	Debit	**Credit**
	$	$
Capital		98 900
Revenue		220 000
Purchases	140 000	
Opening inventory	30 000	
Wages & Salaries	23 000	
Rent & Rates	9 100	
Machinery	40 000	
Stationery	3200	

Trade receivables	20 000	
Trade payables		26 000
Commission receivable		5 800
Carriage outwards	1 3200	
Bank	20 000	
Light & Heat	32 000	
Drawings	20 200	
	350 700	**350 700**

Additional Information

On 31 December 2011 the following was discovered

a) Light and heat accrued $800
b) Inventory at 31 December 2011 was valued at $31 600
c) During the year Mr Mlambo took goods cost $1 500 from the business for his own use.
d) Rent & Rates prepaid $900
e) Commission receivable due but not paid $1 000

Required: -

a) Prepare the Statement of comprehensive income for C Mlambo for the year ended 31 December 2011 and
b) A Statement of financial position as at that date.

Solution

Statement of comprehensive income for C. Mlambo for the year ended 31 December 2011.

	$	$
Sales		220 000
Less cost of sales		
Opening stock	30 000	
Add Purchases	140 000	
	170 000	
Less drawings of goods	1 500	
	168 500	

Less closing stock	31 600	136 900
		83 100
Commission receivable (500 +1 000)		6 800
Gross profit		89 900
Less expenses		
Wages & Salaries	23 000	
Rent & Rates (9 100 – 900)	8 200	
Light & heat (32 000 + 800)	32 800	
Carriage outwards	13 200	
Stationery	3200	80 400
Net Profit		9 500

Statement of financial position for C. Mlambo as at 31 December 2011

		$	$
Non-current Assets			
Machinery			40 000
Stock			31 600
			71 600
Current assets			
Trade receivables		20 000	
Bank		20 000	
Other receivables: Prepaid Rent & Rates		900	
: Commission receivable owing		1 000	
		41 900	
***Less* Current Liabilities**			
Trade payables	26 000		
Other payables -Light & Heat accrued	800		
Working Capital			15 100
			86 700
Financed by:			
Capital			98 900
Add Net profit			9 500
			108 400
Less Drawings (20 200 +1 500)			21 700
			86 700

Please note that an alternative, the ledger accounts explained above can be prepared as workings for amounts accrued or prepaid.

9.8.2 Example 2

The following balances were taken from the books of J. Zimuto for the financial year ended 31 December 2011.

	Debit	Credit

	$	$
Revenue		309 000
Land	96 100	
Rent received		8 200
Stationery	2 000	
Discount allowed	900	
Discount received		1 200
Trade receivables	47 500	
Trade payables		36 900
Carriage inwards	1 700	
Bank	21 100	
Cash on hand	540	
Rent paid	11 200	
Electricity & water	14 300	
Drawings	15800	
Capital		50 540
Purchases	176 400	
Opening inventory	24 400	
Wages	36 100	
	426 940	**426 940**

The following additional information is available as at 31 December 2011.

a) Stock on 31 December 2011 was valued at 36300.
b) Rent received in advance amounted to $1200
c) Unused stationery amounted to $ 700
d) Wages owing $1 100

Required

a) Prepare the Statement of comprehensive income of J. Zimuto for the year ended 31 December 2011.
b) Prepare Statement of financial position as at 31 December 2011.

Solution

Statement of comprehensive income for J. Zimuto for the year ended 31 December 2011

	$	$	$
Revenue		309 000	
Less Cost of sales			
Opening inventory	24 400		
Add Purchases	176 400		
Add Carriage Inwards	1 700		
	202 500		
Less Closing inventory	36 300	166 200	
Gross Profit		142 800	
Add income received			
Add discount received		1 200	
Add Rent received (8 200 – 1 200)		7 000	8 200
Gross profit		151 000	
Less Expenses			
Stationery (2 000 – 700)	1 300		
Discount Allowed	900		
Rent paid	11 200		
Electricity	14 300		
Wages (36 100 +1 100)	37 200	64 900	
Net profit		**86 100**	

Statement of financial position of J. Zimuto as at 31 December 2011

ASSETS		**COST** $	**DEP.** $	**N.B.V** $
Non-current assets: Land	96 100	-		96 100

Current Assets				
Inventory of stationery			700	
Inventory of goods for sale		36 300		
Trade receivables			47 500	
Cash on hand		540		
			85 040	
Less current liabilities				
Trade payables		36 900		
Bank		21 100		
Other payables: Rent Received in advance	1 200			
:Wages Owing	1 100	60 300		24 740
				120 840

Financed by:		
Capital	50 540	
Add Net Profit	86 100	
		136 640
Less drawings	15 800	
	120 840	

Care should be taken when dealing with the transactions of a sole trader in particular capital transactions.

Capital can be introduced indirectly e.g.

(a) The owner pays for business expenses using his private bank account.

(b) The owner brings his personal assets like a motor vehicle in to the business at a certain value. This is recorded as follows:

Debit	Motor vehicle
Credit	Capital

If depreciation policy is given, the examiner expects you to provide for depreciation as usual.

The above also applies to partners.

9.9 Capital and revenue expenditure

It is important to be able to distinguish the difference between capital and revenue expenditure. Revenue expenditure is the amount spent on the day to day running of the business e.g. wages, telephone, etc. while capital expenditure is expenditure incurred on the acquisition of fixed assets acquired for use in the business OR that expenditure which increases their earning capacity e.g. motor vehicles, plant and machinery, land and buildings. Revenue expenditure is a charge to Statement of comprehensive income while capital expenditure is shown in the Statement of financial position under fixed assets. Let's take an example of Mr. Moyo who wants to purchase a building at a purchase price of $5m. In addition to the above price he also incurred the following costs:

- Transfer fees $123 000
- Minor repairs to the building $ 30 000

The price of the building above should include the transfer price of $123 000 not the $30 000 incurred on minor repairs. We say that the former cost has been capitalised and the latter should be debited to the Statement of comprehensive income because it is revenue expenditure. The total cost of the building is now $5 123 000.

9.9.1 Fully worked example with solution

9.9.2 Example 1

From the following transactions, you are required to determine whether the transaction is capital or revenue expenditure.

(a) The purchase of a motor vehicle
(b) Purchases of goods for resale
(c) Painting of a motor vehicle
(d) Insurance premium for 1 year of the motor vehicle
(e) Motor vehicle fuel for the whole year
(f) Installation of a car radio
(g) General repairs to the motor vehicle
(h) Renovation of a building
(i) Road tax of the motor vehicle for one year
(j) General repairs to the building
(k) The installation of electricity cables to the building
(l) Electricity charges for one year
(m) The payment of wages and salaries
(n) Bank interest charged by a commercial bank.

<u>Solution</u>

(a) Capital
(b) Revenue
(c) Capital
(d) Revenue
(e) Revenue
(f) Capital
(g) Revenue
(h) Capital
(i) Revenue
(j) Revenue
(k) Capital
(l) Revenue
(m) Revenue
(n) Revenue

9.10 End of chapter questions

9.10.1

Chikopo is a sole trader whose financial year ends on 31 March 2011. On 1 April 2010, balances in Chikopo's ledger included the following:

	DR	CR
	$	$
Electricity		$400

During the year ended 31 March 2011, Chikopo made the following payments for electricity by cheque:

			$
April	15	2010	400
July	10	2010	310
October	18	2010	650
January	9	2011	540

At 31 March 2011 the amount owing for electricity was $590

<u>REQUIRED</u>

(a) Record the above transactions in the electricity account, showing the amount to be transferred to the profit and loss account for the year ended 31 March 2011.

(b) Complete the following sentence.
The balance on the electricity account is shown as a ----- in Chikopo's Statement of financial position as at 31 March 2011.

9.10.2

In the year to 30 September 2011 James had the following transactions:

2010				
October	20	Paid cash for office stationery	$200	
December	15	purchased office stationery on credit from Jaggers Ltd		$380
2011				
January	4	Returned office stationery to Jaggers Ltd	$45	
August	30	Purchased office stationery on credit from Matopo Book centre		$235
Sept	3	Purchased office stationery and paid by cheque	$110	

REQUIRED:
Write up James' Stationery account for the year ended 30 September 2011. Show the amount to be transferred to the Statement of comprehensive income.

9.10.3

Write up the ledger account of Advance distributors in John's books to record the transactions that follows:

2011
July 1 Invoice received from Advance distributors for goods supplied on credit - $2 800.

July 13 Credit note received from Advance distributors for goods returned of $250.

July 29 John paid the net amount owing to Advance distribution by cheque, deducting 2½% cash discount.

9.10.4

The following information relating to rent payable was extracted from the books of D. Sithole for the month of February 2006.

	$
Rent paid in advance at the beginning	3 500
Rent unpaid at the beginning	4 000
Rent actually paid by cheque	54 600
Rent unpaid at the end	6 300
Rent paid in advance at the end	1 700

Required
Prepare a rent payable account, showing clearly the amount to be transferred to the Statement of comprehensive income.

9.10.5 Question 2

The following trial balance was extracted from the books of J. Banda for the year ended 30 June 2011

	Dr.	Cr.
	$	$
Capital		500 000
Purchase and revenue	156 000	354 000
Rent	35 000	
Discount allowed	12 000	
Discount received		3 500
Sales returns	14 000	
Carriage inwards	23 000	
Motor vehicles	390 000	
Computers	80 000	
Machinery	85 000	
Trade receivables and trade payables	56 000	45 000
Salaries and wages	50 000	
Stock	16 000	
Sundry expenses	1 500	
Carriage outwards	6 000	
General repairs	12 000	
Bank overdraft		23 000
Cash	14 000	
Drawings	15 000	
Loan		40 000
	965 500	965 500

Additional information

(a) Inventory on 30 June 2011 was valued at $26 500.
(b) The following balances were available on 30 June 2011
    Rent paid in advance $1 200
    Sundry expenses owing $1 000
(c) $2 000 of the general repairs balance relate to an amount that was paid as the cost of installing the computers.
(d) Salaries and wages of $4 000 relates to managers' salary for July 2011 which was paid in advance at the year-end.

You are required to:
(a) Prepare the Statement of comprehensive income for the year ended 30 June 2011 and
(b) The Statement of financial position as at that date.

9.11 Examination type questions

Question 1
Classify the following as capital or revenue expenditure.

(i) Repairs and servicing of the van.
(ii) Purchase of delivery vans for stock.

(iii) Fittings four new tyres on the van.
(iv) Wages paid to the firm's workmen for building a garage for the van.
(v) Legal fees charged on the acquisition of a new building.
(vi) Carriage outwards costs.
(vii) Computer operator's salary.
(viii) Petrol used on the van.
(ix) Cost of rebuilding a damaged wall.
(x) Wages paid to workers extending a classroom block.

Question 2

The following information relates to Z. Zimbago, a sole trader.

TRIAL BALANCE AS AT 31st DECEMBER 2006

`	**Debit** **$**	**Credit** **$**
Drawings	3 800	
Office Expenses	773	
Motor Expenses	1 444	
Inventory (1 March 2005)	2 700	
Fixtures and fittings (Cost $18 000)	14 400	
Delivery Van (Cost $8 000)	5 400	
Purchases and revenue	46 404	61 239
Returns	129	235
Heating and Lighting	1 330	
Rent	2 350	
Trade receivables and trade payables	700	2 400
Cash	360	
Bank		300
Bad Debts	50	
Capital	______	15 666
	79 840	79 840

The following additional information is available.

1. Inventory at 31st December 2006 - $4 350.
2. Depreciation is to be charged as follows: -
   5% on fixtures and fittings using the straight line method
   10% on delivery Vans using the diminishing balance method.
3. A provision for Bad Debts of 5% on debtors is to be created.
4. Rent of $60 had been prepaid.
5. Office expenses owing were $180, 00.
6. The Bank Statement dated 30th March 2006 shows bank charges amounting to $60, No entry has been made in the books.

REQUIRED:

(a) Prepare the Statement of comprehensive income for the year ended 31 December 2006. [12]

(b) A Statement of financial position as at that date. [13]

Question 3

The following trial balance was extracted from the books of B. Boss as at 31st March 2007.

	Debit $	Credit $
Capital…………………………………………		33 000
Drawings …………………………………..	2 500	
Building at cost ……………………….......	20 000	
Fixtures and equipment at valuation………….	3 400	
Motor Vehicle at cost…………………………	8 000	
Provision for depreciation of motor vehicles….		3 250
Provision of doubtful debts……………………		200
Trade receivables …………………………………	7 500	
Trade payables……………………………………		6 700
Bank Overdraft ……………………………….		2 880
Motor Vehicle expenses ……………………...	1 240	
General expenses ……………………………..	2 030	
Wages …………………………………………	11 940	
Insurance …………………………………...	1 470	
Carriage Inwards………………………………	700	
Discount received ……………………………..		250
Revenue ………………………………………..	92 100	
Purchases …………………………………..	68 500	
Sales returns …………………………………..	1 200	
Inventory 1 April 2006 …………………………	9 900	
	138 380	**138 380**

Additional Information: -

1. At 31st March 2007:
   a. Inventory was valued at $10 200.
   b. Wages outstanding amounted to $1 080.
   c. Insurance prepaid amounted to $210.
2. During the year ended 31st March 2007 Boss took goods costing $300 for his own use. No entries had been in the accounting records.

3. The provision for doubtful debts is to be maintained at 2% of the debtors.

4. Motor vehicles are to be depreciated at 20% per annum using the reducing balance method.
5. Fixtures and equipment were valued at $2 800 on 31st March 2007. No fixtures and equipment were bought or sold during the year 31st ended March 2007.

PREPARE:

(a) Statement of comprehensive income for the year ended 31st March 2007.
(b) Statement of financial position as at that date.

Question 4

Wezhira's financial year ends on 30th September 2004. He provides the following information; On 1 October 2003, Wezhira's capital account showed a balance of $32 000. On 1 January 2004, he transferred his private motor vehicle to the business at a valuation of $4 500. During the year ended 30 September 2003, Wezhira's drawings amounted to $9 000. Net loss for the year was $1 300.

(a) Write up Wezhira's capital account as it would appear in the nominal ledger for the year ended 30 September 2004. Pay special attention to dates and details.
(b) The excess of current assets over current liabilities is known as …………
(c) Given that opening capital is $8 000, closing capital is $10 000 and drawings is $ 5 000, then net profit is…………….of sales.
(d) Gross profit expressed as a percentage of cost is called………………….

10. BANK RECONCILIATION STATEMENT

10.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Explain the need for preparing the reconciliation statement*
- *Outline the causes that affect the agreement of cash book and statement balances*
- *Draw an up dated Cash Book.*
- *Draw a Bank Reconciliation Statement.*
- *Draw an up dated Cash Book and a Bank Reconciliation Statement*
- *State reasons why a cheque may be dishonoured by the bank.*
- *Give reasons why it is necessary to reconcile the cash book and bank statement.*
- *State the bank balance that should be shown in the Statement of financial position of a trader and state whether it is an asset or a liability.*

10.2 Introduction

It is unlikely that on any specific day the bank balance shown in the cashbook will correspond with the statement of the balance at the bank account issued by the bank. A bank reconciliation statement is a statement that is prepared with the main objective of trying to make the two balances agree *(the bank balance as per cashbook and the bank balance as per bank statement).*

10.3 Purposes of bank reconciliation statements

(a) To discover items appearing only in the bank statement e.g. bank charges, interest paid / received.
(b) To detect errors made by the bank or firm's cash book clerk.
(c) To detect and prevent theft and fraud.
(d) To determine the actual cash balance with the bank at a given time.

10.4 Causes of the difference between cashbook balance and the bank balance

The following are some of the reasons why there is such a difference between the bank balance and the cash book balance:

10.4.1 Unpresented cheques

Depending with the bank and the type of the account, it takes a minimum of 5 – 10 working days for a cheque to go through the clearing system of the bank and be available for cash. Let's suppose that at the time of reconciling the cash book balance with the bank balance, there is a certain cheque that is in the cash book reflecting to have been paid out but has not yet hit the bank for clearance. Such cheque is treated as an unpresented cheque when preparing a reconciliation statement.

10.4.2 Bank lodgements

Deposits made into the bank but not yet credited by the bank due to the clearing process of the bank may also cause a difference between the two balances. If a cheque is received, it is credited in the cashbook while waiting to be deposited into the bank account. The cashbook balance will be higher than the bank balance as a result of deposit made but not yet credited by the bank. This should again be taken into consideration when preparing a bank reconciliation statement.

10.4.3 Payments and receipts effected directly through the bank

For transactions to be easier, the company might enter into an agreement with various stakeholders such that routine payments and receipts are effected through the bank e.g. direct debits, standing orders and credit transfers. On the other hand, the bank might record in the account, amounts relating to bank interests, bank charges, ledger fees, cash deposit fees, commission fees, interest paid and interest received and direct debit proceeds paid directly into the bank account. We will only get to know about them when we receive a bank statement at the end of the period.

10.4.4 Errors in the cash book and at the bank

During the process of preparing the cashbook, the cashier might commit some errors such as overstating, understating or omitting some entries. It is obvious that such errors will not reflect on the bank statement. On the other hand, the bank can also make some errors when processing transactions relating to a bank account of an enterprise. If these errors are combined, they will affect the agreement between the cash book balance and the bank statement balance. They should be corrected if the two balances are to reconcile. The bank reconciliation statement reconciles the balance at the bank as per cashbook, whenever the bank statement is received.

Procedure:

For a bank reconciliation statement to be prepared, we are supposed to be provided with the cashbook and the bank statement covering that period. The following provides a general guideline that should be followed when preparing a bank reconciliation statement.

1. Tick off similar items in the cashbook (bank column) and on the bank statement as in the following examples. The previous reconciliation *(if any)* should also be used to tick off items appearing on the current bank statement. All items ticked off should not be used in the preparation of a reconciliation statement as they appear on both the cashbook and the bank statement.
2. Prepare an updated cash book/supplementary cashbook for items that are appearing on the bank statement but not in the cashbook, starting with the balance as per cashbook. Unpicked items on the credit side of the bank statement should be entered on the debit side of the cashbook and vice-versa.
3. Identify unpresented cheques on the credit side of the cashbook and also deposits not yet cleared by the bank on the debit side of the cashbook. They are used to prepare the bank reconciliation statement.
4. Prepare a bank reconciliation statement.

Pro-forma- Bank reconciliation statement

	Normal balance	Overdraft
Balance/ Overdraft as per cashbook balance	xxx	xxx
Adjustments:		

Unpresented cheques	Add	Deduct
Bank lodgements	Deduct	Add
Balance/ Overdraft as per bank statement	xxx	xxx

10.5 Bank overdraft

The adjustments needed to reconcile the bank overdraft according to the firm's books with that shown in the bank's books are the complete opposite of what is done when the account is not overdrawn. The bank uses the letters "O/D" or Dr. after the amount of the balance to show that the account is overdrawn. O/D is the abbreviation for overdraft.

10.6 Fully worked examples with solutions

10.6.1 Example 1

The cashbook of R. Greens (bank columns only) is given below.

2000			$	2000			Cheque No.		$
May	1	Balance b/d	500	May	1	Rent	085		500
	3	Cash	300		12	Motor vehicles	086		900
	6	Brown	510		16	Cash			300
	10	Farai	900		20	Zizhou	087	250	
	23	Cash	560		30	Elijah	088		860
	31	Daniel	700		31	Balance c/d			660
			3 470						3 470
April	1	Balance b/d	660						

On 1 April 2000, Greens received the following bank statement:

2000		Details/Cheque Number	Dr.	Cr.	$	Balance
May	1	Balance brought forward				500
	3	Cash deposit	300		800	
	10	Brown		510		1 310

13	Cheque Number: 085	500		810
15	Stop order: Insurance	125		685
17	Cheque Number: 086	900		515 O/D
16	Cash withdrawal	300		385
20	Credit transfer: Kandlela		1 600	1 085
23	Cash deposit		560	1 645
31	Bank charges	176		1 469

You are required to:

(a) Update the cashbook starting with the balance of $660.

(b) Prepare a statement under its proper title to reconcile the amended cashbook balance with the bank balance.

Solution

As explained before, we tick common items between the cashbook and the bank statement as follows:

Cashbook

2000			$	2000			Cheque No.	$
May	1	Balance b/d	500√	May	1	Rent	085	500 √
	3	Cash	300 √		12	Motor vehicles	086	900 √
	6	Brown	510 √		16	Cash		300 √
	10	Farai	900		20	Zizhou	087	250
	23	Cash	560 √		30	Elijah	088	860
	31	Daniel	700		31	Balance c/d		660
			3 470					3 470

Bank statement.

2000		Details/Cheque Number	Dr.	Cr.	Balance
					$
May	1	Balance brought forward			500√
	3	Cash deposit		300 √	800
	10	Brown		510 √	1 310
	13	Cheque Number: 085	500 √		810

15	Stop order: Insurance	125		685
16	Cash withdrawal	300 √		385
17	Cheque Number: 086	900 √		515 *O/D*
20	Credit transfer: Kandlela		1 600	1 085
23	Cash deposit		560 √	1 645
31	Bank charges	176		1 469

After having ticked common items, the updated cashbook can now be prepared as following.

Updated cash book as at 1 April 2000

2000	Details	$	2000	Details	$
April 1	Balance b/d	660	April 1	Stop order: Insurance	125
1	Credit transfer: Kandlela	1 600		Bank charges	176
				Balance c/d	1 959
		2 260			2 260
April 1	Balance b/d	1 959			

Bank reconciliation statement as at 1 April 2000

		$	
Balance as per cash book			1 959
Add unpresented cheques:	Zizhou - 087	250	
	Elijah - 088 088	860	1 110
			3 069
Less bank lodgements:	Daniel	700	
	Farai	900	1 600
Balance as per bank statement			1 469

10.6.2 Example 2

The bank statement for C. Audio's for the month of February 2001 is as follows

2001		**Dr**	**Cr.**	**Balance**
				$
Feb 1	Opening Balance			5 197 *O/D*
8	Cheque No. 121: L. Chacks	122		5 319 *O/D*
16	Cheque deposit		244	5075 *O/D*
20	Cheque No. 122: Dodo	208		5 283 *O/D*
21	Cheque deposit		333	4 950 *O/D*
28	Cheque No. 123: M. Tongai	57		5 007 *O/D*
28	Dr: Standing Order	49		5 056 *O/D*
28	Bank Charges	28		5 084 *O/D*

Notes

(a) The cheque deposit of $400 was appearing on the reconciliation statement as at 28 February 2001, a deposit made but not yet cleared (bank lodgement).
(b) A cheque payment to H. Black (Cheque No. 124) was not yet presented to the bank by the 28th of February 2001.

The cashbook for February 2001 is given below:

2001				2001			
Feb	16 N. Mavanga		244	Feb	1 Balance b/f		5 197
	21 K. Ndoda		333		6 L. Chacks		122
	28 U. Kamwe	160			28 J Shorai	490	
	28 Balance c/d	5 072					
			5 809			**5 809**	
				Mar	1 Balance b/d	5 072	

Required:

a) Write the updated cash book and,
b) Draw up a bank reconciliation statement as on 28 Feb 2001

Solution

Before we update the cashbook, we are supposed to tick off common items between the cashbook and the bank statement as follows:

2001		**Dr**	**Cr.**	**Balance $**	
Feb	1 Opening Balance			5 197	*O/D*
	8 Cheque No. 121: L. Chacks	122 √		5 319	*O/D*
	16 Cheque deposit		244 √	5075	*O/D*
	20 Cheque No. 122: Dodo	208		5 283	*O/D*
	21 Cheque deposit		333 √	4 950	*O/D*
	28 Cheque No. 123: M. Tongai	57		5 007	*O/D*
	28 Dr: Standing Order	49		5 056	*O/D*
	28 Bank Charges	28		5 084	*O/D*

The cashbook for February 2001 is:

2001	**Debit**			2001			**Credit**
Feb	16 N. Mavanga √		244	Feb	1 Balance b/f		5 197
	21 K. Ndoda √		333		6 L. Chacks √	122	
	28 U. Kamwe	160			28 J Shorai	490	
	28 Balance c/d	5 072					
			5 809				**5 809**
				Mar	1 Balance b/d	5 072	

C. Audios
Updated cashbook

Trade creditor: M. Tongai		57	Bal. b/d		5 072
			Dodo		208
			Standing Order		49
			Bank Charges	28	
Balance c/d		5 300			
		5 357			**5 357**
			Bal. b/d		5 300

Bank reconciliation statement as at 28 February 2001

Overdraft as per cash book	5 300	
Add Deposits not yet cleared by bank -Bank lodgements) -U. Kamwe	160	
		5 460
Less Unpresented Cheques	490	
Overdraft as per bank statement		**4 970**

Notes:

1. First tick off common items, entries towards the end of the period of the bank statement i.e. on 28 February and the remaining on the bank statement are used for updating the cashbook. Students should however be careful when ticking common items. Items appearing on the previous reconciliation statement and the current bank statement should be considered when preparing a bank reconciliation statement. They should be ticked.
2. Entries on the debit side of the cashbook not ticked represent a deposit not yet recorded by the bank for example (U. Kamwe $160).
3. Entries on the credit side of the cashbook not ticked represent unpresented cheque i.e. J Shorai $490.
4. If the cashbook and the bank statements are not given, one has to identify entries in the bank statement that were omitted in the cashbook from the explanations and then update the cashbook as in the following example.

10.6.3 Example 3

On 30 June 1999 the bank column of Rodger Dow's cashbook showed a debit balance of $12 600 and the bank statement showed $13 500. On the examination of the cashbook and the bank statement the following was revealed.

a) Cheques amounting to $935, which were issued to creditors and entered in the cashbook before 30 June, were not presented for payments until after that date.
b) Cheques amounting to $230 had been recorded in the cashbook as having been paid into the bank on 30 June, but were entered on the bank statements on 1 July.
c) A cheque deposit for $70 had been dishonoured in June, but no record of this fact appeared in the cashbook.
d) A dividend of $340 paid direct into the bank had not been recorded in the cashbook.
e) Bank interest and charges of $60 had been charged by the bank but had not been entered in the cashbook.

f) No entry has been made in the cashbook for a trade subscription of $15 paid by banker's order in January 1999.

Required:

a) Prepare an updated cashbook.
b) Prepare a bank reconciliation statement

Solution:

Updated cashbook

Bal. b/d	12 600	Bank Charges	60
		Trade subscription	15
Dividend	340	Dishonoured Cheque	70
		Balance c/d	12 795
	12 940		**12 940**
Balance b/d	12 795		

b) **Bank reconciliation statement as at 30 June 1999**

Balance as per updated cash book	12 795
Add unpresented cheques	9 35
	13 730
Less Deposits not yet cleared by bank (Bank lodgement)	230
Balance as per bank statement	13 500

10.7 Dishonoured cheques

When a cheque is received from a customer and paid into the bank, it is recorded on the debit side of the cashbook. It is also shown on the bank statement as banking by the bank. However, at a later date it may be found that the cheque has not gone through the account of the drawer and the bank has failed to honour the cheque. The cheque is therefore known as a " dishonoured cheque". The bank would automatically show the original banking entry as being cancelled by showing the cheque paid out of our bank account. As soon as this happens they notify Rodger Dow *(above)*, who will then also show the cheque as being cancelled by a credit entry in the cashbook. The amount must be then debited to the debtors account.

10.8 Correction of Errors

The bank reconciliation statement can be used in the correction of errors. For one to correct the errors, he should understand the nature and extent of such an error. The magnitude of the errors can be explained in the following different terms.

i. We have errors that affect the cashbook only. When making a correction, they should only be corrected in the cashbook. Under no circumstances should they be corrected in the bank reconciliation statements.
ii. We also have errors that affect the bank balance only. Such errors should be corrected through the bank reconciliation statement only.

iii. We also have such errors that affect both the cashbook and the bank balance. The correction of such errors is effected through the cashbook and the bank reconciliation statement.
iv. In an examination, you might be given errors that do not affect both the cashbook and the bank balance. Such type of errors should be ignored since they do not have any effect on the balancing of either the cashbook balance or the bank statement balance.

10.8.1 Example – Bank reconciliation and errors

The summary of the bank column in the cashbook of Chandipa Ltd for the year ending 30 June 2001 is as follows:

	$
Opening balance	1 654
Receipts	332 478
	334 132
Payments	316 735
Closing Balance	17 397

Your investigation of the accounting records for this period reveals the following information.

a) Cheques paid to suppliers amount to $1 435 have not yet been presented at the bank, and cheques paid into the bank $1 620 on 30 June 2001 have not yet been credited to the company's account.
b) Standing orders entered in the bank statement have been omitted from the cashbook in respect of a lease payment on company car, of 12 months at $96 per month and annual insurance of $150.
c) Bank Charges of $452 shown in the bank statement have not been entered in the cashbook.
d) A cheque drawn for $127 has been entered in the cashbook as $172 and a cashbook page on the receipts side has been under added by $200.
e) A cheque for $238 has been debited to the company's bank account in error by the bank.
f) The bank statement shows a favourable balance as at 30 June 2001 of $15 465.

<u>Required:-</u>

Prepare a bank reconciliation statement as at 30 June 2001, together with a corrected cashbook position.

<u>Solution</u>

Corrected Cash Book

Uncorrected balance b/d	17 397	Standing order		
		Lease Payments (12x96)		1 152
Overstated Cheque (172 – 127)	45	Insurance		150
Under cast Total	200	Bank Charges	452	
		Balance c/d		15 888
	17 642		**17 642**	

Chandipa Ltd. Bank Reconciliation statement as at 30 June 2001

		$	
Balance as per corrected cash book		15 888	
Add Unpresented cheques		1 435	
		17 323	
Less Deposits not yet cleared by the bank	1 620		
Cheque debited in error by bank	238		1 858
Balance as per bank statement		15 465	

End of chapter questions

10.8.2 Question 1

The following is a summary of Tonderai Chiwara's cashbook (bank columns only) for the month of August 1999.

Dr.			Cr.
	$		$
Balance b/fwd	12 623	Payments	246 987
Receipts	256 725	Balance c/fwd	22 361
	269 348		269 348
Balance b/fwd	22 361		

The cashbook balance ($22 361) showed above did not agree with the balance as per the bank statement for the same month. Further investigations revealed the following discrepancies.

(a) Cheques drawn from the bank amounting to $15 621 had not been presented to the bank for payment.
(b) Uncleared deposits amounted to $12 369 for the same month.
(c) Bank charges of $453 were not entered in the cashbook but were appearing on the bank statement.
(d) The bank did not cash a cheque for $589 received from a customer, but instead the cheque was returned marked *"Refer to the drawer"*. No adjustment was made in the cashbook relating to such a transaction.
(e) The bank, in error, credited Tonderai bank account with $1 056 for a payment made to a creditor in August.
(f) A cheque of $4 500 received from a debtor was incorrectly entered as $5 400 in the cash book.

You are required to:
(a) Prepare a supplementary cashbook starting with the closing balance shown.
(b) Prepare a bank reconciliation statement, showing clearly the original balance as per bank statement.

10.9 Examination type questions

Question 1

At 30 April 1997, Charles' Cash book showed a debit balance of $8 224 in his bank Account. His bank statement showed a credit balance of $8 926 at the same date. Charles checked his cash book entries to the bank statement and found the following:

(i) An amount of $1 200 was paid into the bank on 29 April 1997.
(ii) Cheques sent to suppliers G. Zuze $600
M. Moyo $1 215
Z. Zifambi $494
(iii) A dividend received from Onko Ltd was $400.
(iv) An amount of $336 was received by credit transfer from A. Kims
(v) A payment of $325 was made by standing order to Fire and Theft Insurance Company.
(vi) A Cheque for $920 from T. Broke had been returned by the bank as dishourned.
(vii) Bank Charges were $128.
(viii) An amount of $300 received from Trish was credited by the bank in error to Charles Account.

(b) Make any additional entries that are required in Charles Cash book and calculate the new cash book balance at 30 April 1997.
(c) Prepare a Statement to reconcile the Book Statement balance to the new cash book balance at 30 April 1997.

Question 2

. Jason's Cashbook for March 2001 Showed the following entries: -

2001			**2001**		

March 1	Balance b/d	2 400	March 12	1. Dooks	760
6	Cash and Cheques	510	16	F. Fuzwayo	580
18	A. Foley	300	30	J. Japata	190
29	M. Jackson	450	31	Balance c/d	2 130
		3 660			3 660
April 1	Balance b/d	2 130			

Jason received the Bank Statement shown below on 2 April 2001

2001	DETAILS	DR	CR	BALANCE
March 1	Balance			2 400 CR
8	Cash and Cheques		510	2 910 CR
9	Cheque – Dooks	760		2 150 CR
15	Cheque – F. Fuzwayo	580		1 570 CR
21	Cheque		300	1 870 CR

(a) Prepare a Bank Reconciliation Statement, to reconcile the Balances shown in Jason's Cash Book and Bank Statement on 31 March 2001.

(b) (b) Certain items shown on a bank statement may not yet be entered in the customers cash book. Name any 4 such items.

Question 3

Following is the Cash book (bank columns) of Zwenyika for December 2007.

2007				2007			
Dec	6	J. Hlalo	155	Dec	1	Balance b/d	3 872
	20	P. Pinky	189		10	P. Zodwa	206
	31	D. Dube	211		19	M. Radebe	315
	31	Balance c/d	3 922		29	C. Chuma	84
			4 477				4 477

The Bank Statement received in the month of December was:

2007	DETAILS	DR	CR	BALANCE
Dec 1	Balance			3 872 O/D
6	Cheque		155	3 717 O/D
13	P. Zodwa	206		3 923 O/D
20	Cheque		189	3 734 O/D
22	M. Radebe	315		4 049 O/D
30	Standing Order	200		4 249 O/D
31	Credit Transfer		180	4 069 O/D

31	Bank Charges	65	4 134 O/D

REQUIRED

(a) Write the Cash Book up to date, taking into Account necessary items.
(b) Draw up a bank reconciliation statement as at 31 December 2007.

The cash -book of a business shows a favourable bank balance of $38 560 at 30 June 1997. After comparing the entries in the cash- book with the entries on the related bank statement you find that:

1. Cheques amounting to $2 180 entered in the cash -book have not yet been presented for payment to the bank.
2. An amount of $500 entered on the debit side of the cash –book has not been banked.
3. An amount of $950 has been credited by the bank to the account on error.
4. The bank has debited and then credited the bank statement with an amount of $480 being a Maphosa's cheque, which it forwarded on 1 July 1997 marked 'sufficient funds-return to drawer'.
5. Interest of $100 has been charged by the bank, but not yet entered in the cash- book.
6. A cheque from a customer incorrectly entered in the cash-book as $880 had been correctly entered by the bank as $1 880.

You are required to:

a) Show the additional entries to be made in the cash-book and bring down the corrected balance.
b) Prepare a bank reconciliation statement.

11. ACCOUNTING FOR DEPRECIATION

11.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Define the term 'depreciation'.*
- *Explain the causes for depreciation.*
- *Explain the purposes of providing for depreciation of non-current assets.*
- *State the advantages and disadvantages of the straight line method and reducing balance method.*
- *State the accounting principles applied when adjusting for depreciation of non-current assets.*
- *Calculation of depreciation using straight line, reducing balance and revaluation methods.*
- *Prepare ledger accounts and journal entries for the provision of depreciation*
- *Prepare a relevant extract from a trader's Statement of financial position.*
- *State what is meant by the disposal of non-current assets.*
- *Calculation of profit or loss on disposal*

11.2 Introduction

Depreciation can be defined as a loss in the value of fixed assets due to usage, obsolescence, and wear and tear or as that part of the cost of fixed asset that gets used up as the asset is being used. Depreciable amount is equal to historic cost or revalued amount less scrap value (residual value). The depreciation charge allocated to a period should be recognised as an expense in the Statement of comprehensive income.

Fixed assets are used in business for a number of years to produce goods or services and because of this reason, their cost cannot be charged to the Statement of comprehensive income in one year but should be charged over their useful life in order to match the cost (depreciation) and income generated by the assets in line with the accrual concept (matching concept) and going on concept.

The purpose of depreciation is to match the cost (depreciation) with the income generated by the asset. It is not a way of valuing assets.

If an asset is bought part way through the year e.g. 1 July for a Company whose year end is 31 December each year, it should not be charged a full year depreciation but a 6 months' depreciation i.e. annual depreciation x 6/12 the same thing applies to assets sold part way through the year. This means depreciation on asset acquired or sold partway through the year should be time apportioned. However, in an examination you may be given an accounting policy, which provides that a full year's depreciation is charged in the year of purchase and none in the year of sale, follow this policy.

11.3 Methods of providing for depreciation

Depreciation is to be allocated over the period expected to benefit from the use of the asset. Thus, managers should select a method regarded as the most appropriate to the type of asset and its use in the business. There are several methods of providing for depreciation but the most common are: -

a) Straight-line method
b) Reducing balance method
c) Revaluation method

11.3.1 The straight line method

It is also known as the fixed instalment method of calculating depreciation. One should allocate the net cost equally to each year of the useful life of an asset. It is most applicable to assets like patents, and leases where time is the key factor in the passing of the benefits to be derived from the use of an asset. The formula for calculating annual depreciation provision under the straight-line method is as follows or else we use a fixed percentage:

$$\text{Annual Depreciation} = \frac{\text{Acquisition cost - Estimated residual value.}}{\text{Expected useful life (in years)}}$$

<u>Journal Entries</u>

	DR	CR.
Statement of comprehensive income (Depreciation expense)	xxx	
Provision for depreciation a/c. (Accumulated Depreciation a/c.)		xxx

The Statement of financial position must then report only the undepreciated cost (Net Book Value) as follows:

	Cost	Acc. Dep	N. B. V.
Non-current Assets			
e.g. Motor Vehicle	xxx	xxx	xxx

Example 1 – straight-line method of depreciation

PD Equipment (Pvt.) Ltd. bought a motor vehicle on 1 January at cost $37 000 with an estimated useful life of 5 years and a scrap value of $2 000.

1. You are required to prepare the following ledger accounts
   a motor vehicle account
   b provision for depreciation account
2. Show the Statement of comprehensive income & Statement of financial position extracts in the third year of the asset.

Solution

Machinery account

		$			$
Year 1			**Year 1**		
January 1	Bank	37 000	December 31	Balance c/d	37 000
Year 2			**Year 2**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 3			**Year 3**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 4			**Year 4**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 5			**Year 5**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 6					
January 1	Balance b/d	37 000			

Depreciation charge $= \frac{(\$37000 - \$2000}{5} = \$7000/\,year$

The following is a provision for depreciation for asset's useful life.

Provision for depreciation account

Year 1			**Year 1**		
Dec 31 Bal. c/d		7 000	Dec 31 SCI		7 000
		7 000			**7 000**
Year 2			**Year 2**		
Dec 31 Bal. c/d	14 000		Jan 1 Bal. b/d	7 000	
			Dec 31 SCI		7 000
		14 000		**14 000**	
Year 3			**Year 3**		
Dec 31 Bal. c/d	21 000		Jan. 1 b/d	14 000	
			Dec 31 SCI		7 000
		21 000		**21 000**	
Year 4			**Year 4**		
Dec 31 Bal. c/d	28 000		Jan 1 Bal. b/d	21 000	
			Dec 31 SCI		7 000
		28 000		**28 000**	
Year 5			**Year 5**		
Dec 31 Bal. c/d	35 000		Jan 1 Bal. b/d	28 000	
			Dec 31 SCI		7 000
		35 000			**35 000**
			Year 6		
			Jan 1 Balance d/d		35 000

SCI -⟶ *Statement of comprehensive income*

Statement of comprehensive income Extract for the year ended 31 December 19 x 0

Gross profit xxx

Less expenses

Depreciation- Motor vehicle	7 000

Statement of financial position extract as at 31 December 19x3

	Cost	Acc. Depreciation	N.B.V
Non-current Assets			
Motor Vehicles	37 000	21 000	16 000

Advantages of the straight – line method

1. It is simple to use and apply.
2. It avoids increased profits in the latter years of the asset.

Disadvantage

1. Only by chance can the benefits be the same.
2. Uncertainty in future benefits and estimated useful life of an asset.
3. It does not reflect that the greatest losses in the market value occur in the first year of use.
4. It does not reflect the unevenness of the loss in the market value over several years.
5. It does not reflect the diminishing losses in value, which occur in later years, as the asset approaches the end of its useful life.

11.3.2 The reducing balancing method

Annual Depreciation is charged as a fixed percentage to the net book value of the asset. The net book value decreases each year and theoretically the balance of the unallocated cost at the previous accounting period. The balance of unallocated costs at the end of the estimated useful life should be equal to the estimated residual value. The method involves allocation of large depreciation amount in earlier years of an asset's life than to later years.

Justification

a) An asset loses greater value or generates higher benefits in the early years of usage than in later year.

b) Maintenance costs will rise as the asset's ages and appropriate allocation of depreciation cost should be made to equalise the total of depreciation plus maintenance costs in each year of an asset useful life.

At this level of study the rate of depreciation is always given. Care should be taken with this method. In the first year it ignores a scrap value i.e. the percentage given is applied on cost not depreciable amount and in subsequent years. It should be applied on the carrying amount.

Advantages

It approximates reality in respect of certain assets and greater loss is expected to be made in the first year of the asset's life.

Example 2 – Reducing balance method of depreciation

Let's suppose that the asset, which was bought by PD Equipment in example 1 above, is being depreciated using the reducing balance method at the rate of 20% per year.

1. You are required to prepare the following ledger accounts
   a motor vehicle account
   b provision for depreciation account
2. Show the Statement of financial position extracts in the third year of the asset.

Solution

Machinery account

Year 1		**$**	**Year 1**		**$**
January 1	Bank	37 000	December 31	Balance c/d	37 000
Year 2			**Year 2**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 3			**Year 3**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 4			**Year 4**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000
Year 5			**Year 5**		
January 1	Balance b/d	37 000	December 31	Balance c/d	37 000

The following is a provision for depreciation for asset's useful life.

Provision for depreciation account

Year 1			**Year 1**		
Dec 31 Bal. c/d		7 400	Dec 31 SCI		7 400
		7 400			**7 400**
Year 2			**Year 2**		
Dec 31Bal. c/d	13 320		Jan 1 Bal. b/d	7 400	
			Dec 31 SCI		5 920
		13 320		**13 320**	
Year 3			**Year 3**		
Dec 31Bal. c/d	18 056		Jan. 1 b/d	13 320	
			Dec 31 SCI		4 736
		18 056			**18 056**
Year 4			**Year 4**		
Dec 31Bal. c/d		21 845	Jan 1 Bal. b/d	18 056	
			Dec 31 SCI		3 789
		21 845		**21 845**	
Year 5			**Year 5**		
Dec 31 Bal. c/d	24 876		Jan 1 Bal. b/d	21 845	
			Dec 31 SCI		3 031
	24 876				**24 876**

Statement of comprehensive income extract for the year ended 31 December 19 x 0

Gross profit	xxx
Less expenses	
Depreciation- Motor vehicle	4 736

Statement of financial position extract as at 31 December 19x3

	Cost	Acc. Depreciation	N.B.V
Non-current Assets			
Motor Vehicles	7 000	18 056	18 944

11.4 Revaluation method

Revaluation method is applied to non-current assets which are difficult to place value as separate entities, for example, loose tools. It becomes important that these assets are valued at the beginning of every financial year. This value is compared with the one at the end of year and the value by which the asset would have reduced in value is the depreciation charge for the year.

Illustration

It is the policy of the business to value fixtures at the end of each financial period. On 1 April 2008, fixtures were valued at $12 700 and its value on 31 March 2009 was $11 900.

Required
Calculate depreciation for the year ended 31 March 2009 using the revaluation method.

Suggested solution

		$
Value of fixtures at the beginning of the year	12 700	
Less the value at the end of the year	11 900	
Deprecation charge for the year ended 31 March 2009	800	

11.5 Disposal of fixed assets

The cost of the benefit derived from the use of assets cannot be ascertained until the assets have completed their useful life and have been sold or otherwise disposed off. The standard provides that when an asset is disposed the difference between the net sales proceeds and the net book value should be recognised as income or expense in the Statement of comprehensive income The method is to open the asset disposal account and to reverse the existing entries in the asset and provision for depreciation accounts in respect of the asset disposed. For example, On 31 December 2001, plant and machinery acquired at cost $120 000 in 1992 was sold for $40 000. The accumulated depreciation to date was $70 000.

The journal and ledger entries will be as follows:

	Debit	Credit
1. Disposal account	120 000	
Assets – plant & Machinery Account		$ 120 000
To close the asset account at cost.		
2. Provision for depreciation account	$70 000	
Disposal / Realisation account		$70 000
To close the provision for depreciation account.		
3. Cash account	$40 000	
Disposal account		$40 000
To recognise cash received at disposal.		
4.a) DR Statement of comprehensive income	$10 000	
CR. Disposal		$10 000
Being loss on disposal		

b) DR Disposal account
CR. Statement of comprehensive income
If a profit has been made at disposal

Pro-forma Disposal A/c

Historical Cost	xxx	Accumulated Depreciation	xxx
		Bank / Cash/ Trade-in Value/Insurance proceeds	xxx
Profit (Balancing Figure)	xxx	Loss (Balancing Figure)	xxx

LEDGER ACCOUNTS

Plant & Machinery account

	$		$
1 Jan Bal. b/d	120 000	Dec 31 Disposal Account	120 000

Provision for Depreciation account

	$		$
31 Dec Disposal account	70 000	Jan 1 Bal. b/d	70 000

Cash account

	$		
Assets Disposal	40 000		

Asset Disposal account

	$		$
Plant & Machinery	120 000	Sales proceeds	40 000
		Depreciation	70 000
		Profit & loss	10 000
	120 000		**120 000**

Statement of comprehensive income (extract) for the year ended 31 Dec 1993
$

***Less* expense**

Loss on disposal	10 000

11.6 Fully worked examples with solutions

11.6.1 Example 1

On 1 January 2000, Machipisa Chiwara, a sole trader based in Chiredzi purchased a motor vehicle (No. 1) for $100 000. On 30 June 2001, he purchased another motor vehicle (No. 2) for $150 000. It is Machipisa's policy to depreciate all motor vehicles held at the end of each year on a straight-line method at the rate of 20% per annum on cost on each month of ownership.

You are required to prepare a motor vehicle account and provision for depreciation account for the 3 years ending 31 December 2002 assuming that his financial year-end is 31 December each year.

Solution

Motor vehicle account

2000		**$**	**2000**		**$**
January 1	Bank	100 000	December 31	Bal. c/d	100 000
2001			**2001**		
January 1	Bal. b/d	100 000	December 31	Bal. c/d	250 000
June 30	Bank	150 000			
		250 000			250 000
2002			**2002**		
January 1	Bal. b/d	250 000	December 31	Bal. c/d	250 000

Provision for depreciation account

2000		$	2000		$
December 31	Bal. c/d	20 000	Dec 31	Statement of comprehensive income	20 000
2001			**2001**		
December 31	Bal. c/d	55 000	January 1	Bal. b/d	20 000
			December 31	Statement of comprehensive income	35 000
		55 000			55 000
2002			**2002**		
December 31	Bal. c/d	105 000	January 1	Bal. b/d	55 000
			December 31	Statement of comprehensive income	50 000
		105 000			105 000

11.6.2 Example 2

Abraham Mohammed started business on 1 January 1998. The following information relates to the purchases and disposal of machinery.

1 January 1998	Bought machinery *(X)* for $50 000.
30 June 1999	Bought machinery *(Y)* for $60 000.
30 September 2000	Sold machinery *(X)* for $32 000.
1 October 2001	Bought machinery *(Z)* for $80 000.

Notes:

1. It is the company's policy to depreciate all machinery over 4 years after estimating a disposal value of $10 000.
2. A full year's depreciation is charged in the year of purchase but no depreciation is charged in the year of disposal.

Required

Prepare the following ledger accounts for the 4 years ending 31 December 2001

a) The machinery account
b) Provision for depreciation account
c) Machinery disposal account

Solution

Machinery account

1998		**$**	**1998**		**$**
January 1	Bank	50 000	December 31	Bal. c/d	50 000
1999			**1999**		
January 1	Bal. b/d	50 000	December 31	Bal. c/d	110 000
June 30	Bank	60 000			
		110 000			110 000
2000			**2000**		
January 1	Bal. b/d	110 000	September 30	Disposal	50 000
			December 31	Bal. c/d	60 000
		110 000			110 000
2001			**2001**		
January 1	Bal. b/d	60 000	December 31	Bal. c/d	140 000
October 1	Bank	80 000			
		140 000			140 000

Provision for depreciation account

1998		**$**	**1998**		**$**
December 31	Bal. c/d	10 000	Dec 31	Statement of comprehensive income	10 000
1999			**1999**		
December 31	Bal. c/d	32 500	January 1	Bal. b/d	10 000
			December 31	Statement of comprehensive income	22 500
		32 500			32 500
2000			**2000**		
September 30	Disposal	20 000	January 1	Bal. b/d	32 500
December 31	Bal. c/d	25 000	December 31	Statement of comprehensive income	12 500
		45 000			45 000
2001			**2001**		
December 31	Bal. c/d	55 000	January 1	Bal. b/d	25 000
			December 31	Statement of comprehensive income	30 000
		55 000			55 000

2002			2002		
			January 1	Bal. b/d	55 000

Machinery disposal account

2000		$	2000		$
Sep 30	Machinery	50 000	Sep 30	Provision for depreciation	20 000
Dec 31	Statement of comprehensive income	2 000	Sep 30	Bank	32 000
		52 000			52 000

Notes

a) Depreciation for machinery is calculated as follows:

$$\text{Machine X} = \frac{\$50000 - \$10000}{4} = \$10000$$

$$\text{Machine Y} = \frac{\$60000 - \$10000}{4} = \$12500$$

$$\text{Machine Z} = \frac{\$80000 - \$10000}{4} = \$17500$$

b) The balance of $2 000 on the debit side of the disposal account represents a profit on disposal account.

11.6.3 Question 3

Sam Bennett depreciates his machinery using the reducing balance method at the rate of 25% per annum and depreciation is charged for each month of ownership i.e. from the date of purchase up to the date of sale. Sam Bennett prepares his financial accounts on 31 December each year. The following information relates to his machinery.

1. On 1 June 1994, he bought a machinery for $120 000.
2. He bought another machinery on 1 January 1996 for $100 000.
3. The machinery that was bought on 1 June 1994 was sold for $60 000 on 30 August 1996.

You are required to open the following ledger accounts for the 3 years ending 31 December 1996.

a) The machinery account
b) Provision for depreciation account

c) Machinery disposal account.

Solution

Machinery account

1994		**$**	**1994**		**$**
June 1	Bank	120 000	December 31	Bal. c/d	120 000
1995			**1995**		
January 1	Bal. b/d	120 000	December 31	Bal. c/d	120 000
1996			**1996**		
January 1	Bal. b/d	120 000	August 30	Disposal	120 000
January 1	Bank	100 000	December 31	Bal. c/d	100 000
		220 000			220 000
1997					
January 1	Bal. b/d	100 000			

Provision for depreciation account

1994		**$**	**1994**		**$**
December 31	Bal. c/d	17 500	Dec 31	Statement of comprehensive income	17 500
1995			**1995**		
December 31	Bal. c/d	43 125	January 1	Bal. b/d	17 500
			December 31	Statement of comprehensive income	25 625
		43 125			43 125
1996			**1996**		
August 30	Disposal (4)	55 938	January 1	Bal. b/d	43 125
December 31	Bal. c/d	25 000	December 31	Statement of comprehensive income	37 813
		80 938			80 938
			1997		
			January 1	Bal. b/d	25 000

Disposal account

1996		$	1996		$
Aug 30	Machinery	120 000	Aug 30 Provision for depreciation		55 938
			Aug 30 Bank		60 000
			Dec 31	Statement of comprehensive income	4 062
		120 000			120 000

Notes

1. \$17 500 is depreciation calculated for the first machinery for 7 months from 1 June 1994 as follows

$$\$120\,000 \times 25\% \times \frac{7}{12}$$

2. Depreciation for 1995 is calculated as follows:
   (\$120 000 - \$17 500) x 25% = \$25 625
3. Depreciation for 1996 is calculated as follows:

   1^{st} machinery (\$120 000 – \$17 500 – \$25 625) x 25% x $\frac{8}{12}$ = \$12 813

   2^{nd} machinery (\$100 000 x 25% = \$25 000

   Total depreciation = \$37 813
4. This represents total depreciation of machinery number 1 from the date of purchase up to the date of disposal.

11.7 End of chapter question

11.7.1 Question 1

Plant & Equipment which cost \$16 000 has an estimated useful life of four years and depreciation is provided at the rate of 20% per annum. Calculate the annual depreciation expense, Statement of financial position value at the end of each year of useful life using the following methods.

a) Straight – line
b) Reducing balance

11.7.2 Question 2

K. Moyo bought a machinery on 1 January 2000 for \$200 000. Depreciation on all machinery is charged at the rate of 25% per annum, for each month of ownership using the reducing balance method. K. Moyo's financial year-ends on 31 December each year. On the 1^{st} of July 2002, he bought another machinery at a cost of \$250 000 and the machinery that was bought in year 2000 was sold on the 1^{st} of October the same year (2002).

You are required to prepare the following ledger accounts for the years ending 31 December 2000, 2001 and 2002 and the profit and loss and Statement of financial position extracts for the year ended 31 December 2002.

(a) The machinery account
(b) The machinery provision for depreciation account
(c) The machinery disposal account

11.8 Examination type questions

Question 1

The Trial Balance of Zengesa Dube at 29 September 2004

Included	**Debit**	**Credit**
	$	$
Plant and Machinery	30 000	
Provision for Depreciation on Plant and Machinery		12 000

On 30 September 2004 Zengesa sold a machine for $2 000 in cash. This machine had originally been bought for $4 500. Depreciation written off the machine up to 29 September 2004 was $2 400. These are no entries in Zengesa Dube's books to records this sale.

Prepare the following account in the ledger of Zengesa Dube for the year ending 30 September 2004.

(a) Plant and Machinery account
(b) Provision FOR Depreciation of plant and machinery account
(c) Disposal of Machinery account.

Question 2

Balances extracted from the books of Bossolona at 30 1998 are given as follows:

	$
Machinery at cast	108 000
Provision for depreciation of machinery	42 000

The following transactions took place in the year ended 30 April 1997 –

June 6 1998 - purchased a machine costing $20 000 and paid by cheque.
October 8 1998 – sold a machine cost $11 000 when purchased on 1 June 1995.
December 12 1998 – purchased a machine costing $14 000 on credit from Meikles.

A full year's depreciation is provided for on Machinery in the year of purchase, but no depreciation is provided for in the year of disposal or sale. Depreciation is calculated on machinery owned at 30 April each year at a rate of 25% using the straight line method.

REQUIRED, FOR 30 APRIL 1999:

(a) Machinery account

(b) Provision for Depreciation on Machinery account
(c) Disposal of Machinery account

Question 3

7. Jimmy and Joe went into partnership on 1 April 2000. On that date, they purchased equipment on credit from Z X Y Ltd for $10 000. The partners decided to provide a full year's depreciation on equipment in the year of purchase but no depreciation is the year of sale. It was agreed that depreciation should be calculated on equipment owed at 31 March each year at the rate of 20% per annum, using the straight line method. On 1 October 2000, half of the equipment was sold on credit to Zenzo Ltd for $3 500.

Prepare the following account for the year ended 31 March 2002.

(i) Equipment account
(ii) Provision for depreciation of Equipment account
(iii) Disposal of Equipment account

Question 4

Abuja bought a printer on 1 October 2004 for $40 000. He expects the printer to have a useful life of 10 years and to be able to sell it at the end of that time for $4 000. Using this information. He could use the straight line method or the reducing balance method at 20% p.a.

Calculate how much depreciation will be changed in Abuja's profit and loss account for the next 3 years under each of the two methods.

YEAR ENDED 30 SEPTEMBER	**STRIAGHTLINE METHOD**	**REDUCING BALANCE METHOD**
2005	-	-
2006	-	-
2007	-	-

12. BAD DEBTS AND PROVISIONS

12.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Distinguish between bad debts and provision for doubtful debts.*
- *Make journal entries to record bad debts written off.*
- *State what is meant by a bad debt recovered.*
- *Write up the bad debts bad debts recovered and the provision for doubtful debts accounts from the given list of transactions.*
- *Explain how a provision differs from a liability.*
- *State the accounting principles applied when adjusting for bad debts and doubtful debts.*
- *State the ways in which a business might decide on the amount of its provision for doubtful debts.*
- *Explain how the provision for doubtful debts is shown in the Statement of financial position.*
- *Suggest the ways in which a trader may reduce the possibility of bad debts.*

12.2 Introduction

At times customers fail to pay for goods are sold on credit,. This irrecoverable amount is known as a bad debt. Should this happen, it would be prudent to remove it totally from the accounts and to charge the amount as an expense to the statement of comprehensive income.

A debt may be regarded as uncollectable the following reasons ;:-

a) A debtor has disappeared without trace.
b) It is not worth it to take the Debtor to court
c) A debtor is bankrupt as a result of insolvency

However, if a debtor is bankrupt his assets are seized and sold in order to pay creditors. The accounting entry to write off debtors' account is;

Debit Bad debt account
Credit Trade receivables account

If we are not sure whether the debtor will pay, the debts remain in the ledger and are not written off. A provision for bad debt is required.

The entry required is
Debit Statement of comprehensive income
Credit Provision for bad debt account

Once a provision is created it is netted off against such a net figure for Debtor's.

Example – bad debts

ABC Ltd. has total debtors at the end of the year of $36 000, of these it was discovered that Mr. C. D Moyo who owed $800 couldn't be traced.

Required: -
Show the entries required in the ledger of ABC Ltd. to record the above transactions.

Solution

C.D. Moyo's account

	$		$
Balance b/d	800	Bad debts	800
	800		800

Bad debts account

	$		$
C.D. Moyo	800	Statement of comprehensive income	800
	800		800

Example – provision for bad debts

Stepson has trade receivables of $15 200 at his year-end of 31 December 2001, he also wishes to provide against the possibility of not receiving 3 % of his remaining trade receivables.

Required
Calculate the provision for bad debts required at 31 December 2001.

Solution

	$
Provision for bad debts (15 200 x 3%)	456
Total provision required	456

Once a provision for doubtful debts is created, future provisions required should increase or decrease the existing provision as follows:

$\left.\begin{array}{l}\text{Debit Statement of comprehensive income}\\\text{Credit Provision for doubtful debt}\end{array}\right\}$ with the increase only

Or

$\left.\begin{array}{l}\text{Debit Provision for bad debts}\\\text{Credit Statement of comprehensive income}\end{array}\right\}$ with the decrease only

From the following example you are required to show the provision for bad debts account and clearly show the amount to be charged to the Statement of comprehensive income for the year ended 31 December 2001.

The opening and closing balances of debtors are $5 000 and $6 500 respectively. A provision for bad debts has been maintained at 5% for quite a number of years.

Solution

Provision for Doubtful debts a/c

		$			$
2001			2001		
Dec 31	Bal. c/d (6 500 x 5%)	325	Jan 1	Bal. b/d (5 000x5%)	250
			Dec 31	Statement of comprehensive income	75
		325			**325**
			2002		
			Jan 1	Bal. b/d	325

12.3 Bad debts recovered

It is possible to receive money from a Debtor written off previously. When this happens, the entries required are:

Debit Trade receivables (to restate the Debtor)
Credit Bad debt recovered account

Debit Bank account
Credit Trade receivables account } With cash received

Debit Bad debts recovered account
Credit Statement of comprehensive income } Being income because we had initially written off this debt.

12.4 A fully worked example with solution

12.4.1 Example 1

On 31 December 2000, Moyo's trade receivables totalled $6 000. He created a provision for bad debts of 5%.
And on 31 December 2001 his trade receivables amounted to $9 000. He decided to write off the account of a customer owing $600, which he failed to trace. He also decided to maintain the provision for bad debts at 5% and to create a provision for discount allowed of 2%.

Required

a) Prepare the provision for bad debts account for the years ending 31 December 2000 and 2001.
b) Prepare the provision for discount allowed account.
c) Prepare extracts of the Statement of comprehensive income and
d) An extract of the Statement of financial position for the year ended 31 December 2001.

Solution

a) Provision for bad debts account

2000		**$**	**2000**		**$**
31 December	Bal. c/d	300	31 December	Statement of comprehensive income	300
2001			**2001**		
31 December	Bal. c/d	450	1 January	Balance b/d	300
			31 December	Statement of comprehensive income	150
		450			450
			2002		
			1 January	Balance b/d	450

Notes

a) In 2000, the provision for bad debts is created by multiplying $6 000 by 5%.

b) In 2001, the provision for bad debts is supposed to be $450 i.e. 5% of $9 000. The provision for debts account should therefore be increased by $150 since the other $300 was transferred in the previous year and the profit and loss account is debited by that increase.

b) Provision for discount allowed account

2001	**2001**		
	31 December	Statement of comprehensive income	171

Please note that the provision for discount allowed is a percentage of the net trade receivables and in our example above it has been calculated as follows:
($9 000 - $450) x 2% = $171.

c) Statement of comprehensive income extracts for the year ended 31 December 2000 and 2001.

	2000	**2001**
Expenses	$	$
Provision for bad debts	300	150
Bad debts	600	
Provision for discount allowed		171

Statement of financial position extract as at 31 December 2001

Current assets

Trade receivables		9 000
Less provision for bad debts	450	
Less provision for discount allowed	171	621
		8 379

12.4.2 Example 2

The following information was obtained from the books of Linda Dick.

Date	**Total Trade receivables**
31 December 1996	$16 000
31 December 1997	$12 000
31 December 1998	$20 000

On 31 December 1994 Linda Dick decided to create a provision for debts equal to 5% of trade receivables and decided to maintain the same percentage thereafter.

You are required to prepare the provision for bad debts account for the 3 years ending 31 December 1998.

<u>Solution</u>

Provision for bad debts account

1996		**$**	**1996**		**$**
December 31	Balance c/d	800	December 31	Statement of comprehensive income	800
1997			**1997**		
December 31	Statement of comprehensive income	200	January 1	Balance b/d	800
December 31	Balance c/d	600			
		800			800
1998			**1998**		
December 31	Balance c/d	1 000	January 1	Balance b/d	600
			December 31	Statement of comprehensive income	400
		1 000			1 000
			1999		
			January 1	Balance b/d	1 000

Notes

1) The provision for bad debts in each year is calculated as 5% of trade receivables as follows:
   a) 1996 - 5% x $16 000 = $800
   b) 1997 - 5% x $12 000 = $600
   c) 1998 - 5% x $20 000 = $1 000

   The above figures should be subtracted from the trade receivables when preparing the Statement of financial position.

2) An increase or decrease in the provision for bad debts is transferred to the profit and loss account as an expense or income. For example a decrease from 1996 to 1997 of $200 is transferred to the profit and loss account as an income, whilst an increase from 1997 to 1998 of $400 is transferred as an expense.

12.5 End of chapter questions

12.5.1 Question 1

H. Wiseman makes a provision for doubtful debts equal to 5% of trade receivables at the end of the financial year.

On 1 January 1995, the balance in the provision for doubtful debts account was $890.

Total trade receivables were as follows:

At 31 December 1995 $23 000
At 31 December 1996 $17 800
At 31 December 1997 $25 000

It was however discovered that credit sales amounting to $1 500 was omitted from the books as on the 31st of December 1997.

You are required to prepare the provision for doubtful debts account for the 3 years ending 31 December 1995, 1996 and 1997.

12.6 Examination type questions

Question 1

35. On 31 December 1998, T.M's trade receivables totalled $6 000. He created a provision for bad debts of 5% and created a provision for discount allowed of 2% of good trade receivables.

REQUIRED:

(a) The provision for bad debts account for 1998 and 1999.
(b) The provision for discount allowed account.

(c) The item 'trade receivables' as it would appear is the Statement of financial position at 31 December 1999.

Question 2

37. Spar provides us with the following information on 31 December 2006.

	Jan 2000	Dec 2001
Trade receivables	$ 90 000	$8 000
Provision for bad debt, 1 January 2000	$ 500	$ 500

During the year ended 31 December 2001 one of the trade receivables, Chikwereti, was declared insolvent and his debt is to be written off, amounting to $400.
Provision for bad debts is 5% on trade receivables.

<u>REQUIRED:</u>
Prepare the provision for bad debts for the two years, 2000 and 2001.

Question 3

38. The following information was extracted from the books of Z. Zooms.

Trade receivables**:** at	31 December	1999	$5 000
	31 December	2000	$6 000
	31 December	2001	$4 000

Additional information:

An invoice for credit sales amounting to $2 000 was misplaced and this information was not dealt with in the books for 31 December 2001. Provision is to be maintained at 10% as trade receivables each year.

<u>REQUIRED:</u>
Write up the provision for bad debts account for each of the three years ended 31 December 1999, 2000 and 2001.

Question 4

On 31 December 2011 a firm's trade receivables totalled $12 000. On 1 January 2011 the provision for doubtful was $850. It was decided to adjust the provision for doubtful debts so that it equals 5% of trade receivables.
Required
Show the entries in the:
(a) Provision for doubtful debts.
(b) Statement of comprehensive income extract for the year ended 31 December 2011.
(c) Statement of financial position extract as at 31 December 2011.

Question 5

S. Dlodlo commenced business on 1 January 2010. On 31 December 2010 there were trade receivables of $12 000 and on the same date, a provision for bad debts of 5% was created. Trade receivables increased in 2011 and on 31 December 2011, the figure stood at $14 300. This figure included bad debts of $600 which Dlodlo decided to write off. She decided to maintain the provision for bad debts at 5% of trade receivables. She also created a provision for discount of 1% of the net debtors.

Required.

(a) Prepare the provision for bad debts account for the year ended 31 December 2010 and 2011.

(b) Show the entries which appear in the Statement of comprehensive income for each of the years ended 31 December 2010 and 2011.

(c) Draw up a Statement of financial position extract showing the trade receivables as at 31 December 2011.

13. ERRORS AND SUSPENSE ACCOUNTS

13.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Explain the errors which affect the agreement of the trial balance.*
- *Rewrite the trial balance to correct the errors and enter any difference remaining on the trial balance as a balance on the suspense account.*
- *Prepare journal entries with narratives to correct the errors.*
- *Write up the suspense account to show how it will appear after all the errors have been corrected.*
- *State the effect on the net profit of the adjustment of each of the given errors.*
- *If any item has no effect on the net profit, state 'no effect'.*
- *Calculate the amended profit after the adjustments have been made.*
- *Prepare a revised Statement of financial position.*

13.2 Introduction

In chapter 6 we discussed about how to prepare a trial balance. If there are no errors both the debit and the credit side of the trial balance should agree. Sometimes the trial balance may agree whilst the bookkeepers have committed some errors. If the trial balance does not agree, such errors are corrected through the suspense accounts. In this chapter we are going to look at both errors that affect the trial balance and ways of correcting them. Bookkeeping errors can be divided into two main categories; errors that affect the trial balance and errors that do not affect the trial balance.

13.3 Errors that affect the trial balance (Suspense account)

13.3.1 The suspense account

Errors that do cause a trial balance to disagree are corrected by means of one entry in the suspense account and a corresponding entry in the account containing the error. Only errors that cause a trial balance to disagree are corrected by means of an entry in this account. e.g. purchases daybook overcast

Debit Suspense account
Credit Purchases

Errors made in the trial balance are corrected through a one-sided journal entry, which is either debited or credited to suspense account.

These arise in these situations: -

13.3.2 Error in subsidiary books

These are mainly addition errors e.g. daybooks under cast and overcast sales, purchases, sales returns, purchases returns, discount column of cashbook overcast or under cast.

13.3.3 Errors in the ledger

a) When only a debit entry or a credit entry of a transaction has been posted to the ledger.
b) An amount has been posted to an incorrect ledger account i.e. where a double entry system is completed with different figures.
c) When one entry of transaction has been posted to the wrong side of an account.
d) Error when balancing a ledger account or an error when bringing forward the balance of an account.

13.3.4 Errors in the trial balance

a) When an account balance has not been included in the trial balance.
b) When accounts balance is listed incorrectly.
c) When an account is included in the balance with wrong amount.
d) Addition error when totalling the trial balance.

13.4 Correction of errors

Both types of errors, i.e. those which affect and those, which do not affect the trial, balance, need to be corrected when discovered. The correction is done by means of general journal. The correct way of writing a journal is that the debit entry should come before the credit entry and narratives must be included unless the question states that they are not required.

Although we distinguish the difference between these errors, it should be noted however that when examined they are usually examined together. Errors that do not cause a trial balance to disagree are always corrected by means of a two-sided ledger (and journal entry) e.g. a purchase of goods on credit is debited to plant & machinery account. The error is corrected as follows:

Debit Purchases account
Credit Plant & Machinery account

13.4.1 Correcting accounts that have been overstated, understated and omitted

If any entry has been omitted or understated, the adjustment will be done on the same side of the account as the original entry. If an entry has been overstated, the adjusting entry will be on the opposite side of the account. Before we correct any error, we should know whether the account has a credit balance or debit balance in the ledger e.g. If sales account has been under cast by $8 000. We know that the sales account has got a credit balance in the ledger. Since in this case it has been under cast, we need to make an adjustment on the same side of the original entry i.e. credit side. We therefore correct that by **debiting the suspense and crediting the sales account**

The examiner can ask students to correct these errors in one of the following ways: -

a) Correcting of errors during the account period
b) Correcting errors after the preparation of trial balance.

In this situation the examiner requires you to:

i) Write journal entries to correct the errors
ii) Show the suspense account clearly showing how the trial balance difference is cleared
iii) Draw up the corrected trial balance.

c) Correction of errors after the preparation of final accounts.

In this situation the examiner requires students to: -

i) Write journal entries correcting the errors
ii) Show the suspense account and how it is cleared.
iii) Prepare a statement of revised gross profit and / or Net profit
iv) Prepare a corrected Statement of financial position.

As pointed out earlier, in an examination these errors are normally examined together. As such before you answer the question you need to identify errors which affect the trial balance and those that do not, errors which affect the trial balance should be corrected through the suspense and those that do not affect, should not be corrected through the suspense account.

The other type of error where students have a difficulty is when only one entry of a transaction has been posted to the wrong side of an account. This would result in recording two debits or two credits and one entry in the suspense account with the sum total of the other entries.

<u>Example</u>

A discount received of $507 was incorrectly posted to discount allowed account, to correct this, the entries required are

	Debit $	Credit $
Suspense (507+507)	1014	
Discount allowed		507
Discount received		507

13.4.2 Correction of errors made during the accounting period

The following errors were discovered in the books of E. Benjamin

1. The difference on the credit side was $6 730.00
2. A page of the sales daybook with $7 800 was missing.
3. The debit side of telephone account was overcast by $530
4. A credit purchase invoice for $98 was entered into the purchase journal as $89
5. Commission paid of $800 was credited to the commission received account
6. The sale of an old piece of equipment for $900 was credited to sales account.
7. An invoice of $200 for the purchases of stationery on credit has been omitted from the books of prime entries.

<u>Required:-</u>

Journal entries to correct the above errors and a suspense account clearly showing the original difference. (Narratives not required)

<u>Solution</u>

Details	**Debit $**	**Credit $**
i) Suspense	7 800	
Sales		7 800
ii) Suspense	530	
Telephone		530
ii) Purchases	9	
Trade payables		9
iv) Commission received	800	
Commission paid	800	
Suspense (800 +800)		1 600
v) Sales	900	
Equipment disposal account		900
vi) Stationery	200	
Trade payables		200

Suspense A/c

	$		$
Sales	7 800	Difference per trial balance	6 730
Telephone	530	Commission paid	800
		Commission received	800
	8 330		**8 330**

Please take note that the difference as per trial balance is the balancing figure between the two sides of the suspense account and was the original difference between the two sides of the trial balance.

13.4.3 Correction of the profit figure that has been subjected to errors

When you are required to compute the correct net profit for the period there are certain errors, which do not affect the Net Profit and they are not to be considered here. An error is said to affect the net profit if it has an effect on any item appearing in the Statement of comprehensive income as in the following examples.

13.5 Fully worked examples with solutions

13.5.1 Example 1

The following is a draft Statement of financial position for Smith a retailer as at 31 December 2000

		$		**$**
Non-current assets				194 000
Current Assets				
Inventory		50 000		
Trade receivables		29 000		
Cash		18 000		
		97 000		
less Current liabilities				
Trade payables	25 000			
Bank overdraft	52 000			
Suspense	14 000	91 000		6 000
				200 000
Financed by:				
Capital			190 000	
Add Net Profit			30 000	
				220 000
Less drawings			20 000	
				200 000

Further investigation of the suspense account balance revealed the following errors: -

a) Bank charges of $400 had been omitted from the cash book.
b) Cash sales of $3000 made on 31 December 2000 were debited to sales account and credited to Debtors account.
c) The total of discount allowed was under cast by $2 000.
d) An amount of $86 paid for transport was debited to stationery account.
e) A stock sheet totalling $1 200 was omitted from closing stock account
f) A provision for bad debts of 5% of the Debtors is to be created.
g) A return outward of $8 000 was debited to returns inwards account.

Required:

a) Journal entries (Narrations are not required)
b) Write up suspense account
c) A statement of corrected Net Profit figure.
d) A corrected Statement of financial position

Solution

		Dr.	Cr.
		$	$
a)	Bank charges	400	
	Bank		400
b)	Cash on hand	3000	
	Trade receivables	3000	
	Revenue		6 000
c)	Discount allowed		2 000
	Suspense		2 000
d)	Transport	86	
	Stationery		86
e)	Inventory	1 200	
	This entry in the journal is one- sided		
f)	Provision for bad debts (29 000+3000) x5%	1 600	
	Statement of comprehensive income		1 600
g)	Suspense	16 000	
	Returns outwards		8 000
	Returns inwards		8 000

Suspense Account

Returns inwards	8 000	Difference per trial balance	1 4000
Returns outwards	8 000	Discount allowed	2 000
	16 000		**16 000**

Statement of corrected Net Profit

		$	$
Profit as per draft accounts			30 000
Add:	Inventory omitted	1 200	
	Revenue	6000	

	Returns outwards	8 000	
	Returns inwards	8 000	23 200
			53 200
Less:	Provision for bad debts	1 600	
	Bank charges omitted	400	
	Discount allowed	2 000	4 000
Correct Net Profit			**49 200**

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2000

			$		$
Non-current assets					194 000
Current Assets					
Inventory (1 200 + 50 000)			51 200		
Trade receivables (29 000+3 000)	32 000				
Less Provision for doubtful debts	1 600		30 400		
Cash (18 000+3 000)			21 000		
Total current assets				102 600	
Less Current Liabilities					
Trade payables		25 000			
Bank (52 000+400)		52 400	77 400		25 200
					219 200

Financed by:

Capital	190 000	
Add Net Profit	49 200	
		239 200
Less drawings	20 000	
		219 200

13.5.2 Example 2

The accounts of M. K. Moyo showed a profit figure of $98 000 for the year ending 31 December 1999. The auditor discovered the following errors:
(a) The correct valuation of opening inventory was $13 000 whereas the figure used in the accounts was $9 000.
(b) The closing inventory figure used was $19 000, the correct figure which should have been used was $29 000.

Required
Calculate the revised profit

Profit per draft	98 000	
Add closing inventory understated	10 000	
		108 000
Less opening inventory understated	4 000	
Revised profit	104 000	

13.5.3 Example 3

On 31 December 2002 S. Madzingira prepared the following trial balance, which failed to agree.

	Debit	Credit
Sales		19 900
Capital		9 400
Stock	800	
Creditors		8 000
Debtors	9 000	
Drawings	1 200	
General expenses	500	
Rent	1 800	
Motor vehicle	10 000	
Purchases	13 100	
	36 400	37 300

Subsequent investigations revealed the following errors

(a) The sales journal was overcast by $400.
(b) No entry was made in the books in respect of goods valued at cost $1 100 taken by S. Madzingira for his personal use.
(c) A payment to a creditor of $500 was correctly credited to the cashbook but not posted to the trade payables' account.
(d) No entry was made in the books when S. Madzingira brought an office desk valued at $1 200 on 1 July 2002.

Required
(a) Prepare the journal entries to correct the above errors. (Narratives are not required)
(b) Prepare a suspense account showing the original difference as per the trial balance.
(c) Prepare the corrected trial balance after the above errors have been corrected.
(d) State the purpose of preparing the trial balance?

Solution

Details	**Dr.**	**Cr.**
	$	$
Revenue	400	
Suspense		400
Drawings	1 100	
Purchases		1 100
Trade payables	500	
Suspense		500
Furniture and fittings	1 200	
Capital		1 200

Suspense account

	$		$
Difference as per trial balance *(Bal. figure)*	900	Revenue account	400
		Trade payables' account	500
	900		900

The corrected trial balance as at 31 December 2002

	Dr.	**Cr.**
Revenue *(19 900 – 400)*		**19 500**
Capital *(9 400 + 1 200)*		**10 600**
Inventory	800	
Trade payables *(8 000 – 500)*		**7 500**
Trade receivables	9 000	
Drawings *(1 200 + 1 100)*	**2 300**	
General expenses	500	
Rent	1 800	
Furniture and fittings	**1 200**	

Motor vehicle	10 000	
Purchases *(13 100 – 1 100)*	**12 000**	
	37 600	37 600

d) Purpose of the trial balance

The trial balance is mainly used to check the mathematical accuracy of the clerk involved in the preparation of each of the ledgers before the balances are posted to the trial balance.

13.6 Examination type questions

Question 3

State the type of error in the following:

(a) A sale of goods to B. Bonzo for $900 was entered in Bosso.
(b) The purchase of Machinery for $2 000 was entered in the Machinery repairs account.
(c) A purchase of goods on credit from Nyore Nyore for $690 was entered in the books as $960.
(d) A payment by cheque to M. Moyo for $15 000 was debited to the bank account and credited in Moyo's account.
(e) The interest earned account was under cast by $200 and also the interest payable account was under cast by the same amount.
(f) A return of goods previously bought on credit from Nyore Nyore was completely omitted from the books.

(a) State any 4 errors that are not revealed by a Trial Balance.
 (b) Give 2 errors affecting the agreement of a Trial Balance.
 (c) State one purpose of preparing a trial balance.
 (d) The following trial balance at 30 April 1997 has some errors.

Question 4

TRIAL BALANCE FOR THE YEAR ENDED 30 APRIL 1997

	DEBIT	CREDIT
Capital at 1 May 1996		20 000
Drawings	2 000	
Revenue		60 525
Purchases	29 900	
Inventory at 1 May 1996	8 750	
Inventory at 30 April 1997		7 300
Administration expenses	15 017	
Discounts allowed		1 100
Discounts received	930	
Equipment	25 000	
Cash in Hand	200	
Bank (CR)	1 760	
Trade receivables	3 588	
Provision for doubtful debts	140	

Trade payables		2 200
Suspense account	3 840	
	91 125	91 125

REQUIRED:

Re – write the Trial Balance to correct the errors.

Question 5

Bizeck Traders prepared a Trial Balance on 31 December 2001. The Totals of the Trial balance agreed and final accounts were prepared for the year ended 31 December 2001 showing a net profit of $20 000.

The following errors were, however discovered

(a) Repairs to fixtures, $125, had been debited to fixtures account.
(b) Sales on credit to Wierse, $154, had been entered in the account of A. Wise.
(c) Cash drawings of $200 had been completely omitted from the books.
(d) Purchases account had been under cast by $100 and the wages account had been overcast by $100.
(e) Purchases on credit, $495, from Dizzy were entered in the books as $594.
(f) A cheque for $300 received from Botha was debited in his account and credited in bank account.

REQUIRED:

Prepare a statement of corrected net profit for the year ended 31 December 2001.

Question 6

A Trial balance failed to balance with the debit side totalled $144 000 and the credit side totalled $140 800. The difference was placed in a suspense account. Later, the following errors were discovered.

(a) One page of sales journal had not been entered in the sales account in the nominal ledger. The total of the page was $1 400.
(b) Purchases journal was overcast by $400.
(c) The total of discounts allowed for March, $600, had not been entered in the discounts account.
(d) Cash received from a debtor, $800, had been entered in the cash book but had not been entered in the customer's account in the sales ledger.
(e) Goods sold on credit to G. Zuze for $400 were not recorded in the books.
(f) A payment of $1 200 to a supplier had been entered twice in that suppliers account in the purchases ledger.

REQUIRED:

(a) Prepare journal entries to correct the above errors.
(b) Prepare a suspense account to show how it will appear after all the errors have been corrected.

14) The draft Statement of financial position of a business at 31 March 1999 is shown below

Fixed Assets	30 000	Capital		55 000	
		Net Profit			27 000
Current Assets				82 000	
Stock	18 000	less: Drawings	25 000		
Debtors	12 000			57 000	
Bank	5 000				
		Current liabilities			
		Creditors			8 000
	65 000			65 000	

After the Statement of financial position Draft is prepared, the following errors are discovered:

(a) Stock worth $3 000 was bought on credit and no entry was made in the books.
(b) A debtor owing $ 1 000 paid his account by cheque on 31 March 1999.
(c) A debtor owing $500 at 31 March has stated that he is unable to pay and is to be written off.
(d) Goods which cost $4 800 were returned to the supplier on 30 March 1999. No record of this was has been made in the books.

REQUIRED:

Prepare A revised Statement of financial position at 31 March 1999.

14. CONTROL ACCOUNTS

14.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Explain the reasons for keeping control accounts.*
- *Prepare the Sales ledger control account and the Purchases ledger control account.*
- *State the reasons why the debtors' accounts may have a credit balance.*
- *State the reasons why creditors' accounts may have a debit balance.*
- *List the items which are not entered in the control accounts and the reasons thereof.*

14.2 Introduction

These are accounts that contain in total the entries that are made in the individual ledger. They are prepared monthly from the totals of the relevant books of prime entry e.g. the total of sales daybooks is entered on the debit side of the control accounts. This helps the business if it has many customers
At the same time the business must ensure:

1. That accuracy is maintained with all customers and suppliers individually.

2. That in total, the individual balances are summarised and for the sake of the Trial balance and Statement of financial position, these totals must be accurate and in line with the individual status of all accounts.

Control accounts are kept in the general ledger and are only concerned with the TOTAL of the figures posted to the individual accounts of customers and suppliers. If all individual entries are correctly added up and totals correctly posted to the control accounts, then the closing balance of the Control Accounts is equal to the total of individual Accounts

14.3 Purposes of Control Accounts

1. To determine total figures for credit sales and credit purchases.
2. To check on the accuracy of the ledger they control.
3. To facilitate the location of errors.
4. They enable the Statement of financial position to be prepared quickly,

We have two main Control Accounts in a Financial Accounting System. Both are found in the General Ledger but control individual accounts in two separate ledgers as shown below: -

14.4 Sales/Receivables/Debtors Ledger Control Account

Randall Gives some guidelines as follows:
The usual entries in the control accounts are as follows:-

Sales/Debtors Ledger control A/C

Debit bal. b/f from previous period	xxx	Credit Balance from previous period	xxx
Credit sales for the period	xxx	- set off	xxx
Refunds to customers	xxx	cash/Cheques received from Debtors	xxx
Dishonoured cheques	xxx	- discount allowed	xxx
Interest on overdue account	xxx	- bad debts	xxx
Bad debt previously		- cash /cheques received in respect of bad debt	xxx
written off (reinstating)	xxx	previously written off	
Credit balance at the end of the Period Bal. c/d	xxx	- debtor balance c/f	xxx
	xxx		**xxx**

<u>Explanations</u>

1 Opening debit balance should be on the debit side of the control account and opening credit balance should be on the credit side
2 Bad debts recovered should be entered on both sides of the control account.
3 Set off appears in both the two control accounts i.e. on the debit side of the purchases ledger control account and on the credit side of the sales ledger control account
4 Credit Sales and Credit Sales Returns are entered in the control accounts net of trade discount.
5 Closing credit balance should be included as a balance carried down on the debit side of the control accounts and closing debit balance should be included on the credit side of the control accounts as a balance carried down

<u>Notes:</u>

The general guidelines are that anything, which is not entered in the Debtors Ledger, is also not entered in the control account. From this reasoning, the following should be ignored when preparing control accounts.

(a) Cash sales - the double entry is completed in the cash account and the sales account and therefore does not affect trade receivables.
(b) Cash sales returns – this transaction do not involve trade receivables and therefore does not appear in the sales ledger control account.
(c) Trade discounts – trade discount is not recorded anywhere in the books of accounts and so does not appear in the control accounts.

(d) Provision for bad debts – is the profit set aside to cover future bad debts while control accounts are for the previous period.

14.5 Purchases/Creditors/Payables ledger control Account

The usual entries found in the control account are as follows:

Payables/Purchases Ledger control A/C

Debit balance b/f	xxx	Credit balance b/f	xxx
Purchases returns	xxx	Credit purchases	xxx
		Interest charged on overdue accounts	xxx
Discount received	xxx	Refund from suppliers	xxx
Set off with debtors ledger	xxx		
Cash paid to credit suppliers	xxx		
Credit balance at the end of the period	xxx	Debit balance at the end of the period	xxx
	xxx		**xxx**

Explanations

1 Opening debit balance should be on the debit side of the control account and opening credit balance should be on the credit side

2 Set off appears in both the two control accounts i.e. on the debit side of the purchases ledger control account and on the credit side of the sales ledger control account

3 Credit Purchases and Credit Purchases Returns are entered in the control accounts net of trade discount

.4 Closing credit balance should be included as a balance carried down on the debit side of the control accounts and closing debit balance should be included on the credit side of the control accounts as a balance carried down

Notes:

The general guidelines are that anything, which is not entered in the Creditors Ledger, is also not entered in the control account. From this reasoning, the following should be ignored when preparing control accounts.

(a) Cash purchases- the double entry is completed in the cash account and the purchases account and therefore does not affect trade receivables.

(b) Cash purchases returns – this transaction do not involve trade payables and therefore does not appear in the purchases ledger control account.

(c) Trade discounts– trade discount is not recorded anywhere in the books of accounts and so does not appear in the control accounts.

14.6 Conclusion

If in examination returns are shown as returns outwards or returns inwards without an indication whether they are for cash sales or credit sales always assume they are returns on credit purchases or credit sales and include them in the control account.

14.7 Fully worked examples with solutions

14.7.1 Example 1

The following details were extracted from the books of Millet (Pvt.) Ltd.

Opening balances *1 January 2000*	
Sales ledger balance	18 000
Purchases ledger balance	14 000
Transactions during the period.	
Credit sales	?
Cash sales	23 000
Credit purchases	?
Cash purchases	14 900
Interest on overdue Debtors accounts	520
Sales Returns	5 000
Bad debts	2 000
Purchases returns	2 200
Discount allowed	7 000
Discount received	850
Cheque from Debtors	27 000
Cash paid to Credit suppliers	15 000
Set - off between sales and purchases ledger	3 000
Closing balances *31 December 2000*	
Sales ledger balance	11 710
Purchases ledger balance	21 750

Required

Prepare a sales ledger control account and a purchase ledger control account, showing clearly the amounts of credit sales and credit purchases.

SOLUTION

Sales ledger control account

Bal. B/d	18 000	Sales returns	5 000
Credit sales *(Difference)*	37 190	Bad debts	2 000
Interest on overdue accounts	520	Discount allowed	7 000
		Bank	27 000
		Set off	3 000
		Bal. c/d	11 710
	55 710		**55 710**
Bal. b/d	11 710		

Purchases ledger control a/c

Returns	2 200	Bal. b/d	14 000

Bank	15 000	Purchases *(Difference)*	28 800
Discount received	850		
Set off	3 000		
Bal. c/d	21 750		
	42 800		**42 800**
		Bal b/d	21 750

Note
Cash sales and purchases are not entred in the control accounts.

14.7.2 Example 2

The following information was taken from the books of John Khupe for the month of January 1996.

	$
Opening debtors balances on 1 January:	
Debit	3 610
Credit	100
Credit sales	35 000
Cash and cheques received from debtors	30 260
Discount allowed to debtors	500
Goods returned by debtors	400
Interest on overdue accounts	1 500
Debtors' cheque dishonoured	800
Sales ledger balance set off against the purchases ledger balance	100
Bad debts written off	150
Closing debtors balances on 31 January on the credit side	200

Required
(a) Prepare and balance the sales ledger control account for the month.
(b) State two advantages of preparing control accounts
(c) How many a credit balance arise in a debtor's account?

Solution

Sales ledger control account

	$		$
Balance b/d	3 610	Balance b/d	100
Sales	35 000	Receipts from debtors	30 260
Interest on overdue accounts	1 500	Discount allowed	500
Dishonoured cheques	800	Returns inwards	400
Balance c/d	200	Set - off	100
		Bad debts written off	150
		Balance c/d	9 600
	41 110		41 110
Balance b/d	9 600	Balance b/d	200

b. The advantages of preparing a control account are

- It is used in the calculation of the figure for sales and purchases in the case of an incomplete record environment.

- It is also used to check the arithmetic accuracy and errors that might have been committed by the ledger clerks who are involved in the preparation of such a ledger.
- It also helps to prevent errors.

c. A credit balance, in a sales ledger control account might arise under the following circumstances

- When a customer or debtor has overpaid his or her account.
- When a customer has returned goods and a refund is yet to be made.
- Goods have been paid for in advance.

14.8 Examination type questions

Question 1

The following figures are taken from the books of David

2004

Sept 1	Balances brought down in the purchases ledger	$40 (DR)
		$2 800 (CR)

Sept 30. Totals for the month

Purchases journal	$6 300
Returns outwards journal	$1 100
Cheques paid to creditors	$5 750
Discounts received	$ 110
Provision for doubtful debts	$ 400
Cash refunded by creditors	$ 10
Discount allowed	$ 600
Purchases ledger debit balances	$ 30

REQUIRED

(a) Select the relevant information and prepare David's purchases ledger control account for the month of September 2004.

(b) Give 2 reasons for preparing control A/Cs.

Question 2

16. On 1 April 2003 the balances brought down on the ledgers:

Purchases ledger	$1 960 (CR)
Sales ledger	$1 750 (DR)
Sales ledger	$100 (CR)

Totals of the journals for April 2003 were:

Purchases journal	$4 190
Sales journal	$5 150

Purchases Returns journal	$	135
Returns inwards journal	$	270

The Cash book for April 2003 showed-

Cheques received from customers	$4 990
Cheques paid to supplies	$3 830
Cheques paid to debtor in respect of	
Overpayment	$100
Discount allowed	$110
Discount received	$180

The journal entries for April 2003 showed in
Bad debts writers off $74

REQUIRED:
Prepare the sales and purchases ledger control account for the month of April 2003

Question 3
The following balances appeared in the ledger of M. Dambudzo on 31 May 2009

		$
Trade receivables on 1 May 2009		13 600
Credit sales		49 160
Cash and cheques received from credit customers		39 520
Discount allowed		1 690
Returns inwards		1 870
Customers cheques dishonoured		2 230
Accounts settled by contra		1 980
Cash refund in respect of overpayment		330
Bad debts written off	1 050	

Required
Prepare the sales ledger control account for the month of May 2009.

15. INCOMPLETE RECORDS

15.1 End of chapter objectives

By the end of the lesson, the student should be able to:

- *Explain what is meant by incomplete records.*
- *State the reasons why a business does not maintain a full double entry system.*
- *Describe the term 'statement of affairs'*
- *Draw up the statement of affairs to determine the opening capital balance.*
- Explain the relationship between margin and mark-up using illustrations.
- *Prepare the sales ledger control account and the purchases ledger control account to determine sales and purchases respectively.*
- *Prepare the cash book to determine the closing bank/cash balance.*
- *Prepare the Statement of comprehensive income and Statement of financial position of the business using incomplete records.*
- *Apply the knowledge of accruals and prepayments to calculate the amount from expenses accounts to be transferred to the Statement of comprehensive income.*

15.2 Introduction

Mr Edward Chamisa in his Book Principle of accounts define incomplete records as a situation where the transactions of a business have not been recorded using the concept of double entry system. There are a number of reasons why business do no keep their accounts on a double entry:

i) There is no legal requirement
ii) Small business find it expensive
iii) In majority of the cases they lack the skills of preparing accounts properly

In practice businesses are forced to prepare financial statements when required for tax purposes or when required by the bank when seeking loans or an overdraft facility. The problem with incomplete records is that of missing information, which varies from question to question. As a result, it is not possible to prescribe the specific accounting technique to use in every situation. You first look for what is provided and look at what is missing then apply the appropriate technique to obtain the correct information

15.3 Preparing accounts from incomplete records

The following techniques should be applied when preparing accounts from incomplete records.

15.3.1 Statement of affairs

The accounting equation is also known as statement of affairs. This is a list of all assets and liabilities of the business at a given period. It is used in extreme cases where business does not keep any accounting records. In practice, the accountant together with the owner of the business has to ascertain the assets and liabilities at the beginning and end of the accounting period. In examination the list will be provided. We determine profit as follows:

Capital at the end of current period	(A-L)	=	xxx
<u>Less</u> capital at the beginning of the period	(A-L)	=	<u>xxx</u>
Increase / decrease in capital			xxx

Add drawings during the year of goods or cash taken for own use	xxx
Less Capital introduced during the year either in form of cash or any Other asset	xxx
Profit for the year	**xxx**

15.3.2 Control accounts

The Debtors (or sales) ledger control account may be used to find any of the following, credit sales, receipts from trade receivables and closing trade receivables. However in certain questions it is not possible to separate credit sales from cash sales and the control account is used to determine total sales. The purchases ledger control accounts may also be used to determine any of the credit purchases, opening trade payables' balance, payments to trade payables and closing trade payables' balances. If you are given any of the three items in a control account you can determine the forth one as the balancing figure

15.3.3 Cash and bank summary

A cashbook may be used to find closing bank and cash balances, drawings, cash sales and cash stolen.

15.3.4 Margin and mark-up

Margin is gross profit expressed as a percentage of sales; whilst mark up is gross profit expressed as a percentage the cost price. The gross profit percentage may be used to calculate any missing figure in the trading account e.g. total sales, total purchases, cost of goods sold, closing stock or gross profit.

The relationship between margin and mark-up

Both margin and mark-up relate to gross profit figure using different avenues. The following is the relationship between the two.

If margin $= \frac{a}{b}$ then mark-up $= \frac{a}{b-a}$

If mark-up $= \frac{d}{c}$ then margin $= \frac{d}{c+d}$

Where: *a* and *d* are numerators
b and *c* are denominators

One or more of the above techniques may be used to find missing information.

15.4 Fully worked examples with solutions

15.4.1 Example 1

Since starting business, S. Siziba has not kept proper books of accounts. He provides his accountant with a list of assets and liabilities to enable him to prepare his financial statements for tax purposes;

	1/01/2000	31/12/2000
	$	$
Premises	80 000	80 000
Trade receivables	18 000	36 000
Trade payables	12 000	22 000
Cash on hand	500	2 500
Plant & Equipment	50 000	49 100
Motor vehicle	-	60 000
Long term loan	30 000	30 000

His drawings for the year ended 31 December 2000, amounted to $31 000. He brought into the business his personal car valued at $60 000.

Required

a) A calculation for the profit or loss for the year ended 31 December 2000

b) A Statement of financial position as at 31 December 2000

Statement of Affairs

		1/01/2000		31/12/2000	
		$		$	
Premises		80 000		80 000	
Trade receivables		18 000		36 000	
Cash on hand	500		2 500		
Plant and Equipment	50 000		49 100		
Motor vehicle		-		60 000	
		148 500		227 600	
Less Trade payables 12 000		22 000			
Loan	30 000	42 000	30 000	52 000	
Capital (net assets) at the end		106 500		175 600	
Less Capital at the beginning				106 500	
				69 100	
Add drawings				31 000	
					100 100
Less capital introduced					60 000
Profit for the year					**40 100**

Solution

Statement of financial position as at 31 December 2000

Non-current assets

	$	$
Premises		80 000
Plant & Machinery		49 100
Motor vehicle		60 000
		189 100

Current Assets

Trade receivables	36 000	

Cash		2 500	
		38 500	
Current Liabilities- Trade payables	2 000	16 500	
			205 600
Long-term Liabilities- Loan			30 000
			175 600

Financed by:

Capital	106 500	
Capital Introduced		60 000
Add profit		40 100
		206 600
Less drawings	31 000	
		175 600

15.4.2 Example 2

Sharon a stationery retailer who does not keep proper books of accounts provided her accountant with the following information:

	31/03/1999	**31/03/2000**
	$	$
Premises	100 000	100 000
Plant & Equipment	60 000	59 200
Trade receivables	42 000	64 000
Trade payables	21 000	32 000
Wages paid in advance	700	600
Telephone expenses owing	4 500	900
Inventory	24 000	36 000
Cash on hand	500	1 200

The only book kept by Sharon is a cashbook, summary of which for the year ended 31/03/2000 is given below;

Cashbook (bank column only)

Bal. b/d	56 000	Drawings	12 000
Cash takings banked	34 000	Wages & salaries	50 000
Receipts from receivables	59 000	Payments to suppliers	50 000
Bal. c/d	5 000	Telephone expenses	9 000
		Rent	15 000
		Purchases	18 000
	154 000		**154 000**

Additional information

1. The following amounts have been paid from the cash takings before they were banked.

	$
Purchases	6 000
Drawings	13 000
Wages	1 500

2. She had also taken goods worth $7 500 for her own use.
3. There was no purchase or disposal of fixed assets during the year.

Required:-

(a) Prepare a Statement of comprehensive income for the year-ended 31 March 2000
(b) Statement of financial position as at 31 March 2000

Solution

In this question we are expected to use the following accounting techniques;

a) Accounting equation to determine opening capital.
b) Control accounts to determine credit sales and Purchases
c) Cash account to determine cash sales.
d) Knowledge of prepayment and accruals

Step 1 - Determine opening capital using the equation: **Assets *less* liabilities = Capital**

Assets			$
Premises			100 000
Plant & Equipment			60 000
Trade receivables			42 000
Inventory			24 000
Bank			56 000
Cash			500
Other receivables-Wages paid in advance			700
			283 200
Less Liabilities			
Trade payables		21 000	
Other payables - Telephone owing	4 500	25 500	
Opening Capital			257 700

The common mistake is to forget to include bank because it is not listed with other assets

Step 2- Calculation of credit sales

Receivables/Debtors Control A/C

	$		$
Bal. b/d	42 000	Bank	59 000
Credit sales	81 000	Bal. c/d	64 000
	123 000		**123 000**

Bal. b/d	64 000

The mistake students usually make in the examination is to treat cash banked as cash sales which is wrong, total cash sales is made out cash banked + cash used to pay expenses before it was banked.

Total Revenue = Credit sales + Cash sales

= \$ 81 000 + \$55 200 = \$136 200

Credit Purchases

Payables/Creditors Control A/C

Bank	50 000	Bal. b/d	21 000
Bal. c/d	32 000	Credit purchases	61 000
	82 000		**82 000**

Total purchases \$ 61 000 + \$18 000 (from bank) + \$ 6 000 (Cash) = \$85 000.

Step 3

Cashbook (Cash Column Only)

	\$		\$
Bal. b/d	500	Purchases	6 000
Cash Sales *(difference)*	55 200	Drawings	13 000
		Wages	1 500
		Banked	34 000
		Bal. c/d	1 200

	55 700	**55 700**

Or
6 000 + 13 000 + 1 500 + 34 000 + 700 - 1200 – 500 = $55 200

Total drawings = 7 500 + 12 000 + 13 000 = $32 500. Make up of drawings is stocks, by a cheque and cash.

Step 4
Compute the charges to profit and loss account for those expenses with accruals or prepayments by preparing relevant ledger accounts.

Telephone A/c

	$		$
Bank	9000	Bal. b/d	4 500
Bal. c/d	900	Statement of comprehensive income	5 400
	9 900		**9 900**

Or
9 000 – 4 500 + 900 =$ 5 400

Wages & Salaries

	$		$
Bal. b/d	700	Statement of comprehensive income	51 600
Bank	50 000	Bal. c/d	600
Cash	1 500		
	52 200		**52 200**

Or
50 000 + 700 + 1 500 - 600 = **51 600**

Sharon's Statement of comprehensive income for the year ended 31 March 2000

		$	$
Revenue			136 200
Less Cost of Sales			
Opening inventory		24 000	
Add Purchases	85 000		
		109 000	
Less inventory drawings		7 500	
		101 500	
Less Closing inventory		36 000	65 500

Gross profit			70 700	
Less Expenses				
Wages	51 600			
Telephone	5 400			
Rent	15 000			
Depreciation	800	72 800		
Net Loss			2 100	

Statement of financial position for Sharon as at 31 March 2000

Non-current assets				$
Premises			100 000	
Plant & Equipment			59 200	
			159 200	
Current Assets				
Inventory		36 000		
Trade receivables		64 000		
Other receivables - Wages paid in advance	600			
Cash		1 200		
Working capital		101 800		
Less current liabilities				
Trade payables	32 000			
Other payables –Telephone owing	900			
Bank Overdraft	5 000	37 900	63 900	
			223 100	

Financed by:		
Capital	257 700	
Less net loss		2 100
		255 600
Less drawings (12 000 + 13 000 + 7 500)	32 500	
		223 100

The goods taken by the proprietor for his own use worth $7 500 should be added to drawings and deducted from the purchases figure. **In the examination, watch out for the bank account because it can be overdrawn.**

15.4.3 Example 3

Joseph Mazura who does not keep proper books of accounts supplied his accountant with the following information: -

	31/06/2000	30/06/2001
Premises	150 000	150 000
Inventory	36 000	62 000
Trade receivable	32 000	59 000
Trade payables	19 000	42 000

He also gave details of payments made as follows:

Suppliers $73 000

Wages	$25 000
Rent	$18 000

a) All sales were on credit
b) Mark up on goods was maintained at 30% on cost
c) He advised his accountant that all payments were made out of sales except for a loan from his brother of $8 000, which carries interest of 5 %, which he received on 1 January 2001.

Required:

a) Determine the Gross profit.

Solution

In this question we can use control accounts to determine purchases only but cannot uses it to determine sales. We can find sales by the use of gross profit % given.

Payables/Creditors Control A/C

Cash	73 000	Bal. b/d		19 000
Bal. c/d	42 000	Purchases	96 000	
	115 000			**115 000**

Statement of comprehensive income for J. Mazura for the year ended 30 June 2001

		$		$
Revenue (30% X $70 000*) + 70 000				91 000
Less Cost of Sales				
Opening inventory		36 000		
Add Purchases	96 000			
		132 000		
Less closing inventory		62 000	70 000	
Gross Profit				**21 000**

15.4.4 Example 4

Sibongile Moyo commenced trading on 1 September 1994 with capital of $40 000 that was all used to open a business bank account. Unfortunately, Sibongile has found it difficult to keep her business accounts properly. However the following information is available for the year ended 31 August 1995.

1. All business receipts and payments have been passed through the business bank account.
2. All business receipts are deemed to be from credit customers.
3. Bank payments have been summarised as follows: -

	$
Payments to suppliers	64 240
Fixtures and Fittings	20 000

Motor Vehicles		12 000
Rent & Rates		3 200
Heat & Light		900
Wages	5 600	
Drawings		8 000

4. All fixed assets were acquired on 1 September 1994.

5. Inventory in trade was valued at cost at 31 August 1995 at $6 000.

6. A 20% gross profit margin is achieved on all sales.

7. Depreciation is provided at the following annul rates on the cost of fixed assets:

Motor vehicles	25%
Other fixed assets	10%

8. Trade payables at 31 August 1995 amounted to $7 300 and trade Debtors were $6 900 at that date.

9. All purchases and sales are on credit.

You are required to:

(a) Prepare a Statement of comprehensive income for the year ended 31 August 1995 and

(b) The Statement of financial position as on that date.

Solution

Bank account

	$		$
Capital	40 000	Payments to suppliers	64 240
Receipts from trade receivables	75 025	Fixtures and fittings	20 000
		Motor vehicles	12 000
		Rent and rates	3 200
		Heat and light	900
		Wages	5 600
		Drawings	8 000
		Balance c/d	1 085
	115 025		115 025
Balance b/d	1 085		

Payables/Creditors control account

	$		$
Payments to creditors	64 240	Purchases	71 540
Balance c/d	7 300		
	71 540		71 540
		Balance b/d	7 300

Receivables/Debtors control account

	$		$
Sales	81 925	Receipts from debtors	75 025
		Balance c/d	6 900
	81 925		81 925
Balance b/d	6 900		

Statement of comprehensive income for the year ended 31 August 1995

	$	$
Revenue		81 925
Less cost of sales		
Purchases	71 540	
Less closing inventory	6 000	65 540
Gross profit		16 385
Less trading expenses		
Rent and rates	3 200	
Heat and light	900	
Wages	5 600	
Depreciation: *Motor vehicles*	3 000	
Fixtures and fittings	2 000	14 700
Net profit		1 685

Statement of financial position as at 31 August 1995

	$	$	$
Non-current assets	Cost	Depreciation	N.B.V.
Fixtures and fittings	20 000	2 000	18 000
Motor vehicles	12 000	3 000	9 000
	32 000	5 000	27 000
Current assets			
Inventory		6 000	
Trade receivables		6 900	
Bank		1 085	
		13 985	

Less trade payables	7 300	6 685
		33 685

Financed by:	
Capital	40 000
Add net profit	1 685
	41 685
Less drawings	8 000
	33 685

Notes

a) The creditors control account is opened to calculate credit purchases.
b) The trading account is opened to calculate gross profit and sales.
c) The debtors control account is opened to calculate receipts from debtors.
d) The bank account is opened to calculate the closing bank account.

15.5 Examination type questions

Question 3

Joe is a sole trader who does not keep full accounting records. All purchases and most of his sales are on credit.

Balances on 1 April 2003 included,	$
Debtors	8 000
Creditors	$6 000

During the year ended 31 March 2004, Joe recorded the following information;

		$
Receipts from trade receivables		84 000
Payments to trade payables	75 000	
Discounts allowed		5 000
Discounts received		3 000
Credit Sales		90 000
Credit purchases		77 000

REQUIRED:

(a) Calculate Joe's trade receivables and trade payables as at 31 March 2004.

Question 4

Jimmy owns a general store, buying and selling his goods on credit. Sales are both for cash and credit terms. Full accounting records are not kept, but Jimmy supplies the following information for the year ended 30 September 2000.

	AT 31 OCTOBER 1999	AT 30 SEPTEMBER 2000
	$	**$**

Inventory	26 000	16 000
Trade receivables	15 000	12 000
Trade payables	11 500	14 000

Other information for the year is as follows:

	$
Receipts from trade receivables	125 000
Payments	85 0000
Discounts allowed	4 000
Discounts received	2 000
Cash Sales	25 000

(a) Calculate Jimmy's Sales and purchases for the year ended 30 September 2000.

(b) Use your answer to (a), together with other information given to prepare Jimmy's Trading account for the year ended 30 September 2000.

Question 5

N. Nothing carries on a business as a trader. She has not kept proper records of her transactions for the year ended 30 April 1998. However, the following information is available.

	AT 1 MAY 1997	**AT 30 APRIL 1999**
	$	**$**
Fixtures and fittings	12 000	10 000
Inventory	4 000	5 000
Trade receivables	600	720
Trade payables	120	300
Other payables - Rent owing	400	-
Other receivables -Rates prepaid	140	180
Balance at bank	6 025	?

N. Nothing's receipts and payments for the year to 30 April 1998 were: -

		$
Receipts (all banked):	Cash Sales	19 000
	Receipts from debtors	5 640
Payments (by cheque):	Payments to Creditors	3 660
	Wages	2 200
	Rent	6 000
	Rates	5 100
	Electricity	615
	Personal drawings	14 000

REQUIRED:

(a) Bank Account
(b) N. Nothings Statement of comprehensive income for the year ended 30 April 1998.

Question 6

On 1 January 2004, Bambasonke's financial position was,

Fixed assets	$19 700
Current assets	$17 100
Current liabilities	$12 800

There were no long term liabilities.

During the year 2004, he bought fixed assets for $2 300 and borrowed $2 000 repayable in the year 2006. At the end of the year, his current assets were $21 500 and his Current Liabilities were $13 300. He had taken drawings worth $12 000 during 2004 and his fixed assets had depreciated by $ 33 000.

REQUIRED:

Draw up a statement, which may be in Statement of financial position form, to show the net profit for 31 December 2004.

16. DEPARTMENTAL ACCOUNTS

16.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Calculate the rate of inventory turnover.*
- *State the basis in which the joint expenses are apportioned between departments.*
- *Understand the purpose of preparing department accounts.*
- *Prepare columnar Statement of comprehensive income when dealing with a business which has two departments.*
- *Prepare the Statement of financial position of a business which has two departments.*

16.2 Introduction

A departmental store or shop is one with more than one department but all under one roof. The aim of preparing departmental accounts is to determine the profit or loss per department.
From the trading account, all the figures required are obtained from the analysed subsidiary books.

16.3 The importance of departmental accounts.

As the business grows, organisations divide their activities into smaller units known as departments. This is done to improve efficiency and to achieve better control. When this happens, the accounting system should be modified in such a way that the financial results of each department can be reported. This is achieved by using analysed daybooks showing total purchases, sales and returns for each department. In examinations, these are normally given:

In order to determine the net profit of each department, all expenses must be allocated to their various departments. These expenses can be charged to a particular department because they relate directly to that particular department, e.g. wages of personnel who work exclusively for a specific department. There are others that cannot. For these expenses, suitable bases of apportionment must be used to allocate them to all the departments e.g. rent.

For the profit and loss account, the expenses are apportioned between departments using one of the following methods:

16.3.1 Average inventory

This is used to apportion insurance on stock to departments and is determined as follows:

Department A

$$\frac{\text{Opening inventory + Closing inventory}}{2} = \text{Average for A}$$

Department B

$$\frac{\text{Opening inventory + Closing inventory}}{2} = \text{Average for B}$$

To get a charge for say department A

$$= \frac{\text{Average for A}}{\text{Sum of Average for A and B}} \times \text{Total Insurance}$$

16.3.2 Floor Space Occupied

This is used to apportion expenses like Rent, Rates, Heating and Light, Factory insurance and cleaning.

16.3.3 No. of Employees

This is used to apportion expenses like wages and salaries, canteen expenses.

16.3.4 Turnover (Revenue/Sales)

This is used to apportion expenses like sales commission, delivery expenses and other selling costs, administrative costs.

16.3.5 Purchases

This is used to apportion expenses like carriage inwards. However, estimated percentages or ratios & fractions may be used if given by the question.

16.3.6 Plant Value (N.B.V)

This is used to apportion depreciation.

16.4 Fully worked examples with solutions

16.4.1 Example 1

Benjamin Mwale is the sole proprietor of a business, which has two departments: Hardware and Electrical. The following is his trial balance as on 31 December 2002.

	Debit $	Credit $
Capital		100 000
Land and buildings	250 000	
Fixtures and fittings	200 000	
Provision for depreciation: Land and buildings		50 000
Fixtures and fittings		20 000
Revenue : Hardware		750 000
Electrical		560 000
Purchases: Hardware	410 000	
Electrical	390 000	
Opening inventory: Hardware	20 000	
Electrical	30 000	
Wages and salaries: Hardware	32 100	
Electrical	42 900	
Carriage inwards: Hardware	2 300	
Electrical	4 700	
Electricity and water: Hardware	5 000	
Electrical	7 400	
Carriage outwards: Hardware	1 200	
Electrical	2 300	
Insurance: Hardware	12 500	
Electrical	12 500	
Trade receivables	40 000	
Trade payables		34 000
Provision for bad debts		5 000
Drawings	71 100	
Bank balance		15 000
	1 534 000	1 534 000

Additional information

(a) Closing inventory is valued as follows:
Hardware $25 000

Electrical $32 000

(b) Depreciation is provided on all fixed assets as follows

Land and buildings - at 5% on cost using the straight-line method.

Fixtures and fittings – at 10% using the reducing balance method.

(c) Electricity owing amounted to $4 500.

(d) Water paid in advance amounted to $3 000.

(e) The provision for bad debts is to be adjusted to 10% of trade debtors.

You are required to prepare

(a) The departmental trading account in a columnar form showing clearly the gross profit or loss of each department for the year ended 31 December 2002.

(b) The combined Statement of comprehensive income for the year ended 31 December 2002.

(c) The Statement of financial position for the business as at 31 December 2002.

Solution

(a) Departmental trading account for the year ended 31 December 2002

	Hardware		**Electrical**		**Total**	
	$	**$**	**$**	**$**	**$**	**$**
Revenue		750 000		560 000		1 310 000
Less cost of sales						
Opening inventory	20 000		30 000		50 000	
Add purchases	410 000		390 000		800 000	
	430 000		420 000		850 000	
Add carriage inwards	2 300		4 700		7 000	
	432 300		424 700		857 000	
Less closing inventory	25 000	407 300	32 000	392 700	57 000	800 000
Gross profit		342 700		167 300		510 000

(b) The combined Statement of comprehensive income for the year ended 31 December 2002.

	$	$
Gross profit b/d		510 000
Decrease in provision for bad debts (5 000 – (40 000 x 10%))		1 000
		511 000
Less trading expenses		
Wages and salaries (32 100 + 42 900)	75 000	
Electricity and water (4 500 + 5 000 + 7 400 – 3 000)	13 900	
Carriage outwards (1 200 + 2 300)	3 500	
Insurance (12 500 + 12 500)	25 000	
Depreciation: Land and buildings (5% x 250 000)	12 500	
Fixtures and fittings (200 000 – 20 000) x 10%	18 000	147 900
Net profit		363 100

(C) Statement of financial position as at 31 December 2002

	$	$	$
Non-current assets			
	Cost	Depreciation	Net book value
Land and buildings	250 000	62 500	187 500
Fixtures and fittings	200 000	38 000	162 000
	450 000	100 500	349 500
Current assets			
Inventory (25 000 + 32 000)		57 000	
Trade receivables	40 000		
Less provision for bad debts	4 000	36 000	
Other receivables – water prepaid		3 000	
		96 000	
Less current liabilities			
Trade payables	34 000		
Other payables - Electricity accrued	4 500		
Bank balance	15 000	53 500	
Working capital			42 500
			392 000
Financed by			
Capital			100 000
Add net profit			363 100
			463 100
Less drawings			71 100
			392 000

16.4.2 Example 2

Mlambo is a sole trader who carries on a business as a retailer of assorted products, which is divided into two departments: grocery and hardware. On 31 December 2000 the following Trial Balance was presented to his accountant.

	Debit	Credit
Trade receivables & Trade payables	10 000	9 600
Bank	5 000	
Revenue: Grocery		220 000
Hardware		290 000
Capital		60 000
Rent	30 000	

Wages & Salaries			90 000	
Bad debts			15 000	
General expenses			18 000	
Stock insurance			27 000	
Carriage inwards			6 000	
Commission			48 000	
Motor at cost		92 000		
Provision for depreciation on Motor vehicles				18 400
Inventory: Grocery			21 000	
Hardware	56 000			
Purchases: Grocery		70 000		
Hardware		110 000		
			598 000	**598 000**

Additional information

(a) Inventory on hand on 31 December 2000 Grocery $34 000
Hardware $68 000

(b) Motor vehicles are depreciated using the straight-line method at the rate of 20% on cost

(c) Depreciation is to be allocated as follows: 20% Grocery and 80% Hardware

(d) Rent is allocated according to floor area occupied that is

Grocery	300m²
Hardware	700m²

(e) Wages and salaries are allocated in proportion to number of employees which are;

Grocery	8
Hardware	2

(f) Sales commission and general expenses are allocated according to turnover.

(g) Bad debts pertains to Hardware

(h) Insurance is apportioned according to average stock

(i) Carriage inwards is allocated according to purchases.

(j) Bonuses to be paid to departmental managers as following;
-Grocery 5% of net profit before deducting such a bonus
-Hardware 8% of net profit after deducting the bonus

(k) Rent prepaid $3 000 and wages & salaries due $5 000

Required

(a) Prepare the departmental Statement of comprehensive income of Mlambo for the year ended 31 December 2000 and

(b) The Statement of financial position as at 31 December 2000

Solution

Statement of comprehensive income for Mlambo for the year ended 31 December 2000

		Grocery		**Hardware**		**Total**
		$		**$**		**$**
Revenue		220 000		290 000		510 000
Less cost of sales						
Opening inventory	21 000		56 000		77 000	
Purchases	70 000		110 000		180 000	
Carriage inwards	2 333		3 667		6 000	
	93 333		169 667		263 000	
Less Closing inventory	34 000	59 333	68 000	101 667	102 000	161 000
Gross profit		160 667		188 333		349 000
Less expenses						
Rent	8 100		18 900		27 000	
Bad debts	-------		15 000		15 000	
General expenses	7 765		10 235		18 000	
Insurance	8 396		18 704		27 100	
Sales Commission	20 706		27 294		48 000	
Depreciation	3 680		14 720		18 400	
Wages & Salaries	76 000		19 000		95 000	
Bonus	1 806	126 353	4 776	128 629	6 677	255 082
Net Profit		34 314		59 704		94 018

Statement of financial position as at 31 December 2000

Non-current assets	**Cost**	**Deep**		**N.B.V**
Motor vehicle	92 000	36 800	55 200	

Current assets

Inventory		102 000		
Trade receivables		10 000		
Bank		5 000		
Other receivables - Prepayments		3 000		
		120 000		
***Less* Current Liabilities**				
Trade payables	9 600			
Other payables - Accrued bonuses	6 582			
Other payables - Accrued wages	5 000		21 182	98 818
				154 018
Financed by:				
Capital				60 000
Add Net Profit				94 018
				154 018

Workings

(a) Carriage on Purchases

Grocery $\frac{70\ 000}{180\ 000}$ x 6 000 = 2 333

Hardware $\frac{110\ 000}{180\ 000}$ X 6 000 = 3 667

(b) Rent

Grocery $\frac{300}{1\ 000}$ X (30 000 – 3 000) = 8 100

Hardware $\frac{700}{1\ 000}$ X (30 000 – 3 000) = 18 900

(c) General expenses

Grocery $\frac{220\ 000}{510\ 000}$ x 18 000 = 7 765

Hardware $\frac{290\ 000}{510\ 000}$ x 18 000 = 10 235

(d) Stock Insurance

Grocery $\frac{27\ 500}{27\ 500 + 62\ 000}$ x 20 000 = 8 296

Grocery $\frac{62\ 000}{27\ 500 + 62\ 000}$ x 20 000 = 18 704

(e) Sales Commission

Grocery $\frac{220\ 000}{510\ 000}$ X 48 000 = 20 706

Hardware $\frac{290\ 000}{510\ 000}$ X 48 000 = 27 294

(f) Depreciation

20% x 92 000 = 18 400

Grocery = 3 680

Hardware = 14 720

(g) Wages & Salaries

Grocery $\frac{8}{10}$ X (90 000 + 5 000) = $76 000

Hardware $\frac{2}{10}$ X (90 000 + 5 000) = $19 000

(h) Bonus

Grocery 5% x (106 667 – 124 547) = $894

Hardware $\frac{8}{108}$ x (188 333 – 112 853) = $4 776

Comments on b and c

Where you are given expenses to be apportioned to departments and these require adjustments for accrual and prepayment, you should make adjustments first before apportioning the expenses to departments. This is what we have done to rent, wages & salaries.

Comment on bonus

Care needs to be taken when dealing with bonus based on net profit per department. Bonus may be based on a percentage of net profit before deducting the bonus. The bonus is calculated as follows:

Gross income less all expenses (excluding bonus) x % of the bonus.

In other questions, bonus may be based on net profit after deducting the bonus, this is calculated as follows:

$\frac{\%\ \text{Bonus}}{100 + \%\ \text{bonus}}$ X Net Profit before Bonus

Students should note that a bonus is treated as an accrual in the Statement of financial position unless it is specified that the bonus has been paid.

16.5 Examination type questions

Question 1

Meikles Stores is divided into 2 departments, groceries and furniture on 31 August2004 the following information was extracted from the books.

Inventory at 1 September 2003	Groceries	3 500
	Furniture	4 500
Purchases	Groceries	30 000
	Furniture	100 000
Returns Inwards	Furniture	2 000
Customs Duty	Furniture	1 500
Carriage outwards	Furniture	500
	Groceries	400
Revenue	Furniture	260 000
	Groceries	140 000

Inventory at 31 August 2004 were valued at:

Groceries	3 500
Furniture	4 200

(a) Prepare a Department Trading Account in Column or form for the year ended 31 August 2004.

(b) Calculate the gross profit percentage on turnover of each department.

(c) State one advantage of preparing a Departmental Trading Account.

Question 2

Shilongo Stores has two Departments: Electrical and Household goods. The following information is available for the year ended 31 December 2005.

	Electrical	**Household Goods**
Inventory: 1 Sep 2002	12 000	1 000
31 Aug 2003	14 000	2 000
Purchases	40 000	13 000
Carriage inwards	2 000	4 000
Revenue	60 000	20 000
Wages of assistants	8 300	4 100

Items to be allocated between the departments:

Rent	$6 900
Carriage outwards	1 600
General expenses	400
Depreciation of fittings	600

Additional Information:

(a) Rent is to be apportioned on the basis of floor space. The electrical goods department occupies twice as much space as the household goods department.
(b) Carriage outwards and general expenses are to be apportioned on the basis of sales.
(c) Depreciation is to be shared equally between the 2 departments.

Required
Prepare a Departmental Statement of comprehensive income for the year ended 31 December 2003.

Question 3
Mambo is the owner of a shop selling groceries and clothing. Below is the trial balance extracted from his books on 31 March 2009.

Trial balance of Mambo as at 31 March 2009.

	Debit	**Credit**
	$	**$**
Capital		76 830
Delivery vehicles	107 000	
Furniture and fittings	85 000	
Revenue: Grocery		160 000
Clothing		195 000
Purchases: Grocery	69 000	
Clothing	73 800	
Opening inventory: Grocery	18 600	
Clothing	14 950	
Wages and salaries: Grocery	13 300	
Clothing	9 100	
Carriage inwards: Grocery	1 650	
Clothing	4 350	
Electricity and water	5 740	
Insurance	6 210	
Rent and rates	4 450	
Telephone	2 990	
Cash	960	
General expenses	1 150	
Bad debts	1 770	
Trade receivables	16 650	
Trade payables		18 160
Drawings	6 100	
Bank balance	7 200	
	449 990	449 990

Additional information
1. Inventory on 31 March 2009 was: Grocery $15 500.
: Clothing $13 090
2. Depreciate delivery vehicles by 10% per annum and Furniture and fittings by 5% per annum.

3. Apportion all expenses in the ratio of 3:2 for Grocery and Clothing respectively except depreciation which should be shared equally by the two departments.

Required

(a) Prepare the departmental Statement of comprehensive income for the year ended 31 March 2009.

(b) Draw up the Statement of financial position as at 31 March 2009.

Question 4

R. Jones is a proprietor of a shop with two departments. The following the trial balance extracted from his books on 31 December 2009.

Trial balance of R. Jones as at 31 December 2009

	Debit $	Credit $
Capital		11 900
Motor vehicles	8 500	
Furniture and fittings	5 200	
Revenue: Department A		18 610
Department B		16 960
Purchases: Department A	9 600	
Department B	10 800	
Inventory (1 January 2009): Department A	3 200	
Department B	1 900	
Wages and salaries: Department A	1 000	
Department B	2 400	
Insurance	190	
Rent and rates	1 150	
General expenses	360	
Trade receivables	1 850	
Trade payables		1 630
Drawings	2 200	
Bank balance	7 200	
	49 100	49 100

Additional information

1. Inventory on 31 December 2009 was: Department A $3 900.
: Department B $4 200.
2. Depreciate motor vehicles by 20% per annum and Furniture and fittings by 10% per annum.
3. Apportion all expenses in the ratio of 3:2 for Department A and Department B respectively.

Required

(a) Prepare the departmental Statement of comprehensive income for the year ended 31 December 2009.

(b) Draw up the Statement of financial position as at 31 December 2009.

Question 5

Tina owns a small business with two departments, furniture and gardening. The following was extracted from his books on 30 June 2007.

Trial balance of Tina as at 30June 2007.

	$
Capital	77 450
Premises	60 000
Equipment and fittings	10 200
Revenue: Furniture	112 500
Gardening	40 500
Purchases: Furniture	79 100
Gardening	22 100
Inventory (1 July 2007): Furniture	9 300
Gardening	4 100
Wages and salaries: Furniture	18 000
Gardening	7 700
Carriage outwards	1 450
Advertising	2100
General expenses	1 200
Electricity and water	6 000
Trade receivables	3 700
Trade payables	10 300
Drawings	10 000
Bank balance	5 800

Additional information

1. Inventory on 31 December 2009 was: Furniture $11 100.
   : Gardening $4 700.
2. Depreciation on equipment and fittings is at the rate of 10% per annum.
3. The two departmental managers are to receive commission of 5% of the gross profit of their departments.
4. General expenses and electricity and water are to be apportioned between the departments according to surface area which is furniture 240 square meters and gardening 160 square meters.
5. All other expenses are to be allocated in proportion to revenue.

Required

(a) Prepare the departmental Statement of comprehensive income for the year ended 30 June 2007.

(b) Draw up the Statement of financial position as at 30June 2007.

17. NON-PROFIT MAKING ORGANISATIONS

17.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Account for the existence of the non-profit making organisations*
- *Explain the special technical terms used in clubs and societies.*
- *Explain the sources of finance for a non-profit making organisation.*
- *Define the terms, subscription account, Statement of comprehensive income account, receipt and payments account and statement of affairs.*
- *Prepare the subscription account to show the amount to be transferred to the Statement of comprehensive income account.*
- *Draw up the trading account, Statement of comprehensive income account, receipts and payments account and the Statement of financial position of clubs and societies.*
- *Distinguish between the receipt and payments account and the Statement of comprehensive income account.*
- *Prepare control accounts to ascertain the sales and purchases of a business.*

17.2 Introduction

Non profit-making organisations are organisations that do not make profit for distribution to members like sole traders, Partnerships and limited companies. E.g. Social clubs, burial societies, education institutions like Teacher's training colleges, local authorities, churches like Roman Catholic, government bodies like Bulawayo City Council, sport clubs like Highlanders, Dynamos, professional societies like CIS, SAAA.

17.3 Special terminology for non-trading organisations

	Non - Profit making organisation	**Ordinary trading/profit making Business.**
1.	Accumulated Funds	Capital
2.	Receipt and payments account	Cash book (bank a/c or Cash A/C)
3.	Statement of comprehensive income a/c	Statement of comprehensive income
4.	Surplus	Net Profit
5.	Deficit	Net loss
6.	Statement of financial position	Statement of financial position or statement of affairs

17.4 Common sources of income for Non – Trading organisations

17.4.1 Subscriptions

This is a common source of income for a non-profit making organisation. Subscriptions to be credited in the Statement of comprehensive income account depend on the policy of the organisation. There are two types of policies to transferring subscriptions to the Statement of comprehensive income account i.e.

(i) An actual receipt basis
(ii) On an accrual basis

On actual receipt basis subscriptions are included in the Statement of comprehensive income in a year when they were paid. But with the accrual basis you take into account subscription in arrears and subscription in advance. If the question is silent always use the accrual basis. The following is a pro-forma subscription account.

Subscription A/C

Subs in arrears b/d	xxx	Subs in advance b/d	xxx
Income & Expenditure. (Balancing Figure)	xxx	Cash/Bank	xxx
		Bad debts Written off (if any)	xxx
Subs in advance c/d	xxx	Subs in arrears c/d	xxx
	xxx		**xxx**
Subs in arrears b/d	xxx	Subs in advance b/d	xxx

Example of a subscription account.

Free Choice is a club with members who subscribe annually for a fee of $400. On 1 Jan 2000, the beginning of their financial year, there were members who had not paid their previous subscriptions amounting to $4 800 whilst some had already paid the 2000 subscriptions in advance for $5 600. During the year 2000, $20 400 was received from members in respect of subscriptions.

At the year-end the following balances remained:
Subscriptions in advance - $6 000
Subscriptions in arrears - $4 400

<u>Required: -</u>
Prepare a subscription account showing clearly the amount to be transferred to the Statement of comprehensive income account.

Subscription a/c

	$		$
Bal. b/d -arrears	4 800	Bal. b/d - advance	5 600
Income & exp. Account	19 600	Bank	20 400
Bal. c/d - advance	6 000	Bal. c/d – arrears	4 400
	30 400		**30 400**
Bal. b/d - arrears	4 400	Bal. b/d -advance	6 000

Alternatively membership subscriptions could be determined by multiplying the number of members by the sub per member for the given period (usually one-year).

Note that subscriptions in arrears are a current asset while subscriptions in advance are current liabilities. (However, sometimes subscriptions in arrears for more than one year may be written off as bad, therefore a candidate need to be very watchful in the examination).
Subscriptions appearing in the Receipts and Payments account reflect the amounts that were actually paid in by members. Yet in the Statement of comprehensive income subscriptions should only be in respect of the current periods subscriptions: Therefore, a subscription account should be opened and the balances brought down entered as follows:

Subs in arrears are a balance b/d on the debit because members owe the society (some kind of Debtors). Subs in advance are a balance b/d on the credit because the society owes the members their prepaid subscriptions (some kind of Creditors)

17.4.2 Donations and Legacies

These are usually included as incomes in the year of receipt. However, if the donation /Legacy is for a specific purpose, as indicated by the donor, such should be credited to the accumulated fund instead of being recorded as an income. This also applies to large sums of donations/Legacies that are not specific.

17.4.3 Joining/Entry fees and life membership fees

Upon receipt these should be credited immediately to a deferred income account and should be transferred to Statement of comprehensive income account (as income) over the number of years the club expect to provide the members with its services.

17.4.4 Collection at matches and prizes

Non-profit making organisations also derive their income from gate takings and prizes like the selling of raffle tickets. The income should be credited to the Statement of comprehensive income account for the period in which it was received.

17.4.5 Interest received

If a fund gets interest on money deposited in a bank or invested, this is credited to Statement of comprehensive income account as income.

17.4.6 Rent from the letting of properties

This should be credited to the Statement of comprehensive income account.

17.4.7 Disposal of assets

Care should be taken because the clubs normally treat the sale value as income. Profit or loss on disposal should be calculated in the usual manner by comparing net book value with sales proceeds.

17.4.8 Auxiliary Activities

These are activities that a club engages in order to raise additional funds. Auxiliary activities need to be divided into Non-trading with trading activities. A student needs to prepare a trading account for each of the auxiliary activity in order to determine whether a profit or loss has been made e.g. bar trading, sale of stamps, sales of goods to members, selling of food in a restaurant. If a club makes a profit from this activity, it should be credited to the Statement of comprehensive income account, if it is a loss it should be debited to the Statement of comprehensive income account.

17.4.9 Profit-making activities

A Trading account is prepared if the organisation has an auxiliary activity e.g. operating a tuck - shop that will raise some funds for the organisation. Only the profit from the trading activities is posted to the Statement of comprehensive income account. All expenses relating to the trading activities are to be debited in the trading account.

	Bar		**Stamp**		**e.t.c.**		
Revenue		xxx		xxx		xxx	
Less Cost of sales							
Opening inventory		xxx		xxx		xxx	
Add Purchases	xxx		xxx		xxx		
		xxx		xxx		xxx	
Less Closing inventory		xxx	xxx	xxx	xxx	xxx	xxx
Gross Profit		xxx		xxx		xxx	
Less other expenses e.g. bar wage	xxx		xxx		xxx		
Profit transferred to Statement of comprehensive income account				xxx		xxx	
xxx							

With Non- trading activities the net should be included in the Statement of comprehensive income account.

E.g. (a) Annual dinner = Sales of tickets		x
Less expenses	(x)	
(b) Refreshments		x
Less cost of food	(x)	
(c) Social function receipt		x
Less expenses		(x)
(d) Christmas Dinner receipts	x	
Less expenses		(x)
(e) Raffles – Sale of tickets	x	
Less of cost of prices		(x)
Less cost of tickets	(x)	

(f) Disco receipts		x
Less Disco expenses	(x)	

17.5 The difference between a receipt and payment account and the income & expenditure account

(a) Receipts and Payment Account is prepared on cash basis whereas the Statement of comprehensive income Account works on an accrual basis.
(b) Receipt and Payment account doesn't take into account accruals and prepayments i.e. it includes incomes and expenditures of any accounting period, past, present and future periods whereas the Statement of comprehensive incomes shows only items incurred for the current accounting period.
(c) Statement of comprehensive income account shows non-cash items e.g. depreciation, profit or loss on disposal of fixed assets, which are never found in the receipts and payments.
(d) Receipts and payments account includes capital expenditure like motor vehicle, whereas the Statement of comprehensive income does not. The following is an example of how receipts and payments account can be compiled.

Example

Receipts and payments account for the year ended 31 May 2001

Receipts			**Payments**		
Balance B/d – (1 June 2000)		5 000	Purchase club stock		4 000
Membership subscriptions		16 000	Rent		500
Donation received		9 000	Operating expenses		8 500
Sales from club Bar		10 000	Stationery		700
Sales of raffle tickets	4 500		Plant and equipment	28 000	
			Bal. c/d		2 800
		44 500			**44500**
Bal. b/d		2 800			

Some items in the receipts and payments account might need to be adjusted for any accruals or prepayments before using them in the Statement of comprehensive income accounts. Such items include: - Sales from the club's bar must be added together with credit sales which we get from the control accounts which can also be prepared from given information. Purchases might as well need the same adjustment. Expenses might be accrued or prepaid and thus need to be adjusted before receiving them into the Statement of comprehensive income account.

17.5.1 Receipts and payments account

It is a summary of cash transactions. This is equivalent to a cashbook in an ordinary company and it is a useful source of an Statement of comprehensive income account.

17.5.2 Statement of comprehensive income account

This is the substitute of a profit and loss account. In its compilation we start off with income from subscriptions and general donations. Then income from the trading account of auxiliary activities is added as well. Then deductions are made for expenditure incurred such as depreciation, rent, electricity, stationery, wages and donations to outsiders. The following is a format for the Statement of comprehensive income account: -

	$	$
Subscriptions for the year		xxx
Donations received		xxx
Add / Less Net from non-trading activities		xxx
Add profit from a trading activity		xxx
Total income		**xxx**
Less Expenditure		
Depreciation for plant	xxx	
Loss from trading activity	xxx	
Depreciation for motor vehicles	xxx	
Wages and salaries	xxx	
Operating expenses	xxx	(xxx)
Net Surplus / Net Deficit		**xxx**

17.6 Fully worked example with solutions

17.6.1 Example 1

Mujinga Burial Society was formed in 1996 with 145 members. Up to now the number of members has remained the same and each member pays an annual subscription of $1 000. On 1 January 1998, the books of the society showed the following balances:

Amounts owing for subscriptions		$14 000
Subscriptions received in advance	$12 000	

During 1998, subscriptions received in cash were $160 000. This amount includes subscriptions for year 1999 for 23 members.

On 31 December 1998, subscriptions owing amounted to $10 000.
You are required to prepare a subscriptions account showing clearly the amount to be transferred to the Statement of comprehensive income account.

Solution

Subscriptions account

		$			$
1 January 1998	Balance b/d	14 000	1 January 1998	Balance b/d	12 000
31 December 1998	Income & exp.	*145 000	31 December 1998	Bank	160 000
31 December 1998	Balance c/d	23 000	31 December 1998	Balance c/d	10 000
		182 000			182 000

1 January 1999	Balance b/d	10 000	1 January 1999	Balance b/d	23 000

∗$145 000 = 145 members X $1 000/member

17.6.2 Example 2

The treasurer of Tengwe Country Club has prepared the following receipts and payments a/c for the year ended 31 December 1999.

Receipts			**Payments**	
		$		$
	Opening Bank balance	700	Payments to suppliers of bar stock	4 200
	Members subs	28 000	Printing and stationery	1 500
	Bar takings	8 000	Purchase of equipment	1 500
	Donation	50	Rent	1 200
	Dinner dance receipts	6 000	Dinner dance expenses	2 500
			Electricity	5 400
			Cleaning & Laundry	1 900
			Bal. c/d	24 550
		42 750		**42 750**
Bal. b/d		24 550		

You are also given the following additional information: -

1. The club depreciates equipment using the straight-line method at the rate of 10% on assets held at the end of the year.

2. The following is a list of the club's assets and liabilities

	1 Jan 1999	**31 Dec 1999**
	$	$
Bar inventory	200	900
Bar Payables/Creditors	1 000	7 00
Other payables -Electricity accrued	150	400
Other receivables - Rent prepaid	90	130
Subscriptions prepaid	6 000	8 000
Subscriptions in arrears	3 500	4 700
Equipment	13 000	14 500

Required: -

(a) A Calculation of accumulated fund of Tengwe Country Club at 1 January 1999.
(b) Prepare the Bar Trading Account.
(c) The Statement of comprehensive income Account for the year ended 31 December 1999 and a Statement of financial position as at that date.

Solution

Working 1 – A statement of affairs as at 1 January 1999

Assets		
Bar inventory		200
Other receivables - Rent prepaid	90	
Subscription in arrears		3 500
Equipment		13 000
Bank		700
		17 490
Less liabilities		
Bar payables		1000
Other payables - Electricity accrued	150	
Subscriptions	6000	7 150
Accumulated Fund		10 340

(W2) Bar Trading A/c

Revenue			8 000
Less Opening inventory		200	
Add purchases (W1)	3 900		
		4100	
Less Closing inventory		900	3200
Gross Profit			4800

Payables/Creditors Control ledger Account

(iii)

Bank	4 200	Bal. b/d	1 000
		Purchases	3 900
Bal. c/d	700		
	4 900		4 900

(iv) **Subscription Account**

	$		$
Bal. b/d	3 500	Bal. b/d	6 000
Income & expenditure	27 200	Bank	28 000
Bal. c/d	8 000	Bal. c/d	4 700
	38 700		38 700
		Bal. b/d	8 000

(v) **Rent account**

Bal. b/d	90	Income & Expenditure	1 160
Bank	1 200	Bal. c/d	130
	1 290		1 290

(vi) **Electricity**

Bank	5 400	Bal. b/d	150
Bal. c/d	400	Inc. & Exp.	5 650
	5 800		5 800

Statement of comprehensive income for the year ended 31 Dec 1999

	$	$
Subscription (W1)		27 200
Profit from Bar (W2)		4 800
Donation		50
Dinner dance receipts	6 000	
Less Dinner dance expenses	(2 500)	3 500
		35 550
Less expenditure		
Printing and stationery	1 500	

Rent (W v)		1 160		
Electricity (W vi)		5 650		
Cleaning & Laundry		1 900		
Depreciation – equipment	(10% x 14 500)	1 450		11 660
Surplus of income over expenditure			23 890	

Statement of financial position as at 31 December 1999

Non-current Assets	**Cost**	**Dep.**	**N.B.V.**	
Equipment	14 500	1 450	13 050	
Current Assets				
Inventory		900		
Bank		24 550		
Rent prepaid		130		
Subscription in arrears		4 700		
		30 280		
Less Current Liabilities				
Trade payables	700			
Subscription in advance	8 000			
Electricity accrued	400	9 100	21 180	
				34 230
Financed by:				
Accumulated Fund (W1)				10 340
Surplus of income over expenditure			23 890	
				34 230

17.7 End of chapter questions

17.7.1 Question 1

The Ladies Social Club was formed on 1 January 1999. On 31 December 2000, the treasurer presented a list of receipts and payments as follows.

	$	$
Receipts		
Opening bank balance		15 000
Subscriptions		28 000
Net income from raffle draws		12 000
Donations		10 000
		75 000
Payments		
Rent of club house	10 000	
Printing and stationery	8 000	
Electricity and water	5 600	
Telephone and postage	4 100	
Insurance	3 200	
Net payment from dinner dance	8 600	39 500

Closing bank balance	35 500

The treasurer reported that:

(a) Stationery worth $1 000 was unused at the end of the period.
(b) Subscriptions In advance amounted to $200 whilst subscriptions in arrears amounted to $1 200 31 December 2000.
(c) Insurance was paid to cover a period from 1 January up to 31 October 2000.

You are required to prepare the club's income & expenditure account for the year ended 31 December 2000.

17.8 Examination type questions

Question 1

Complete the following table to name the equivalent terms used by a non- trading organisation.

TRADING BUSINESS		**NON- TRADING ORGANISATION**
(i)	Cash book	---------------
(ii)	Net Loss	---------------
(iii)	Capital	---------------
(iv)	Profit and Loss	---------------

(b) The treasurer of EL NINO Club presented the following account.

SUBSCRIPTION A/C

2005			2005		
August 1	Balance b/d	750	August 1	Balance b/d	300
2006			2006		
July 31	Income & Expenditure	4 500	July 31	Bank	5 850
	Balance c/d	900			
		6 150			6 150
			2006 Aug 1	Balance b/d	900

REQUIRED:

Explain each of the entries is the subscriptions A/C as it appears in the ledger of EL NINO Club.

Question 2

On 1 February 2006, the Boozers Social Club had the following assets and liabilities:

	$
Club Premises	20 000
Bar Stocks	2 000
Bar Creditors	1 800
Subscriptions prepaid	200
Balance at Bank (DR)	1 300
Cash in hand	200
Electricity owing	500
Subscriptions owing	600

(a) Calculate the balance of the Club's Accumulated Fund on 1 February 2006, showing all your working.

(b) State 3 differences between a Receipts and Payments and an Statement of comprehensive income account.

(c) Complete the following sentence: Subscriptions prepaid is shown as a --------- in the Statement of financial position while subscriptions owing is shown as a ---------------.

Question 3

The balances in the books of Sisonke Sports Club on 1 March 2002 were: -

	$
Bank	640
Equipment	1 500 (original cost - $2 500)
Insurance Prepaid	120
Subscriptions owing	200
Accumulated Fund	2 460

The Treasurer produced the following information for the year ended 28 February 2003.

Receipts			Payments		
Balance 1 February 2003		640	Athletic Association Fee		150
Subscriptions	3 450		Annual party expenses	1 890	
Sale of annual party tickets	2 160		Rent of Stadium	1 350	
			Insurance		370
			Purchase of new equipment	1 600	
			Travelling expenses		47.5
			General Expenses		195
			Balance c/d		220
		6 250			6 250
Balance b/d		220			

Additional Notes:

1. Subscription prepaid for 28 February 2003 --------------- $300.
2. Insurance prepaid --------------- $175
3. Equipment is to be depreciated at 20% using the straight line method on the total equipment held at the end of the year.

REQUIRED:

(a) Statement of comprehensive income for the year ended 28 February 2003.
(b) Statement of financial position as at that date.

Question 4

The following Trial Balance was extracted from the books of Newsnet Social Club on 31 August 1996.

	Debit	Credit
Accumulated Fund – 1 Sept 1995		48 650
Bar inventory 1 Sept 1995	5 200	
Bar Supplies	37 200	
Bar Takings		83 400
Wages	29 250	
Sports Equipment	60 000	
Treasurer's Salary	5 000	
Secretarial Expenses	3 100	
General expenses	2 500	
Rates and insurance	4 250	
Subscriptions received		17 000
Profit on social events		3 750
Land and buildings	6 300	
	152 800	152 800

Additional Information:

1.	At 31 August 1996:	Subscriptions accrued	700
		Bar inventory	6 000
2.	Of the total wages of $29 250, wages of bar staff were		$12 500.
3.	Depreciate sports equipment by 10% per annum.		

<u>REQUIRED</u>: AT 31 AUGUST 1996

(b) Bar Trading Account
(c) Statement of comprehensive income

Question 5

On 1 April 2002, balances in the ledger of Nomads Karate Club included the following;

	$
Insurance (debit)	200
Subscriptions prepaid	500

During the year ended 31 March 2003, the Club paid $1 800 for insurance by Cheque and received cheques totalling $2 600 for subscriptions.

On 31 March 2003, Insurance prepaid - $250
Subscriptions received in advance - $300
Subscriptions owing $100

Write up the Club's Ledger Accounts for Insurance and Subscriptions for the year ended 31 March 2003.

18. PARTNERSHIP ACCOUNTING

18.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Define the term 'Partnership'*
- *Explain the advantages and disadvantages of forming a partnership.*
- *Outline the importance and contents a partnership agreement.*
- *Explain the purpose of an appropriation account.*
- *Show the treatment of interest on partners' loans, interest on capital, interest on drawings, partners' salaries and the division of the balance of profit of loss.*
- *Prepare the:*
  - *Statement of comprehensive income*
  - *Appropriation account*
  - *Current Accounts.*
  - *Capital.*
- *Prepare the Statement of financial position with the Adjustments.*
- *Explain the uses of, and differences between, capital and current accounts.*

18.2 Introduction

A partnership is as a business entity which is owned by more than one up to a maximum of twenty people. The partners' major objective is to make profit and sharing it using agreed profit and loss sharing ratios.

There is no maximum number of partners to professional like firms of chartered accountants, solicitors, and etc. There is no maximum because they are not allowed by their professional standards to register themselves as a Company under the provisions of the Companies Act. The maximum number of partners is set at 20 because anything more than that will be difficult to co-ordinate the partnership. More than 20 people would register themselves as a limited liability Company.

18.3 The advantages of a partnership business

1. More capital is raised compared to a sole trader business.
2. Losses are shared between partners.
3. Skills and expertise are shared thereby enhancing the competitiveness of the business.
4. The partners can cover each other in the event of sickness or holidays.
5. It improves the quality of decisions due to consultations.

18.4 The disadvantages of a partnership business

1. There might conflicts regarding the decisions to be taken.
2. It slows down the decision making process due to consultation.
3. Profits have to be shared among the partners.
4. The business has unlimited liability that is in the event of the business failing to pay its debts, personal assets of the owners may be attached to cover the liability.

18.5 The partnership deed

This is a verbal or documented agreement made by the partners before entering into a partnership. The following are the common provisions of this deed.

(a) Capital to be contributed by each partner.
(b) Profit and Loss sharing ratios.
(c) Salary allowable to partner (s), if any.
(d) Maximum amount of drawings.
(e) Interest charged to partners` drawings
(f) Interest allowable on partner's capital and loan.

18.6 The appropriation account

This account shows how the profits have been appropriated or shared by the partners. The following is a pro -forma of an appropriation account.

	$	$
Net trading profit		xxx
Add interest on drawings		xxx
Less interest on capital		(xxx)
Less salary	(xxx)	(xxx)
Profit or (loss) to be shared		xxx

18.7 The capital and current accounts

The capital and current accounts of a partnership should be shown separately. This is up to the partners to show the two separately but it is not a regulation. If there is no capital injection during the year, the capital account will remain fixed from period to period. Transactions relating to the sharing and appropriation of profits and losses are entered in the current account. A current account should be like the one shown below. The closing balance on the current account is then transferred to the Statement of financial position. A credit balance means that the partner has sufficient funds in the partnership and is added to capital in the Statement of financial position whilst a debit balance shows that the partner has withdrawn more than his/her share of profits.

Current account

Balance b/d	xxx	Balance b/d	xxx
Drawings	xxx	Share of profit	xxx
Interest on drawings	xxx	Salary	xxx
Share of loss	xxx	Interest on capital	xxx

Interest on loan	xxx

After balancing off the above account, the balance is transferred to the Statement of financial position as an addition or deduction to the capital accounts.

18.8 The difference between a partnership and a sole trader

1. The capital of a sole trader is contributed by an individual whilst for a partnership it is contributed by the partners.
2. A sole trader does not prepare a current and an appropriation account.

18.9 Fully worked examples with solutions

18.9.1 Example 1

X and Y are in partnership sharing profits and losses in the ratio 3:2 after charging interest on capital accounts at the rate of 5% per annum and salaries of $9 000 and $6 000 per annum respectively. The capital balances at the beginning of the year are X: $50 000, Y: $40 000. In their first year of trading, the partnership made a loss of $25 000. The partners do not maintain current account

<u>Required</u>: -

Prepare:

a) Profit and Loss appropriation a/c.

b) Partners' capital Accounts

<u>Solution</u>

				$
Net Loss				25 000
Add Salaries	X			9 000
	Y			6 000
				40 000
Less Interest on capital				
X	5% x 50 000	2 500		
Y	5% x 40 000	2 000		4 500
				44 500
Share of loss	X		26 700	
	Y		17 800	**44 500**

b) **Capital Accounts**

	X	Y		X	Y
Share of Loss	26 700	17 800	Bal. b/d	50 000	40 000
Balance c/d	34 800	30 200	Salary	9 000	6 000
			Interest on capital	2 500	2 000
	61 500	**48 000**		**61500**	**48 000**
			Balance b/d	34 800	30 200

18.9.2 Example 2

The following trial balance was extracted from the books of the partnership of John and Smith.

	Dr. $	Cr. $
Capital: John		30 000
Smith		50 000
Provision for dep. Fixtures & fittings		4 560
Motor vehicles		12 400
Drawings: John	2 000	
Smith	3 000	
Current accounts: John		5 000
Smith		6 030
Revenue		200 410
Opening inventory	18 000	
Wages and salaries	36 900	
Rent	11 000	
Stationery	4 500	
Purchases	128 600	
Debtors	31 400	
Creditors		24 600
Telephone	14 400	
Sundry expenses	9 056	
Bank charges	3 100	
Cash at bank	16 044	
Fixtures and fittings	24 000	
Motor vehicles	31 000	
	333 000	333 000

Additional information

1) The partnership agreement provides for the following provisions:
   a) 10% interest allowed on partners' capital balances.
   b) Profits and losses to be shared equally.
   c) Interest on drawings is charged at the rate of 10%.
   d) John is entitled to a salary of $5 000.
2) Stationery unused at the end of the period amounted to $500.
3) Rent prepaid amounted to $1 000.
4) Inventory on hand at the end of the period amounted to $42 100.
5) Telephone expense owing amounted to $600.
6) Depreciation is provided as follows:
   a) Fixtures and fittings, at the rate of 10% using the reducing balance method.
   b) Motor vehicles, at the rate of 20% on cost.

You are required to:

(a) Prepare the Statement of comprehensive income for the year ended 31 March 2001 including the profit and loss appropriation account and
(b) A Statement of financial position as at that date.

Solution

Statement of comprehensive income for the year ended 31 March 2001.

	$	$
Revenue		200 410
Less cost of sales		
Opening inventory	18 000	
Add purchases	128 600	
	146 600	
Less closing inventory	42 100	104 500
Gross profit		95 910
Less expenses		
Wages and salaries	36 900	
Rent (11 000 – 1 000)	10 000	
Stationery (4 500 – 500)	4 000	
Telephone (14 400 + 600)	15 000	
Sundry expenses	9 056	
Bank charges	3 100	
Depreciation: Fixtures and fittings	1 944	
Motor vehicles	6 200	86 250
Net profit		9 710
Add interest on drawings		
John (2 000 x 5%)		100
Smith (3 000 x 5%)		150
		9 960
Less interest on capital		
John (30 000 x 10%)	3 000	
Smith (50 000 x 10%)	5 000	
Less salary to John	500	8 500
		1 460
Share of profits: John (½)	730	
Smith (½)	730	1 460

Current accounts

	John	Smith		John	Smith
	$	$		$	$
Drawings	2 000	3 000	Balance b/d	5 000	6 030
Interest on drawings	100	150	Interest on capital	3 000	5 000
Balance c/d	7 130	8 610	Salary	500	-
			Share of profit	730	730
	9 230	11 760		9 230	11 760
			Balance b/d	7 130	8 610

John and Smith Statement of financial position as at 31 March 2001

	$	$	$
Non-current assets			
	Cost	Depreciation	Net book value
Fixtures and fittings	24 000	6 504	17 496
Motor vehicles	31 000	18 600	12 400
	55 000	25 104	29 896
Current assets			
Inventory of goods		42 100	
Inventory of stationery		500	
Trade receivables		31 400	
Other receivables - Prepayments		1 000	
Bank		16 044	
		91 044	
Less Current liabilities			
Trade payables	24 600		
Other payables	600	25 200	
Working capital			65 844
			95 740
Financed by:			
	Capital accounts	Current accounts	Total
John	30 000	7 130	37 130
Smith	50 000	8 610	58 610
	80 000	15 740	95 740

18.10 Examination type questions

Question 1

Pinky and Peter are in partnership sharing profits equally. On 31 March 1992, the following balances were extracted from the partnership books.

		DR	CR
Capital Accounts	Pinky		100 000
	Peter		150 000
Current accounts	Pinky	4 000	
	Peter		6 000
Drawings	Pinky	6 000	
	Peter	10 000	
Inventory (1 April 1991)		56 000	
Purchases and Revenue		180 000	300 000
Discounts		7 000	9 000

Salaries and Wages	30 000	
Rent and rates	15 000	
Administration expenses	14 000	
Insurance	8 000	
Bank	28 000	
Debtors And Creditors	52 000	22 000
Provision for bad debts		3 000
Motor vehicles at cost	240 000	
Provision for depreciation on vehicles		60 000
	650 000	650 000

Additional Information:

(i) Inventory at 31 March 1992 $86 000

(ii) The partners are entitled to interest on capital at 10% p.a.

(iii) Provision for bad debts to be adjusted to $2 000 at 31 March 1992.

(iv) Depreciate motor vehicle at 20% p.a. on cost.

(v) Administration expenses owing $1 000.

REQUIRED:

(a) The partnership Statement of comprehensive income and an Appropriation account for the year ended 31 March 1992.

(b) The Current Accounts of partners at 31 March 10992.

(c) The partnership Statement of financial position as at the same date.

Question 2

50. For each of the following items place one tick in the:

(a) Correct box to show where it appears in a partnership final account.

	INCOME STATEMENT	**APPROPRIATION A/C**
1. Interest on a partner's capital		
2. Interest on a Loan from a partner		
3. Interest on a partner's drawings		
4. Partner's Salaries		

(b) State any 4 items that must be contained in a partnership Agreement or Deed of Agreement.

King and Ozone are partners. **They have agreed to the following:**

(i) Interest is to be allowed on capital at 7% p.a.
(ii) Interest is to be charged on drawings at 5% per annum.
(iii) Ozone is to receive an annual salary of $12 000.
(iv) Profits and losses are to be shared in proportion to their capitals.

For the year ended 31 August 200, the partnership earned a net profit of $24 600. The following balances also appeared in the partnership books.

			$	
Capitals (1 September 1999)	King	30 000		
	Ozone	20 000		
Current accounts	King		3 600	(CR)
	Ozone		1 200	(DR)
Drawings	King		9 000	
	Ozone		17 000	

PREPARE:

(a) Profit and Loss Appropriation account for the year ended 31 August 2000.
(b) Partners' Current Accounts for the year ended 31 August 2000.

Question 3 .

B. Bongo and W. Wedu went into partnership to take over the business carried on by N. Nyoni. They agreed to share profits and losses equally.

The following is the Statement of financial position of N. Nyoni.

Statement of financial position as at 31 December 2000

Assets			**Liabilities**	
Land and buildings		20 000	Capital	42 000
Motor vehicles		12 000	Trade Creditors	9 000
Furniture		1 000		
Stock		10 000		
Trade debtors	6 600			
Cash		800		
		51 000		51 000

All assets and liabilities except cash were taken over by the new partnership. The stock was taken over at $9 800. The purchase price was agreed at $48 000 which was to be settled equally by the partnership. A bank account was opened and Nyoni was paid by cheque on 1

January 2001. The partners contributed a further $2 000 each in cash. In addition, Bango brought furniture valued at $1 000 into the business.

REQUIRED:

(a) Definition of Goodwill

(b) Calculation of Goodwill

(c) The opening Statement of financial position of the partnership.

19. ACCOUNTS FOR LIMITED LIABILITY COMPANIES

19.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Define the term 'limited liability'.*
- *Distinguish between authorised, called-up and paid-up share capital.*
- *Distinguish between share capital (preference shares and ordinary shares) and loan capital (debentures).*
- *Prepare the Statement of comprehensive income and the Appropriation account.*
- *Explain the capital structure of a limited company comprising preference share capital, ordinary share capital, general reserve and retained profits.*
- *Distinguish between capital reserve and revenue reserve.*
- *Prepare the Statement of financial position with the adjustments.*

19.2 Introduction

A company is a legal entity, which is formed by registration under the Companies Act *[Chapter 24: 03]*, in Zimbabwe. Legally a company is recognised as a person, i.e. it can own property, dispose of it, employ people, sue and be sued just like a natural person. The registration is achieved by making an application to the Registrar of Companies, which should be accompanied by two statutory documents namely, the Memorandum of association and the articles of association.

19.3 Limited liability

A company has limited liability that is its affairs are independent of those of its members (shareholders) and its management. This concept means that in the event of the business failing to pay its debts the members will only lose the amount of paid share capital. It therefore follows that no personal assets of the owners will be taken to cover the liability of the company.

19.4 The memorandum and the articles of association

The Memorandum governs the company with outside world. The following are the provisions, which should appear in the memorandum.

a) The name of the company, which shall have *limited* as the last word.
b) The objectives of the company.
c) A statement that the liability of members is limited
d) The amount of share capital with which the company propose to be registered.

The articles contain rules that regulate the internal affairs of the Company. In the absence of written down articles, the company can adopt all or any of Table A articles in the First Schedule of the Act. The following are some of the articles:

a) Powers and duties of directors.
b) Disqualification of directors.
c) Proceedings at general meetings.
d) Votes of members.

19.5 Private and public companies

Two types of limited companies can be formed under the Zimbabwean Companies Act namely companies limited by guarantee and those limited by shares. At this level we only deal with companies limited by shares. A Company limited by shares is one in which the liability of the member is limited to the maximum amount of capital paid or credited on the shares received. We have two types, Private Company and Public Company.

The following are some of the attributes of a private company:

a) It is prohibited by the Act to offer its shares to the public for subscription.
b) An individual can form a private company.
c) The number of its members is limited to fifty.
d) Cannot trade its shares on the Stock Market.

With a public company,

a) It is allowed to offer its shares to the public for subscription.
b) The shares can be traded on the Stock Market.
c) There is no limit to the number of members forming a public company.
d) A minimum of 7 members can form a public company.

19.6 Ordinary and preference share capital

People who buy shares in a company are known as shareholders. The capital that shareholders invest in a company is known as share capital. A limited company can be registered with different classes of share capital. The main classes of share capital are ordinary shares and Preference shares. The following are some of the characteristics of the ordinary share capital.

a) Ordinary shares carry voting rights.
b) Ordinary shares do not carry a fixed rate of dividend.
c) Ordinary share dividend is paid after preference dividend and is proposed by the directors of the company at each annual general meeting. The shareholders do not have the power to force the company to pay them a dividend if the director decides not to pay them.
d) Ordinary shares are traded on the Stock market, in the case of a public company.

Preference shares are attributed to the following:

a) They do not carry voting rights.
b) If a preference share dividend is in arrears for 3 consecutive years, preference shareholders are given some voting rights.
c) Cannot be traded on the stock market.
d) Carries a fixed rate of dividend, which should be paid whether the company has made some profits, or not.
e) Preference share dividend is paid before the ordinary share dividend is paid.

19.6.1 Authorised share capital

This is the maximum share capital that a Company may issue as Authorised by the registrar of Companies. It is also known as the registered capital.

19.6.2 Issued Share Capital (Paid up share capital)

These are shares issued to shareholders and can be less than or equal to the Authorised share capital. In return for their investment, the shareholders will receive a dividend that is a share of profit. They are of two types; interim and final. A company in addition to issue shares can also issue debenture which is a loan to the company carrying a fixed rate of interest per annum based on the nominal value and should be paid whether a company makes a profit or not. Debentures are not part of the share capital.

19.7 Called up share capital

This is the amount of share capital the company has requested its shareholders to pay. It differs from the issued share capital because the latter (paid up) has already been issued to the members and was paid for.

19.8 Debentures

A company, in addition to the issued share capital, can also issuing debentures which represent a loan to the company carrying a fixed rate per annum based on the nominal value and should be paid whether a company makes a profit or not. Debentures are not part of the share capital. These are long-term debt capital. Debenture holders are not owners of the company but rather they are creditors to the company. Debentures carry a fixed rate of interest e.g. 10% Debentures. 10% percent is the rate of interest on those debentures. The debenture interest is an expense to the company not an appropriation of profits.

19.9 Final Accounts of a limited company

The manufacturing and trading accounts of limited companies are basically the same as those of sole traders and partnerships. The profit and loss account of a limited company like that of a partnership is divided into sections – the profit and loss account and the appropriation account.

In addition to the normal revenue and expense, the Statement of comprehensive income of a limited company also shows the following expenses.

a) Directors' emoluments – these are the salaries and fees paid to the company directors. They are charged to the profit and loss accounts because directors are employees of the company.
b) Debenture interest – this is interest paid on long term loan.
c) Auditors' remuneration – this is referring to salaries paid to auditors.
d) Income from investment, which is dividends or interest, received from another company in which the company bought shares or debentures

19.9.1 The format of the Statement of comprehensive income and appropriation account

		$
Net profit before tax		xxx
Less tax provision		(xxx)
Net profit after tax		xxx
Retained profit b/f		xxx
Less: Transfer to reserves	xxx	

Preference Dividend -Interim		xxx	
- Final		xxx	
Ordinary dividend - Interim		xxx	
- Final		xxx	xxx
Retained profit for the year			xxx
Add retained profit b/fwd			xxx
Retained profit c/fwd			**xxx**

19.9.2 Statement of financial position format

	$	$	$
Non-current assets			xxx
Investments (if long term)			xxx
			xxx
Current assets			
Inventory		xxx	
Investment (if short term)		xxx	
Trade receivables		xxx	
Other receivables		xxx	
Bank		xxx	
		xxx	
***Less* Current Liabilities**			
Trade payables	xxx		
Other payables	xxx		
Provision for tax	xxx		
Final dividends proposed	xxx	xxx	
Working capital			xxx
***Less* long-term liabilities**			
Debentures			xxx
			xxx
Capital and reserves			
Ordinary share capital			xxx
Preference share capital			xxx
Capital reserves			xxx
Revenue reserve			xxx
			xxx

19.10 Provisions and Reserves

A provision is an amount of pre-tax profit set aside for a known expense whose amount is uncertain. E.g. Provision for depreciation, Provision for bad debts, Provision for damages on a case, which is before the courts and where it is almost certain that the company will lose the case. A reserve is any post tax profit set aside which is not a provision e.g. General reserve, Distribution reserve; however, there are other reserves which do not arise from profit but from the requirement of the Companies Act. E.g. share premium. Provision can be distinguished from reserves in that Provisions are entered in the Statement of comprehensive income as an expenses (in case of increases) and as income (in case of decreases) whereas reserves are appropriation of profits.

19.11 Reserves

Reserves are of two types, capital reserves that are non-distributable reserves and are created as per requirements of the Companies Act e.g. share premium, capital redemption reserve and revaluation reserve. While revenue reserves are distributable reserves e.g. retained profit and general reserve.

19.11.1 Capital reserves

A capital reserve is sometimes referred to as a non- distributable reserve because it cannot be used to pay cash dividends. It is created by the requirements of the Companies Act example capital reserves are.

<u>Share premium</u>
This reserve is created when shares are issued at a price that is above their par value. Let's suppose that shares with a par value of $1 are being issued at a price of $1.50. The par value of $1 per share should be transferred to a share capital account whilst the balance of 50c representing share premium should be transferred to a share premium account created for that purpose.

<u>Capital redemption reserve</u>
This reserve is created when shares are being redeemed out of internally generated finance. It is created by transferring an amount equal to the nominal value of shares being redeemed from a suitable revenue reserve to the capital redemption reserve.

<u>Revaluation reserve</u>
This reserve is created when fixed assets are revalued. Let's take an example of land and buildings that increase in value from $450 000 to $500 000. The difference between the two values represents a revaluation reserve and it should be transferred to a revaluation reserve in accordance with requirements of the companies act.

19.11.2 Revenue reserves

They are referred to distributable reserves in the sense that they can be used to pay cash dividends. As explained above, transferring some funds from the Statement of comprehensive income to such a reserve creates these reserves. For example transferring undistributed profit from the profit and loss appropriation account to the general reserve account creates a general reserve. In turn, such a reserve can be used to pay cash dividends in the event that retained profits for the year are insufficient to meet such an obligation. A common example of a revenue reserve is retained profits in the appropriation account.

19.12 Fully worked examples with solutions

19.12.1Example 1

The following information was taken from the books of Summit Investments Limited on 31 December 1997.

	$
Authorised and issued share capital	
300 000 Ordinary share capital of $1 each, fully paid	300 000
100 000, 12% Preference shares of $1 each, fully paid[2]	100 000
General reserve (1 January 1997)	250 000
Profit and loss account (1 January 1997)	120 000
Interim dividend declared – Ordinary	60 000
Preference	10 000
Net profit for the year ended 31 December 1997	412 000

At the end of the year, the directors recommended that:

(a) To transfer $256 000 to the general reserve.
(b) The payment of the final preference dividend.
(c) The payment of a final ordinary dividend of 5 cents per share.

You are required to prepare the profit and loss appropriation account.

<u>Solution</u>

		$		$
Net profit for the year			412 000	
Less transfer to general reserves				<u>256 000</u>
				156 000
Less interim dividends:	Preference	10 000		
	Ordinary	<u>60 000</u>	<u>70 000</u>	
				86 000
Less final dividend:[3]	Preference	2 000		
	Ordinary	<u>15 000</u>		<u>17 000</u>
Retained profits for the year				69 000
Retained profit b/ fwd				<u>120 000</u>
Retained profit c/fwd				<u>189 000</u>

19.12.2 Example 2

<u>The Trial balance of Makuvaza limited as at 31 March 2002 was as follows:</u>

	Debit		**Credit**
	$		**$**
Land & Building	85 920		
Ordinary share capital		85 000	
Revenue			75 000
Opening inventory	5 000		
Purchases	28 000		
Retained profit			23 700

[2] *The 100 000 represents the number of preference shares in issue, whilst the 12% represents the rate of preference dividend as a percentage of the nominal value of the preference share. And the $1 represents the nominal value of each preference share.*

[3] *Final dividend = Preference [(0.12 x 100 000) –10 000) = $2 000*
Ordinary 300 000 shares x $0.05/share = $15 000

Motor vehicle		40 000		
Provision for depreciation				8 000
Preference Dividend			1 920	
Rent		1 500		
Light and Water		1 900		
10% Debentures				50 000
8% Preference shares			48 000	
General expenses		500		
Trade receivables		20 000		
Bank		8 080		
Motor expenses		1 500		
Debenture interest		2 500		
Wages and Salaries		2 100		
Bad debts		200		
Provision for bad debts				1 000
Directors emoluments	21580			
Auditing fees		5 000		
Trade payables				5 000
Cash on hand	70 000			
		295 700		**295 700**

Notes:-

1. Inventory at 31 March 2002 was valued at cost at $ 9 000
1. Motor vehicles are depreciated using the reducing balance method at 20%
2. Rent prepaid amounted to $500 and wages & Salaries accrued to $3300.
3. Provision for bad debts to be 4 % of Debtors
4. Tax of $2 200 is to be provided.
5. The directors proposed the following: -
   - To transfer $2000 to general reserve
   - To pay a dividend of 10% on ordinary shares.

Required

a) Statement of comprehensive income for the year ended 31 March 2002.
b) Statement of financial position as at 31 March 2002

Statement of comprehensive income of Makuvaza limited for the year ended 31 March 2002

	$		$
Revenue			75 000
Less Cost of Sales			
Opening inventory	5 000		
Purchases	28 000		
	33 000		
Less closing inventory	9 000		24 000
Gross profit			51 000
Decrease in provision for bad debts (1000 – 800)		200	
			51 200
Less expenses			
Rent (1 500 – 500)			1 000
Wages & Salaries (2 100 + 3 300)		5 400	

Light & Water	1 900	
Debenture interest (50 000 x 10%)	5 000	
Depreciation Motor vehicle 20% (40 000 – 8000)	6 400	
Director’s emoluments		21 580
Audit fees		5 000
Bad debts		200
General expenses		500
Motor expenses		1 500
Total expenses	48 480	
Profit before tax		2 720
Tax		2 200
Profit after tax	520	
Retained profits b/d		23 700
		24 220
Transfer to general reserve	2 000	
Dividend preference: -Interim	1 920	
-Final	1 920	
Ordinary proposed (10% x 85 000)	8 500	14 340
Retained profit c/d		**9 880**

Statement of financial position of Makuvaza limited as at 31 March 2002

	$	**$**	**$**
Non-current Assets			
Land & Building			85 920
Motor vehicle (4000-8000-6400)			25 600
			111 520
Current Assets			
Inventory		9 000	
Trade receivables	20 000		
Less provision for bad debts	800	19 200	
Bank		8 080	
Cash		70 000	
Other receivables		500	
		106 780	
Less Current Liabilities			

Tax payable	2 200		
Dividends (1 920 + 8 500)	10 420		
Wages accrued	3 300		
Debenture Interest	2 500		
Trade payables	5 000	23 420	83 360
			194 880
Capital and reserves: -			
Ordinary share capital		85 000	
Preference Share capital			48 000
General Reserve			2 000
Retained profits			9 880
			144 880
Add long-term debt (10% debentures)			50 000
			194 880

19.13 Examination type questions

19.13.1 The following balances were extracted from the books of Avon ltd on 30 June 2007.

	Debit **$**	**Credit** **$**
Authorised and issued share capital:		
200 000 Ordinary shares of $1.00 each		200 000
Purchases and revenue	301 000	397 000
Rent and rates	3 750	
Directors' fees	9 000	
Preliminary expenses	3 500	
Land and buildings	230 000	
Fixtures and fittings(cost $25 000)	16 000	
Bad debts	2 500	
Trade receivables and trade payables	33 000	20 000
Salaries and wages	29 000	
Inventory on I July 2006	31 000	
General expenses	8 000	
Bank overdraft		1 250
Provision for bad debts		500
Debenture interest	2 000	
8% Debentures		50 0000
	668 750	668 750

Additional information

1. Inventory on 30 June 2007 was valued at $3 500.
2. Rates paid in advance were $250.
3. Provision for bad debts was to be adjusted to 2% of trade receivables.
4. Depreciate fixtures and fittings by 10% on the written down value.
5. The directors recommended to pay a dividend of 10% for the year ended 30 June 2007.

Required

(a) Prepare the Statement of comprehensive income for the year ended 30 June 2007.
(b) Prepare the profit and loss appropriation account for the year ended 30 June 2007.
(c) Draw up a Statement of financial position as at 30 June 2007.

19.13.2 The following trial balance was extracted from the books of Derry ltd on 31 December 2008.

	Debit $	Credit $
Authorised and issued share capital:		
15 000 Ordinary shares of $1.00 each		15 000
Revenue		35 000
Purchases	28 500	
Sales returns and purchases returns	650	150
Rates and insurance	240	
Cash on hand	260	
Discount received		200
Motor vehicles	5 000	
Fixtures and fittings	1 530	
Bad debts	400	
Trade receivables and trade payables	5 500	3 480
Salaries and wages	3 250	
Inventory on I January 2008	3 000	
General expenses	250	
Rent received		400
Provision for bad debts on 1 January 2008		450
Rent paid	600	
Advertising	300	
Interim dividend paid	750	
Bank	4 250	
	54 480	54 480

Additional information
1. Inventory on 31 December 2008 was valued at $4 500.
2. Rates of $40 have been prepaid.
3. Transfer $1 000 to the general reserve.
4. Provision for bad debts was to be adjusted to 5% of trade receivables.
5. Rent received due was $50.
6. Depreciate fixtures and fittings by 10% per annum on cost and motor vehicles by 20% per annum on cost.
7. The directors recommended a final dividend of 15% for the year ended 31 December 2008.

Required
(a) Prepare the Statement of comprehensive income of Derry ltd for the year ended 31 December 2008.

(b) Prepare the profit and loss appropriation account of Derry ltd for the year ended 31 December 2008.

(c) Draw up a Statement of financial position of Derry ltd as at 31 December 2008.

19.13.3 The following trial balance was extracted from the books of Canon ltd on 31 December 2005.

	Debit $	Credit $
Authorised :		
400 000 Ordinary shares of $1.00 each		400 000
600 000 8% Preference shares of $2 each		1 200 000
Issued share capital:		
300 000 Ordinary shares of $1.00 each		300 000
375 000 8% Preference shares of $2 each		750 000
Revenue		466 200
Purchases	178 350	
Rates and insurance	17 700	
Land and buildings	800 000	
Motor vehicles	330 000	
Furniture and equipment	240 000	
Bad debts	4 300	
Trade receivables and trade payables	24 400	15 500
Salaries and wages	39 600	
Inventory on I January 2005	12 140	
Delivery expenses	8 160	
Provision for bad debts on 1 January 2005		300
10% Debentures		50 000
Directors' remuneration	18 000	
General reserve		100 000
Bank at bank	9 350	
	1 682 000	1 682 000

Additional information

1. Inventory on 31 December 2008 was valued at $4 500.
2. Rates owing amounted to $400.
3. Provision for bad debts was to be adjusted to 2% of trade receivables.
4. Debenture interest is still owing.
5. Depreciate motor vehicles by 5% per annum on cost and furniture and equipment by 2.5% per annum on cost.
6. The directors recommended:
   (i) a final dividend of 10c per share.
   (ii) a payment of dividend on preference shares.
   (iii) A transfer of $50 000 to the general reserve.

Required

(a) Prepare the Statement of comprehensive income of Canon ltd for the year ended 31 December 2005.

(b) Prepare the profit and loss appropriation account of Canon ltd for the year ended 31 December 2005.

(c) Draw up a Statement of financial position of Canon ltd as at 31 December 2005.

20. MANUFACTURING ACCOUNTS

20.1 End of chapter objectives

At the end of the topic, the student should be able to:

- *Understand the purpose of preparing manufacturing accounts and the cost classification*
- *Understand the accounting records required by a manufacturing business*
- *Prepare Manufacturing Accounts drawn up to show cost of materials consumed, prime costs and production costs.*
- *Prepare the Statement of comprehensive incomes of a manufacturing business*
- *Prepare the Statement of financial position of a manufacturing business*

20.2 Introduction

In this chapter we will discuss the preparation of Financial Statements of manufacturing business, which buy raw materials, convert them into finished goods and then sell.

A manufacturing business is required to prepare a manufacturing account in addition to the Statement of comprehensive income and the Statement of financial position. The purpose of manufacturing account is to find out how much it costs the company to produce finished products (i.e. to determine factory cost.). The factory cost is then transferred to the trading account to take the place of purchases. Manufacturing Cost is made up of four elements.

(1) Direct material
(2) Direct labour
(3) Direct expenses
(4) Factory overheads

20.3 Direct materials

These are raw materials, which becomes part of finished goods.

20.4 Direct labour

This refers to wages of employees who physically work on the products or operate machines that are used to produce the finished products. These exclude wages paid to the foreman, production manager/ controller/supervisor, and engineers, draft man, etc.

20.5 Direct expenses

These are expenses that are related directly to manufacturing goods. The most common examples are royalty and patents. The Total for direct material, Direct Labour and Direct expenses is prime cost.

20.6 Factory overheads

These are expenses which are incurred in the factory for the production of goods. They are not directly related to the production of goods but are necessary in the production of goods for example, factory supervisor's salaries, factory power, depreciation of plant and machinery and others.

20.7 Format of a manufacturing account.

Direct Materials

	$	
Opening inventory of raw material	xxx	
Add Purchases – Raw Materials		xxx
Add carriage inwards purchases		xxx
Less purchases returns	xxx	
	xxx	
Less Closing Stock	(xxx)	
Raw Material Consumed		xxx
Add Direct (manufacturing) wages	xxx	
Add Direct expenses, if any	xxx	
Price Cost	xxx	
Add Factory Overheads		
Indirect material		xxx

Plant & Machinery Insurance	xxx	
Plant & Machinery Repairs	xxx	
Rent & Rates	xxx	
Factory heat and light	xxx	
Add Opening Work In Progress		(xxx)
	xxx	
Less Closing Work In Progress		(xxx)
Factory cost of production	**xxx**	

Work In progress is partly finished goods at the beginning or end of the financial year of a business.
Format of trading account is like the following:

Statement of comprehensive income

	$	**$**
Revenue		xxx
Less Cost of sales		
Opening inventory of finished goods	xxx	
Add factory cost of production *(from above)*	xxx	
Add purchases of goods from outside suppliers (if any)	xxx	
		xxx
Less Closing inventory of Finished goods	xxx	
		xxx
Gross Profit		**xxx**

Statement of financial position

The Statement of financial position of a manufacturing business differs only on inventories. It shows three types of stock under current assets.

Current assets

Inventory of raw materials
Closing inventory of work in progress
Inventory of finished goods

Once the factory cost of goods has been determined in the manufacturing accounts, it is then transferred to the trading account in place of purchases. However, some firms do not produce enough products for sale, and as much they purchase some finished goods to supplement their requirements.

20.8 Apportionment of expenses

Care should be taken when a cost is to be apportioned between the manufacturing and profit and loss accounts requiring adjustments for accruals and prepayments. In such a case the adjustments should be done first before apportionment.

20.9 Fully worked example with solution

20.9.1 Example 1

The following, information was extracted from ABC Ltd`s books of accounts for the year ending 31 December 2000.

		$
Inventory of raw material at 1 Jan 2000		20 000
Purchases of raw material		80 000
Raw material returns to suppliers		2 000
Work in progress on 1 Jan 2000		1 500
Inventory of finished goods		30 000
Purchase of finished goods	11 000	
Direct Wages	9 000	
Royalties Payable		1 200
Carriage inward on raw material		3 000
Carriage outwards		1 400
Sales Salaries & Wages		1 800
Discount Received		900
Discount Allowed		400
Depreciation of plant & Machinery	1 600	
Rent & Rates		1 800
Insurance on plant		5 000
Maintenance staff wages		7 000
Factory cleaning material		300
Administration expenses		11 000
Revenue		180 000
Light & Heating		3 500

<u>Additional information</u>

1. Inventory of :Raw materials on 31 Dec. 2000 amounted to $28 000
   : Work in progress on - 31 Dec. 2000 $2 800
   : Finished goods - 31 Dec. 2000 $34 000
2. Light & heat, rent & rates are to be apportioned: Factory 80%, Office 20%
3. Light and heat accrued $500 and Rent prepaid $200.

<u>Required: -</u>

Prepare a manufacturing, Statement of comprehensive income for the year ended 31 December 2000.

SOLUTION

Manufacturing Accounts for the year ended 31 December 2000

Opening inventory of raw material		20 000		
Add Purchases of raw material		80 000		
Less returns of raw material	2 000			
		78 000		
Add carriage inwards	3 000		81 000	
				101 000
Less closing inventory of raw materials				28 000
Raw material consumed				73 000
Add Direct wages				9 000
Add Royalty				1 200
Prime Cost			83 200	
Add factory overheads				
Depreciation on plant & machinery		1 600		
Rent & rates (1 800-200) x 80%			1 280	
Insurance & Plant			5 000	
Maintenance & Wages			7 000	
Factory cleaning material			3 00	
Heat & Light (3 500+500) x 80%			3 200	18 380
				101 580
Add Opening inventory of work in progress			1 500	
Less Closing inventory of work in progress			2 800	
Factory cost of production c/d				**100 280**

Statement of comprehensive income

Revenue				180 000
Less cost of Sales				
Opening inventory of finished goods		30 000		
Add Factory Cost of goods produced b/d			100 280	
Add purchases of Finished goods			11 000	
			141 280	
Less Closing inventory of finished goods			34 000	107 280
Gross Profit				72 720
Add discount received			900	
				73 620
Less expenses				
Discount allowed		400		
Carriage outwards		1 400		
Sales- Salaries & wages		1 800		
Administration expenses		11 000		
Rent & Rates (1 800 – 200) x 20%	320			
Light & Heat (3 500 +500) x 20%		800	15 720	
Net Profit				**57 900**

20.9.2 Example 2

The following trial balance was extracted from the books of S. Moyo on 30 June 2002 after the preparation of the manufacturing accounts.

	Dr.	**Cr.**
	$	$
Capital		120 000
Plant and machinery at cost	40 000	
Provision for depreciation on plant and machinery		7 600
Trade debtors	10 000	
Trade creditors		30 000
Opening stock of finished goods	20 000	
Bank	15 000	
Revenue		180 000
Selling & administration cost	28 000	
Office wages and salaries	31 000	
General expenses	19 500	
Cost of goods manufactured	143 800	
Closing (30 June 2002) - Raw materials	9 000	
Work in progress	21 500	
Unpaid manufacturing wages		700
Factory rent and rates prepaid	500	
	338 300	338 300

Additional information

(a) Inventory of finished goods on 30 June 2002 was valued at $24 500.
(b) General expenses include rent payment of $2 500 for Mr. Moyo's private residence.

You are required to prepare a Statement of comprehensive income for the year ended 30 June 2002.

<u>Solution</u>

Statement of comprehensive income of Mr Moyo for the year ended 30 June 2002.

		$	$
Revenue			180 000
<u>Less cost of sales</u>			
Opening inventory of finished goods	20 000		
Add Cost of goods manufactured		<u>143 800</u>	
		163 800	
Less closing inventory of finished goods		<u>24 500</u>	<u>139 300</u>
Gross profit			40 700

<u>Less expenses</u>				
Selling and administration costs		28 000		
Office wages and salaries		31 000		
General expenses ($19 500 – $2 500)	17 000		76 000	
Net loss				35 300

<u>Statement of financial position of Mr Moyo as at 30 June 2002</u>

			$		$
<u>Non-current assets</u>					
Plant and machinery at cost				40 000	
Less provision for depreciation					7 600
					32 400
<u>Current assets</u>					
Inventory: Finished goods			24 500		
: Raw materials		9 000			
: Work in progress			21 500		
Trade receivables			10 000		
Other receivables -Factory rent prepaid			500		
Bank			15 000		
			80 500		
<u>Current liabilities</u>					
Trade payables		30 000			
Other payables -Manufacturing wages owing	700		30 700	49 800	
					82 200
<u>Financed by:</u>					
Capital					120 000
Less net loss					35 300
					84 700
Less drawings *(Moyo's private residence)*				2 500	
					82 200

20.10 End of chapter questions

20.10.1 Question 1

D. Mustafa is a manufacturer of wedding and graduation gowns. On 31 December 2006, he provided you with the following information.

			$
Opening inventories, 1 Jan. 2006 –	Raw materials	13 600	
	Work in progress		14 000
	Finished goods		23 000
Closing inventories, 31 Dec. 2006 –	Raw materials	12 500	
	Work in progress		16 900
	Finished goods		19 800
Raw materials purchases			143 600
Manufacturing wages		21 300	
Royalties and patent fees			6 000
Factory maintenance		10 000	

Revenue of finished goods	308 000	
Repairs to plant and machinery		5 600
Administration expenses		14 000
Factory rent and rates	5 000	
Selling expenses		12 000
Factory power		2 300
Carriage on purchases	1 300	
Depreciation of plant and machinery	3 580	
Bad debts written off	500	

You are required to prepare for the year ended 31 December 2006.

(a) The manufacturing account, showing clearly the cost of Raw Materials Consumed, Prime Cost and Cost of Production.
(b) The Statement of comprehensive income.

20.11 Examination type questions

Question 1

On 31 December 2010, the following balances were extracted from the books of Giga limited:

Inventories: at 1 January 2010

Raw materials	6 000
Work in progress	5 400
Finished goods	7 100
Revenue for the year	50 000
Purchases of raw materials	20 000
Royalties	1 500
Carriage inwards	800
Manufacturing wages	10 000
Factory overheads	25 000

Inventory: at 31 December 2010

Raw materials	5 900
Work in progress	4 500
Finished goods	6 500

(a) Prepare a manufacturing account for the year ended 31 December 2010. Show clearly within the accounts, cost of raw materials consumed, prime cost and cost of goods manufacturing.
(b) Prepare a Trading Account for the year ended 31 December 2010.

Question 2

The following balances were taken from the books of Lerato Manufacturing Company on 31 July 2007.

Raw Materials	Inventory 1 June 20064 500		
	Purchases		48 000
	Inventory 31 July 2007		5 000
Carriage on raw materials			1 000
Factory wages -	Direct	49 800	
	Indirect		33 600
Factory light and power			2 700
Factory general expenses			4 100
Machinery repairs			1 900
Depreciation of factory machinery			5 000

REQUIRED:

Prepare a Manufacturing Account for the year ended 31 July 2007.

Question 3

The following balances were extracted from the books of Lobels Biscuits Company on 31 May 2001.

Inventory, 1 June 2000	Raw materials	1 200	
	Work in progress		2 100
	Finished goods		3 200
Purchases of raw materials		11 500	
Revenue			49 500
Wages and salaries – Factory (direct)		14 600	
Plant and machinery at cost		10 000	
Office equipment			20 000
Carriage outwards			5 000
Factory fuel and power			2 700
Rates and insurance		2 650	
Carriage on raw materials			2 500
Lubricants for machinery			4 000
Factory heating and lighting		1 500	

Additional Information:

1. Inventories at 31 May 2001 were:

Raw materials	1 000	
Work in Progress		2 050
Finished goods		3 500

2. Rates and insurance prepaid 150
3. Factory wages accrued 200

4. Rates and Insurance of 4/5 relates to the factory.
5. Depreciation is written off as follows: Plant and machinery 10%
Office equipment 20%

REQUIRED:
Select relevant figures and prepare Lobels Manufacturing account for the year ended 31 May 2001.

Question 4

P. Ndlovu manufactures Bolts and Nuts. At 31 December 1991, the following information was extracted from the business records.

Inventories at 1 January 1991			
Raw materials		1 900	
Finished goods			2 500
Purchases of raw materials		61 000	
Manufacturing wages		38 400	
Carriage on raw materials			600
Workshop:	rent		12 000
	Power		15 000
	General expenses		1 200
Revenue			171 500
Inventories at 31 December 1991:			
Raw Materials		2 590	
Finished goods			6 500

REQUIRED:
(a) A manufacturing account for the year ended 31 December 1991, showing clearly.

(i) Raw materials consumed
(ii) Prime cost of production
(iii) Total cost of production

(b) Trading account for the same date.

21. ACCOUNTING RATIOS

End of chapter objectives

At the end of the topic, the student should be able to:

- *Understand the need for assessing the performance of a business in the following areas:*
  - *Profitability*
  - *Liquidity*
  - *Efficiency*
- *Calculate the ratios on profitability, liquidity and efficiency of a business*
- *Comment on the performance using the calculated ratios*
- *Calculate the following ratios:*
  - *Percentage of gross profit to sales, percentage of net profit to sales*
  - *Return on capital employed (ROCE)*
  - *Current ratio and quick ratio*
  - *Rate of inventory turnover*
- *Calculate and explain the significance of collection period for debtors; payment period for creditors*
- *Understand the significance of the difference between gross profit percentage and net profit percentage as an indicator of business's efficiency.*
- *Make recommendations and suggestions for improving profitability and working capital.*
- *Understand the problems of inter firm comparison due to factors such as differing accounting policies*
- *Recognise the limitations of accounting ratios..*
- *Discuss the uses of accounting ratios by different stakeholders e.g. owners, managers, banks, investors, suppliers, government and customers for decision making.*

21.1 Introduction

The purpose of accounting is to convey information to users, the Statement of comprehensive income will indicate the profit or loss made by an organisation in a period, while the Statement of financial position will provide a summary of its assets and liabilities at a given date.

Users of accounting information use ratios to gain better understanding of how an organisation has performed. For ratios to useful comparison is necessary.

21.2 The main themes covered by accounting ratios

1. **Profitability ratios** measure how much profit the business has generated from the sales revenue or on the capital employed. A business needs to earn sufficient profits to cover its costs and also to give satisfactory return on owner's equity.

2. **Liquidity ratios** measure the extent to which the company has sufficient current assets to meet its current liabilities. It shows the ability of the business to pay for its debts on time. Therefore liquidity ratios indicate the ***financial* stability** of a business.

3. **Asset utilisation** ratios show how effective the business is in use of its assets. These ratios measure how efficiently management uses and control the resources from day to day activities of the business e.g. stock, debtors and creditors.

4. **Investment ratios** examine the returns to owners of the business.

21.3 The meaning of the accounting ratios.

	Ratio	Meaning of the ratio
1	Gross profit percentage on sales (Gross profit Margin)	This ratio shows the percentage of gross profit that is being generated by the sales of the company.
2	Gross profit percentage on cost (Mark-up)	This ratio shows the percentage of gross profit generated (added to) from the cost of goods sold.
3	Net profit percentage on sales (Net profit margin)	This ratio shows the percentage of net profit that is being generated from sales of the company
4	Expenses ratio	This ratio shows the percentage of expenses incurred for the operation business in order to generate sales revenue.
5	Return on capital employed	This ratio measures the percentage of operating profit that is being generated by the use of total investment made in the business
6	Current ratio	This ratio measures the extent to which the company has sufficient current assets to meet its current liabilities.
7	Quick/Acid test ratio	This ratio measures the extent to which the company has sufficient current assets that are quickly convertible into cash to meet its current liabilities.
8	Inventory turnover ratio (in number of days)	This ratio shows the average number of days that the company takes to sell its stock
9	Trade receivable days (Debtors turnover ratio)	This ratio shows the average number of days that the company takes to collect money from trade debtors.
10	Trade payable days (Creditors turnover ratio)	This ratio shows the average number of days that the company takes to pay its trade creditors

21.4 Formulae of accounting ratios

21.4.1 Profitability Ratios

1. Gross Profit percentage on sales $= \frac{\text{Gross Profit}}{\text{Sales}} \times 100$

2. Gross profit percentage on cost $= \frac{\text{Gross Profit}}{\text{Cost of sales}} \times 100$

3. Expenses ratio $= \frac{\text{Expenses}}{\text{Sales}} \times 100$

4. Net Profit percentage on sales $= \frac{\text{Net profit}}{} \times 100$

Sales

5. Return on Capital employed = $\frac{\text{Net profit}}{\text{Capital Employed (Owner's equity + Loan)}} \times 100$

6. Return on equity = $\frac{\text{Net profit}}{\text{Owner's capital}} \times 100$

21.4.2 Liquidity Ratios

7. Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$

8. Acid Test / Quick ratio = $\frac{\text{Current assets – Stock}}{\text{Current liabilities}}$

21.4.3 Asset utilisation ratios

9. Inventory/Stock Turnover Ratio = $\frac{\text{Cost of sales}}{\text{Average stock}}$

Where average inventory = $\frac{\text{opening inventory + closing inventory}}{2}$

10. Trade receivables/Debtors days: = $\frac{\text{Trade receivables}}{\text{Credit sales}} \times 365$ days

11. Trade payables/Creditors days = $\frac{\text{Creditors}}{\text{Credit purchases}} \times 365$ days

21.5 A fully worked example

The following are financial statements of Mr. R Brown for the trading periods ended 31 December 2001

Statement of comprehensive income for the year ended 31 December 2001

	$	$
Revenue		500 000
Less cost of sales		
Opening inventory	65 000	
Add purchases	245 000	
	310 000	

Less closing inventory	71 500	238 500
Gross profit		261 500
Less trading expenses		
Rent and rates	15 000	
Salaries and wages	26 500	
Depreciation of fixed assets	6 000	
Taxation	10 000	
Interest on loan	2 000	
Other trading expenses	12 000	71 500
Net profit		190 000

Statement of financial position as at 31 December 2001

	$	$
Non-current assets		
Land and buildings		150 000
Motor vehicles		70 000
		220 000
Current assets		
Inventory	71 500	
Trade receivables	54 100	
Bank	45 000	
	170 600	
Less trade payables	40 600	130 000
		350 000
Financed by:		
Capital		203 000
Add net profit		190 000
		393 000
Less drawings		93 000
		300 000
Add long term loan		50 000
		350 000

21.6 Liquidity ratios

Liquidity ratios measure the ability of a business to meet its short-term debts using its current assets.

21.6.1 Current ratio or working capital ratio

Shows the number of times current liabilities are covered by current assets.

Current ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

$$\frac{170600}{40600} = 4.2:1$$

Factors that influence the Current Ratio

1. The nature of the business.
   - A business may require large stocks to be carried.
   - Or where sales are mainly on credit, a large amount of Debtors is carried in the Statement of financial position.
2. Where sales are seasonal, working capital will also fluctuate.

21.6.2 Acidity test ratio or quick ratio

Quick ratio sometimes referred to as liquidity ratio that measures the ability of the business's current assets other than stock to meet current liabilities. Stock includes work in progress, materials and finished goods. The rationale of excluding stock is that it is the least liquid working capital asset. In other words it cannot be readily converted into cash.

Quick ratio = $\frac{\text{Current assets – inventory}}{\text{Current liabilities}}$

$$= \frac{170600 - 71500}{40600} = 2.4:1$$

Comment

A quick ratio of 1:1 is generally considered satisfactory and as such Brown's quick ratio is satisfactory.

21.7 Profitability ratios

These ratios indicate the performance of a business. Investors are interested in knowing whether or not to invest in a business based on the return to their capital. For management, they need to assess their efficiency in terms of their ability to control expenses.

21.7.1 Gross Profit / Sales or Margin

Margin is gross profit expressed as a percentage or fraction of sales. It expresses the gross profit as a percentage of total sales.

Gross profit Percentage = $\frac{\text{Gross profit x 100\%}}{\text{Sales}}$

$$= \frac{261500}{500000} \times 100 = 52.3\%$$

Factors that may lead to a low gross profit percentage

1. An increase in the cost of sales not passed to customers.
2. Reductions in selling price to dispose of slow moving, damaged and obsolete stock.
3. Stolen stock not identified.
4. A price cutting policy usually as a measure to combat competition.
5. Bulk discounts being given to major customers.

21.7.2 Gross profit mark-up

Mark-up is gross profit expressed as a percentage or fraction of the cost price.

$$\text{Mark-up} = \frac{\text{Gross profit}}{\text{Cost of sales}} \times 100$$

$$= \frac{261500}{238500} \times 100 = 109\%$$

21.7.3 Net Profit Percentage

This expresses an organisation's net profit as a percentage of total sales.

$$\text{Net Profit \%} = \frac{\text{Net profit}}{\text{Sales}}$$

$$\text{Net profit percentage} = \frac{190000}{500000} \times 100 = 38\%$$

Factors that may lead to a low net profit ratio

i. A deliberate reduction of costs
ii. An increase in selling price without an increase in cost.

Notes:

A significant decrease in the net profit percentage that is not accompanied by a similar change in the gross margin might indicate that an organisation needs to improve control of its expenses.

21.7.4 Return on Capital Employed (ROCE)

Measures the return or profit made by the total assets employed in the business

$$\text{ROCE} = \frac{\text{Profit before interest \& tax}}{\text{Total capital employed}}$$

$$= \frac{202000}{300000} \times 100 = 67.33\%$$

$202 000 = [Net profit + tax + interest]
190 000 + 10 000 + 2 000

Importance

a) Investors to assess in percentage terms, the level of profit that can be generated by every dollar that they invest, use ROCE.
b) Investors will be satisfied with a return that is higher than what they expect to be compensated for the capital they have contributed in the business.
c) Investors & management can use it to evaluate alternative forms of investment.

What does a low or declining ROCE means?

a) An increase in the cost of borrowing may turn the business into a loss making Company.
b) Additional borrowings may have an adverse effect on profitability.
c) Can be used, as a base of evaluating investment projects, those with low ROCE will certainly be undesirable.

21.8 Assets utilisation

These ratios are used to measure the efficiency with which the resources have been used.

21.8.1 Inventory/Stock turnover ratios

Holding unnecessarily high levels of stock may be expensive for a business in terms of storage and security costs, and the greater the risk that goods will perish because of obsolescence and pilferage.

$$\text{Inventory turnover ratio} = \frac{\text{Cost of sales}}{\text{Average inventory}}$$

$$= \frac{238500}{68250} = 3.5 times$$

$$\text{Average inventory} = \frac{65000 + 71500}{2} = \$68250$$

This ratio measures the number of times; in a year a business sells its average stock. The higher the figure of rate of inventory turnover the better for the organisation.

Comment

A meaningful comparison of this ratio should be made with the average stock turnover in the industry; business in the retail industry should be expected to have a very high stock turnover. Businesses in electrical appliances, hardware and furniture are expected to have low stock turnover ratios as stock may take some time to be sold.

21.8.2 Trade receivables/Debtors Collection period

This ratio measures the period taken on average by trade receivables/Debtors to pay. As a general rule and where possible, average debtors of the opening and closing balances of debtors should be used. It can be calculated in days, weeks and months like the stock turnover ratio. The shorter the period the better, it means business collects its money quite early from t Trade receivables and hence becomes easy to pay its debts and other commitments (wages, bills and Creditors).

Trade receivables/Debtors collection (in days) = $\frac{\text{Trade receivables x 365}}{\text{Credit Revenue/Credit sales}}$

$$= \frac{54100}{500000} \times 365 = 39 days$$

Comment

The business may need to critically analyse the credit period offered to it by Creditors and to assess whether or not there are no pressures for quick availability of cash. In general, it is good for a business to have as short as possible a debtors collection period. It is not surprising for a business to find it technically insolvent with money tied up in Debtors who pay very late, while wages will need to be paid as well as Creditors. It is defined a bad habit to source short – term loans and overdrafts to finance Debtors. A comprehensive credit policy is very necessary, as it will:

a) Establish the maximum credit period perceived in the industry or by the company as best suited to its environment.
b) Establish who should be given credit based on the calibre of customers attracted.

21.8.3 Trade payables/Creditors payment period

Measures the period a business takes before paying its creditors. It is used to take full advantage of the credit period given by suppliers, however where discounts are given, a comparison may be necessary between the cost of finance for the full period of credit compared to the discount given. As a general rule and where possible, average creditors should be used. Where the discount is not meaningful, it is better to avail the full credit period. This will certainly help booster the business's cash flow position.

Trade payables turnover (in days) = $\frac{\text{Trade payables x 365}}{\text{Credit Purchases}}$

$$= \frac{40600}{245000} \times 365 days = 60 Days$$

Note:

Where a business fails to pay its creditors on time, lines of credit may be closed and this may lead to compulsory liquidation.

21.9 The uses of accounting ratios

1. The accounting ratios are the *performance indicators* of a business that is they show the areas of a business that need attention.

2. They are used as *benchmarks* against the same business or other businesses in the same industry.

3. They establish *trends* (changes) from past years on the performance of a business, that is whether the business is improving or not.

4. They provide a *standard* of comparison to make judgment on the performance of a business.

5. They are used to *estimate forward* the likely profit or financial performance of a business by making use of budgets.

6. Accounting ratios are used to *measure* the performance of business in the following areas of profitability, liquidity, effectiveness in use of assets and investment potential.

21.10 Examination type questions

Question 1
The following information relates to the business of Zimuto for December 1999.

Stock	30 000	(1 Jan 1998)
Stock	40 000	(31 December 1999)
Purchases	180 000	
Sales	100 000	
Railage in purchases		10 000
Returns inwards		5 000
Returns outwards		40 000

<u>REQUIRED:</u>

Calculate for 31 December 1999.

(a) Turnover
(b) Cost of Sales
(c) Gross profit mark- up
(d) Gross profit margin
(e) Rate of stock turn

Question 2

A business provided the following information for the year ended 30 September 2005.

Stocks:	1 October 2004		68 000
	30 September 2005		60 000
Mark up		25%	
Rate of stock turn		5 times	

CALCULATE:

(a) Average Stock
(b) Cost of goods sold
(c) Gross profit

Question 3

Brito has been in business for several years. He provides us with the following information for 31 March 2001.

Sales	200 000
Cost of Sales	60 000
Purchases	40 000
Expenses	20 000
Stock	9 000
Debtors	8 000
Bank (CR)	13 000
Expenses accrued	1 000
Income accrued	10 000

Calculate:

(a) Working capital
(b) Gross profit as a percentage of sales
(c) Current ratio
(d) Acid test ratio
(e) Net profit as a percentage of sales

Question 4

State the effect of the following on working capital, whether decrease, increase or no effect.

(a) Bought goods on credit from Pax Afro Ltd.
(b) A debtor, A Mandigora, paid his account by cheque.
(c) A new machinery was bought by cash.
(d) Stock worth \$5 000 was damaged by fire and the business decided to write it off.
(e) A creditor, M. Msimanga, was paid in full by cheque.
(f) Stock worth \$40 000 was bought on credit from T.V. Sales and Hire.
(g) One of the business debtors was declared insolvent and his debt was written off.
(h) The owner of the business took cash from the business as drawings.

(i) The business charged interest on all outstanding debtors.
(j) Returned stock worth $4000 to a supplier because of damages.

Question 5

ACCOUNTING THEORY

(a) --------------- shares carry a fixed rate of divided.
(b) The value of the good reputation and profit making capability of an existing business is called ----------------------.
(c) That part of the cost of a fixed asset consumed during its period of use is called --------------.
(d) The purchase of Motor Vehicles for resale is classified as ------------------ expenditure.
(e) The value of partly finished goods in a manufacturing business is called ----------.
(f) ----------------- is the source document for writing up a petty cash book.
(g) The Petty Cash Book operates on a system called ----------------------.
(h) A -------------------- balance on the packaging materials account after the preparation of final accounts means there is stock of unused packaging materials.
(i) In the ledger of a non- profit making organization, the capital account is replaced by the -------------------- account.
(J) ------------------- is a subsidiary book which is also part of the ledger.

References

Principles of Accounts by Edward Chamisa
Advanced Level Accounting By H Randalls
Practical Foundation in Accounting by Harry Johnson and Austin Whitam
Financial Accounting by Andrew Thomas
Acca newsletters by Philip Dun
International accounting Standards