

**Chalimbana University**

**Integrity. Service. Excellence**

**DIRECTORATE OF DISTANCE EDUCATION**

***BBE 2101: FINANCIAL ACCOUNTING***

**First Edition 2018**

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Private Bag E1

Lusaka

Zambia

Website: [www.chau.ac.zm](http://www.chau.ac.zm/)

**Author**

Matthew Ntabo

Martin Kabwe

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**ACKNOWLEDGEMENTS**

The Directorate of Distance Education wishes to thank Mr. Ntabo Matthew and Mr. Martin Kabwe for writing the Module (1) on Financial Accounting.

**MODULE OVERVIEW**

**Pre-requisite: None**

**Introduction**

Welcome to the course for ‘Financial Accounting.’ The course intends to explain the theoretical concepts of Accounting, preparation of accounts and reporting financial information. You will also learn how to record transactions as they occur on a daily basis, and be able to prepare reports that will assist users of financial information to determine whether the business made a profit or not. You will also be able to prepare reports that show the value of assets and liabilities that has at the end of a defined reporting period. Finally, you will learn how to analyse the trading results of the business in order to assess whether the business is doing well or not.

**Rationale**

Understanding the environment within which the business has to operate is very important for running a business unit successfully at any place. Environmental factors influence almost every aspect of business, be it its nature, location, the prices of products, the distribution system, or personnel policies. This course will therefore, enable learners to be aware of the various components of the business environment, which consists of the economic aspect, the socio-cultural aspects, the political framework, the legal aspects and the technological aspects etc.

Outcomes**Aim**

The aim of this course is to equip learners with the necessary knowledge about various factors that influence business operations.

Outcomes**Learning Outcomes**

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

* Explain the context and purpose of accounting framework of business entities.
* Record transactions and events.
* Demonstrate the use of the double - entry system of accounting and prepare a trial balance including identifying and correcting errors
* Account for assets and liabilities
* Prepare basic financial statements for incorporated and unincorporated entities.
* Evaluate financial performance of an organisation through calculation and analysis of basic ratios

**Summary**

The module looks at accounting framework, record transactions events, double entry accounting systems, how to account for assets and liabilities and preparation of financial statement.



**Prescribed Reading**

BPP(2011) Paper T1 Financial Accounting, 1st Edition. London: BPP Learning Media.

BPP(2013) FIA FFA Financial Accounting,2nd Edition. London: BPP Learning Media.

Wood,F. and Sangster, A.(2011) Business Accounting 1, 11th Edition. London: Pearson



**Recommended Readings**

Millichamp,A.H.(1997) Foundation of Accounting.DP Publications

Clark,P.J (1990) Financial Accounting.Gill & Macmillian

**STUDY SKILLS**

As an adult learner, your approach to learning will be different to that of your school days: you will choose when you want to study, you will have professional and/or personal motivation for doing so and you will most likely be fitting your study activities around other professional or domestic responsibilities.

Essentially you will be taking control of your learning environment. As a consequence, you will need to consider performance issues related to time management, goal setting, stress management, etc. Perhaps you will also need to acquaint yourself with areas such as essay planning, searching for information, writing, coping with examinations and using the internet as a learning resource.

Your most significant considerations will be *time* and *space* i.e. the time you dedicate to your learning and the environment in which you engage in that learning.

It is recommended that you take time now —before starting your self-study— to familiarise yourself with these issues. There are a number of excellent resources on the web. A few suggested links are:

<http://www.how-to-study.com/>

The “How to study” website is dedicated to study skills resources. You will find links to study preparation (a list of nine essentials for a good study place), taking notes, strategies for reading text books, using reference sources, test anxiety.

<http://www.ucc.vt.edu/stdysk/stdyhlp.html>

This is the website of the Virginia Tech, Division of Student Affairs. You will find links to time scheduling (including a “where does time go?” link), a study skill checklist, basic concentration techniques, control of the study environment, note taking, how to read essays for analysis, memory skills (“remembering”).

Time

**TIMEFRAME**

You are expected to spend at least 18 hours of study time on this module. In addition, there shall be arranged contact sessions with lecturers from the University during residential possibly in April, August and December. You are requested to spend your time judiciously so that you reap maximum benefit from the course.

Help**NEED HELP?**

In case you have difficulties during the duration of the course, please get in touch with your lecturer for routine enquiries during working days **(Monday-Friday)** from 08:00 to 17:00 hours on Cell: +260963804004**; E-mail:** [**adsikalumbi@gmail.com**](mailto:adsikalumbi@gmail.com)**; website:** [**www.chau.ac.zm**](http://www.chau.ac.zm/)**.**You can also see your lecturer at the office during working hours as stated above.

You are free to utilise the services of the University Library which opens from 07:00 hours to 20:00 hours every working day.

It will be important for you to carry your student identity card for you to access the library and let alone borrow books.

**LIST OF EQUIPMENT**

In this module you will need the following tools;

a scientific calculator.



**ASSESSMENT**

In this course you will be assessed on the basis of your performance as follows:

**Continuous Assessment 50%**

Assignment 10%

Project 15%

2 Tests of equal weight 25%

**Final Examination 50%**

**Total 100%**

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**UNIT 1: CONTROL ACCOUNTS AND RECONCILIATIONS**

## 1.1 UNIT **INTRODUCTION**

You have done very well, having made progress this far. Congratulations! In this unit I will discuss detailed account preparation. This is a build-up and application of the accruals basis of preparing accounts. The questions will have more issues that are handled when accounting for trade receivables.

Outcomes

## 1.2 UNIT **AIM**

The aim of this unit is discuss how complications are handled in accounts, given a number of issues that normally arise in the course of business.

Outcomes

## 1.3 UNIT OBJECTIVES

At the end of this unit you should be able to do the following

1. Prepare Trade Receivables and Trade Payables Control Accounts
2. Prepare personal accounts of customers and suppliers
3. Reconcile Control Accounts to the Sub-ledger Account Listing Totals.
4. Explain correction of identified errors

Time

## 1.4 TIME REQUIRED

You will be expected to spend about one and half hours on each of the subtopics listed in the objectives. Therefore, you will need a total of six hours to complete this unit.

****

## 1.5 REFLECTION

Supposing you received a call from one of your customers, asking for the balance on his account in your books. Do you think the amount will be exactly the same as the balance in his books? If you rang a supplier for the balance on your account in his books and he gave you a figure that is different from what you are showing in your ledger, what tasks would you carry out to ensure the balances in the two set of books agreed? This now takes us to the topic of Control Accounts.

# 1.6 UNIT TOPICS

## 1.6.1CONTROL ACCOUNTS AND RECONCILIATIONS

The ledger is the main book of accounts. It takes two major formats: the main ledger and the sub-ledger. Accounts in the main ledger are prepared for the purpose of preparing financial statements, namely Statement of Profit or Loss, and The Statement of Financial Position, as you saw from Fundamentals of Financial Accounting (BFA 1101). The sub-ledger contains personal accounts for individualcustomers and suppliers. These accounts are represented in the main ledger by the Trade Receivables Control Account and the Trade Payables Control Account respectively. The following exercise illustrates how transactions are posted to the Control Accounts as totals and how individual transactions are recorded in the personal accounts in the sub-ledger.

The following transactions appeared in the books of Rogers Mandevu in the month of August 2017 ( for the purpose of this exercise, VAT has been ignored):

August 2. Purchased goods on credit from Mpela K 380

August 4. Returned goods worth K 40 to Mpela.

August 6. Sold goods on credit to Peter Sinkala K 950. The customer is entitled to 2 % prompt discount.

August 10. Peter Sinkala returned goods, K 150

August 13. Bought goods on credit to Chomba K 680.

August 15. Issued an invoice to Sandra K 530.

August 18 Sandra becomes bankrupt and pay only K 300. The balance is irrecoverable.

August 20 Sold goods on credit to Anthony K 840

August 22. Sent a credit note to Anthony, K 130

August 24. Purchased Goods on credit from Phalesy K 340.

August 28. Received a credit note from Phalesy for K 65.

August 30. Peter Sinkala paid his account in full by cheque less 5% cash discount.

August 31 Settled Mpela’s account by cheque, less cash discount of 5%

**SOLUTION AND DEBRIEF**

The solution starts by presenting information as it would be posted into the main ledger in the Control Accounts. Then you draw up personal accounts, highlighting how omitted entries would cause an imbalance in the reconciliation. Thereafter, action to correct the errors is taken.

TRADE RECEIVABLES

DETAILS DEBIT DETAILS CREDIT

Sales 2,320 Sales Returns 330

Bank 1,060

Discount Allowed 40

\_\_\_\_ Balance c/d 890

2,320 2,320

Balance b/d 890

TRADE PAYABLES

DETAILS DEBIT DETAILS CREDIT Purchases Returns 150 Purchases 1,400

Bank 323

Discount Received 17

Balance b/d 955 \_\_\_\_

1,400 1,400

Balance b/d 955

PURCHASES (PAYABLES) LEDGER:

CHOMBA

Dr Cr

Purchases 680

Balance c/d 680 \_\_\_

680 680

Balance b/d 680

MPELA \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Dr Cr

Purchases Returns 40 Purchases 380

Bank 323

Discount Received 17

Balance c/d 0 \_\_\_

680 380

Balance b/d 0

PHALESY

Dr Cr

Purchases 340

Purchases Returns 65

Bank 0

Balance c/d 275 \_\_\_

340 340

Balance b/d 275

SALES (RECEIVABLES) LEDGER:

PETER SINKALA

Dr Cr

Sales 950 Sales Returns 150

Cash 760

Discount All 40

\_\_\_ Balance c/d -

950 950

Balance b/d -

SANDRA

Dr Cr

Sales 530 Bank 300

Irrecoverable Debts 230

\_\_\_\_ Balance c/d -

530 530

ANTHONY

Dr Cr

Sales 840 Sales Returns 130

\_\_\_ Balance b/d 710

840 840

Balance b/d 710

TRADE RECEIVABLES ACCOUNT BALANCES LISTING:

Peter Sinkala -

SANDRA -

ANTHONY 710

TOTAL 710

The balance on the Trade Receivables Account (the Control Account) is K890. And so there are errors made in the process of handling transactions with customers.

TRADE PAYABLES ACCOUNT BALANCES LISTING:

Mpela -

Chomba 680

Phalesy 275

TOTAL 955

The balance on the Trade Payables Account (the Control Account) is K 955.

There were no mutual errors made in the process of handling transactions with suppliers.

**DEBRIEF**

1. You can see that when total debit entries are equal to total credit entries in an account, there remains no balance to be taken to the following year.

2. When the balance on the control account is different from that on personal accounts as listed and totalled, then there is an error to investigate and correct. This was the case when the irrecoverable debt was not processed in the control account, and when the total purchases returns were overcast in the control account. 3. A reconciliation of the balance on the trade receivables control account with the listing total of account balance in the sales ledger would be drawn up as follows:

**RECONCILIATION STATEMENT**

Balance per Control Account 890

Add Overcast in Sales Returns 50

940

Less Omitted Irrecoverable debt 230

Balance per Listing total 710

All the errors in this illustration were made in the main ledger. If some errors were made in the sub-ledgers, the correction and adjustment for them would have been to the listing total.

## 1.6.2**ACTIVITIES**

The exercise above has been simplified to illustrate the system or process of handling control accounts. You will therefore be expected to read more on the topic from recommended text books. With increased knowledge you should be able to attempt the following exercise.

Frederick had the following balances on his Trade Receivables and Trade Payables on 1 November 2017.

Amounts owing to suppliers were K 35 840 and Customers owed K55 750 at the start of the month. Credit balances in the Receivables ledger amounted to K4 630 and debit balances in the Payables ledger totalled K2 345. Errors arising in the previous period had all been corrected.

During the month his daybooks showed the following totals:

K

Sales 785 360

Purchases 395 670

Returns outwards 28 720

Returns inwards 36 430

Receipts from customers 590 765

Payments to suppliers 290 404

Discounts allowed 12 573

Amounts written off to bad debts 14 175

Discounts received 8 346

Rebates on customer invoices 2 838

Receivables set off against payables

Ledger balances 6 934

Refunds of cash from suppliers 6 284

On 31 November 2017amounts owed to customers were K3 742. Suppliers who owed him amounts at start of the year had paid K 1 503.

**REQUIRED**

Prepare a Trade Payables Control Account and a Trade Receivables Control Account as it would appear in the general ledger of Frederick, showing the balances to carry forward to the month of December 2017.

The answer to this exercise should be submitted for marking within one week of completing this unit.

## 1.6.3 UNIT **SUMMARY**

In this unit you haveseen that control accounts are maintained to assist in detecting errors that April be made in preparing ledger accounts for customers and suppliers. The errors are then corrected by making entries in the affected ledger. The next section of this unit discusses the exercise of bank reconciliation.

# **UNIT 2: ACCOUNTING FOR TRADE RECEIVABLES**

## 2.1 UNIT INTRODUCTION

I very much commend you for the effort you have put in this far. You have covered topics that combine to define the accounting system of recording transactions in the day books and posting them to the ledger. You have also seen how amounts are transferred to the final accounts namely the statement of profit or loss account for the purpose of reporting a profit made. You now know how assets and liabilities are created when resources have not been consumed in the current period and when there is future settlement of a payable. The last two units introduced control systems in use. They first explained how to reconcile control accounts in the main ledger with balance listings of accounts in the sub ledgers: receivables ledger and payables ledger. The second discussed the reconciliation of the bank balance as shown on the bank statement with that reported on the cash book. In this unit I now go further in explaining what is involved in accounting for activities surrounding trade receivables. In addition to transactions discussed in earlier units, customers may have financial problems that prevent them from paying their debt on time. When the worst come to the worst, they may become bankrupt and the outstanding debt has to be written off as irrecoverable. This uncertainty compels businesses to carry out an aged analysis of receivables to identify debts that may not be settled and make a provision for a possible loss. I will in this unit illustrate how accounting entries are made to take care of irrecoverable debts and the allowance for receivables.

Outcomes

## 2.2 UNIT AIM

In this unit I will explain in detail how accounting for receivables is done.

Outcomes

## 2.3 UNIT OBJECTIVE

At the end of this unit you should be able to do the following

1. Prepare an Aged Analysis of receivable.
2. Calculate and write off irrecoverable debts. Make a provision for irrecoverable debts, and make adjustments to the Allowance for Receivables balance.
3. Calculate the irrecoverable debt expense arising and report the balances on the Statement of Financial Position.

Time

## 2.4 TIME REQUIRED

You should take one and half hours to complete studying the topic for this unit.

****

## 2.5 REFLECTION

Suppose that you plan to spend the cash received from customers in the following year. Would you budget for the exact amount they owe according to the records, or you would budget for something less? Why do you think so?

## 2.6 UNIT TOPICS

### 2.6.1**AGED ANALYSIS OF RECEIVABLES**

A Trade Receivables account balance would represent amounts owed by several customers. For large companies the number of customers would so many that determining how long each debt has been outstanding would be done by means of a computer. How this is done by means of an Aged analysis is illustrated below. Let us assume the Receivables account has a balance of K 1 560. The analysis would list individual customers according to time periods as follows:

**AGED RECEIVABLES ANALYSIS**

CREDIT CUSTOMER

TOTAL OWING

(K) Due for Less than 30 days (K) Due for 30 to 60 days (K) Due for 60 – 90 days (K) Due for more than 90 days (K)

Musesha 1 470 320 800 350

Mutambo 1 000 600 400

Chewe 400 200 200

Kunda 680 500 180

Chilembo 940 400 340 200

Nyambe 670 150 120 400

TOTAL 5 160 870 1 460 2 250 580

The analysis above reveals that a total of K 5,160 has been outstanding for more than the normal credit period of three months. Another K 2 250 is overdue, and the customers involved may be experiencing financial problems of one type or the other. It is important therefore to investigate and establish why customers still owe so much for that long.

1. Supposing the investigation shows that Kunda and Mutambo are officially declared bankrupt and it is doubtful whether Chewe and Chilembo will pay all the amounts they owe. It is necessary in this situation to write off some amounts as irrecoverable and to provide for the probable loss of the debts that are doubtful. Management action may be outlined as follows: 1. To write off all the amounts owed by Kunda, and the balance owed by Mutambo after receiving 40n in a K 1.00.
2. To provide for specific debts owed by Chewe, and make a general provision at 2% of all amounts outstanding for more than 60 days.

The following solution shows the calculations and accounting required to implement the decision.

Calculations:

Total receivables balance 5 160

Less Irrecoverable debts (680 + 600 ) 1 280

3 880

Specific debts 400

General provision

(5 160-1 280 - 400- 870-1 260) 0.02 X 1350 27 (427)

Recoverable debts are only 3 453

Now let us see how these amounts would be posted in the ledger accounts:

TRADE RECEIVABLES

DETAILS DEBIT DETAILS CREDIT

Balance b/d 5 160

Cash 400

Irrecoverable debts 1 280

Balance b/d 3 480

\_\_\_\_ \_\_\_\_\_

5160 5 160

Balance b/d 3 480

ALLOWANCE FOR RECEIVABLES

DETAILS DEBIT DETAILS CREDIT

Irrecoverable debts 427

Balance b/d 427\_\_\_

427 427

Balance b/d 427

IRRECOVERABLE DEBTS

DETAILS DEBIT DETAILS CREDIT

Trade Receivables 1 280

Allowance for Receivables 427 Statement of Profit or Loss 1 707

5160 5 160

The figures to be reported from the accounts above are: K

Statement of Profit or Loss: Irrecoverable debts expense 1 707

Statement of Financial Position

Trade Receivables 3 480

Allowance for Receivables (427) 3 053

### 2.6.2 ACTIVITIES

Now you are ready to attempt the following exercise:

Crispus Jere has total receivables amounting to K542 as at 31 December 2012. It is discovered that of this amount K42 is not recoverable and should be written off as bad debts. At 1 January 2012, a balance of K35 was brought forward from 2011 on the Allowance for Receivables account. He would also like to provide for 5% of the remaining debts. Show these transactions in the ledger accounts and how they would be reported in the Statement of Financial Position

### 2.6.3**SUMMARY**

**Congratulations!** You have achieved another milestone. In this unit you have learnt that the amount outstanding for receivables may not all be collectable. Therefore, it is important to identify actual debts that will not be collected and and write them off as expenses. It also prudent to make a provision for amounts that may not be received. Such amounts are credited to an Allowance for Receivables account, instead of the Trade Receivables account. In the next unit, I will discuss what is involved in accounting for non-current assets in line with international accounting standard in issue.

# UNIT3: ACCOUNTING FOR NON CURRENT ASSETS

## 3.1 UNIT **INTRODUCTION**

It is my pleasure to introduce this unit to you. Accounting for non-current assets starts with acquisition of the assets. An asset may be acquired for cash or on credit. Sometimes an asset may be acquired on a part exchange basis. In whatever way the asset may be acquired, it is then put to good use in the running of the business for a number of years. After a number of years the asset may reach the end of its useful economic life and may be abandoned. Sometimes the asset may actually be disposed of.

Outcomes

## 3.2 UNIT **AIM**

The aim of this unit is to illustrate how non-current assets are accounted for. There are a number of tasks that are carried out in the process of handling acquisition, use and disposal of non-current assets, but the emphasis of this unit is on application of double entry to transactions involved. At later stage you will learn how international accounting standards provide guidance to accounting for non current assets.

Outcomes

## 3.3**UNIT OBJECTIVES**

At the end of this unit you should be able to do the following

1. Explain the purpose of preparing a fixed asset register.
2. Apply double entry of transactions for acquisition and sales of an asset.
3. Define and account for depreciation of various non-current assets.
4. Explain the reason for revaluing an asset and prepare a revaluation account to give effect to a given set of adjustments.

Time

## 3.4 TIME REQUIRED

You should be able to spent about two hours to complete studying this unit and doing the exercise given at the end of the lesson.

****

## 3.5 REFLECTION

When you buy a non current asset, should the expenditure be deducted in full from the sales of the period as an expense?

## 3.6 UNIT TOPICS

### 3.6.1**PREPARATION OF A NON CURRENT ASSETS REGISTER**

When an entity acquires assets they are recorded in a register. The details of the register are obtained from the invoice and asset specifications. The illustration below show how the asset register would look like. This register will contain the following information for each non-current asset.

1. the date of purchase
2. the name and address of supplier
3. the cost of the asset
4. the estimated useful economic life of the asset
5. the estimated residual or resale value of the asset at the end of its useful life
6. a description of the asset
7. a code number for easy identification
8. the method of providing for accumulated depreciation to be used
9. the accumulated depreciation of the asset
10. details of disposal of the asset
11. the location of the asset within the organization
12. the extent to which it is being used
13. the repairs carried out and how much they cost
14. the expiry dates of any licences permitting the organization to use it.

The item details above are kept manually in ledger books or electronically as a computer spreadsheet with columns updated as and when transactions occur. The calculations involved to arrive at the figures to post to the accounts will now be explained with the aid of an example.

ILLUSTRATION No.1

Tambulukani’s accounting year ends on 31 December. The following are the transactions that took place in each of the calendar years. A statement on the depreciation policy of the entity is also given:

2000 1 January Machinery bought for K72 000 and fixtures for K36 000. Amounts were paid by cheque.

20X2 1 July Bought 4 machines at K12 000 each on credit.

20X3 1 October Bought additional fixtures for K20 000.

20X4 1 December Bought fixtures for K20 000 by cheque.

**A NOTE ON ACCOUNTING POLICY**:

Machinery is depreciated at the rate of 20% per annum on cost using reducing balance basis and fixtures at the rate of 10% per annum on cost using straight-line basis. Depreciation is charged in full in the whole year of acquisition and none in the year of disposal.

**SOLUTION**

Machinery Fixtures

K K

Year to 31 December 2000

Cost 72 000 36 000

Depreciation (20% x 72 000) (14 400)

Depreciation (10% x 36 000) (3 600)

Carrying amount 57 600 32 400

Year to 31 December 2001

Additions

Depreciation (20% x 57 600) (11 520)

Depreciation (10% x 56 000) (3 600)

Carrying amount 46 080 28 800

Year to 31 December 2002

Additions -cost 48 000

Depreciation (20% x 94 080) (18 816)

Depreciation (10% x 36 000) (3600)

Carrying amount 75 264 25 200

Year to 31 December 2003

Additions -Cost 20 000

Depreciation (20% x 75 264) (15 053)

Depreciation (10% x 56 000) (5 600)

Carrying amount 60 211 39 600

Notes: Machinery revised cost is K 46 080 000 + K 48 000 = K 94 080

Fixtures revised carrying amount is K 36 000 + K 20 000 = K 56 000

It may help to put up a table showing the build-up of depreciation for each item of noncurrent assets.

ITEM Year 1 Year 2 Year 3 Year 4 TOTAL

K K K K K

Machine 1 14 400 11 520 9 216 7 373 42 509

Machine 2 9 600 7 680 17 280

Old Fixtures 3 600 3 600 3 600 3 600 14 400

New Fixtures 2 000 2 000

TOTAL TO PROFIT OR LOSS 18 000 15 120 22 416 20 653 76 189

Machinery as an asset would be reported on the Statement of Financial Position in each of the years as follows:

ITEM Year 1 Year 2 Year 3 Year 4 TOTAL

K K K K K

Machine -Cost 72 000 72 000 120 000 120 000 –

Accumulated Depreciation 14 400 25 920 44 736 59 789 –

Carrying amount 57 600 46 080 75 264 60 211 -

Accumulated depreciation for Year 3 was found as follows: K 14 400+K 11 520+K 9 216+K 9 600 =K 44 736

**ILLUSTRATION** No. 2

Supposing you are told that Machine 1 has been exchanged with a new one at a valuation of K 33 500, and that the old fixtures would soon be replaced and they currently have a value of

K 16 300. The fair value of the new machinery is K 50 000. What would the accounts look like in Year 5 in the ledger of Tambulukani?

**SOLUTION**

This scenario is a disposal of non-current assets and following are the steps to carry out:

1. Isolate the cost of the asset to a disposal account.

2. Isolate the accumulated depreciation of the asset to a disposal account.

3. Charge the Part exchange account with the value of the old asset from the disposal account.

4. Received the cost of the new asset in the machinery account from the Part Exchange Account.

5. Find any profit or loss on disposal of the asset.

6. Charge depreciation on the remaining asset.

7. Reduce the cost of the asset with any extra loss in value (impairment loss) arising as result of the revaluation.

The account for Fixtures would be written as follow where depreciation is credited to the asset account and reduce it every year.

Dr. FIXTURES Cr.

K K

Balance b/d 39 600 Depreciation 5 600

P & L (Impairment loss) 1 700

Balance c/d 32 300

39 600 39 600

Balance b/d 32 300

The account for Machinery would be written as follow where depreciation is credited to a separate Accumulated Depreciation account, and the assets are kept at cost.

Dr. MACHINERY Cr.

K K

Balance b/d 120 000 Disposal 72 000

Part Exchange 50 000

Balance c/d 98 000

170 000 170 000

Balance b/d 98 000

Dr. ACCUMULATED DEPRECIATION Cr.

K K

Bank 42 509 Balance b/d 59 789

Balance c/d 1 000 1 000

Balance b/d 200

Dr. DISPOSAL Cr.

K K

Machinery 72 000 Accum Depreciation 42 509

P & L (Profit) 4 009Part Exchange 33 500

76 009 76 009

Balance b/d 400

Dr. PART EXCHANGE Cr.

K K

Bank 3 500

Machinery 50 000

Bank 16 500

50 000 50 000

Commentary on the accounts:

1. The opening balance on the fixtures is K 36 000+K 20 000-K 14 400- K 20 000=K 39 600

2. The impairment loss on Old fixtures K 36 000- K 14 400- K 3600- K 16 300 = K 1 700

3. The closing balance on the fixtures is Old fixtures (K 36 000- K14 400- K 3600- K 1 700) + (K 20 000- K 2 000-K 2 000) = K 32 300

4. There is a payment in the Part Exchange account of K 16 500 because the question does not say or mention the name of the supplier who is owed any money on the machine bought. It is understood that the difference between the part exchange value K 33 500 of the old asset and the fair value K 50 000 of the new asset was actually paid in cash through the bank.

### 3.6.2**ACTIVITIES**

The following are the practice exercises for you:

1. Now you can prepare the accounts for Year 1, Year 2, Year 3 and Year 4 for machinery and fixtures under the two practices mentioned: where depreciation is taken to the asset account, and where depreciation is taken to a separate accumulated depreciation account.
2. Prepare the schedule of Non-current asset to report the fixtures on the Statement of Financial Position for all the four years.
3. Prepare a summary of the amounts what would be reported in the Statement of Profit or Loss and the Statement of Financial Position for the assets in Year 5.

You should submit your answers to this exercise for marking within one week of completing this unit.

### 3.6.3**SUMMARY**

In this unit I have explained how accounting for non-current assets is done when there are acquisitions in the year, and when there is a disposal in the year. The fact of revaluation to identify an impairment loss has also been discussed. At the higher level you will be given information from International Accounting Standards that provide conditions for revaluation of assets and the consequential identification of impairment losses. In the next unit I will discuss the Correction of errors and the preparation of the suspense account.

# UNIT 3: CORRECTION OF ERRORS

## 4.1 UNIT**INTRODUCTION**

Now is the appropriate time to discuss errors and their correction. Errors can be made when preparing day books, at the lime of posting entries to the ledger, when making account transfers to close accounts and when preparing the Statement of Profit and Loss Account and the Statement of Financial Position. Errors may affect supplier’s accounts, customers’ accounts and non-current accounts. When errors are made the trial balance is not supposed to balance, but sometimes it does. Therefore, there are errors that do not affect the balancing of the trial balance and other errors that affect the trial balance. Both types of errors must be corrected in order to have accurate records of income, expenses, assets and liabilities.

Outcomes

## 4.2 UNIT **AIM**

In this unit I will explain the process of correcting errors when they arise and the effect on profit reported for a particular period.

Outcomes

## 4.3 UNIT OBJECTIVES

At the end of this unit you should be able to do the following

1. Describe errors that do not affect the trial balance.
2. Differentiate errors that not affect the trial balance from those that affect the Trial balance. Prepare and clear the suspense account after correction of errors.
3. Prepare an adjusted profit statement after correction of errors.

Time

## 4.4 TIME REQUIRED

You should take only one and half hours to complete this unit. This is depended on whether you understand double entry and can perfectly apply it to original transactions and account transfers. Correction of errors is by means of processing account transfers, applying the rule of double entry correctly.

****

## 4.5 REFLECTION

Correction of errors will require your putting together the knowledge you have acquired in all the preceding units. Are you able to do this? In particular: do you think accounting records are a system of procedures and steps to follow, or it comprises topics that are stand alone and unrelated to each other? Can you imagine books with errors and there is no clue as to whether they have occurred? Do you think to identify errors you should trace every transaction from the start on source documents right through to closing accounts?

## 4.6 UNIT OBJECTIVES

### 4.6.1TYPES OF ERROR

There are two types of error:

**Type 1**. Errors that do not affect the trial balance.

**Type 2.** Errors that affect the trial balance.

An error is taken as not affecting the trial balance when the trial balance’s two columns come to the same total, despite that errors have occurred in the accounts. This will be true when amounts involved have been posted to both the debit side and the credit side of some accounts in the ledger and also when the amounts have been omitted from the records completely.

### **4.6.2 ERRORS THAT DO NOT AFFECT THE TRIAL BALANCE**

The following is a description of errors that do not affect the trial balance.

1. **Errors of Omission**

These errors occur when a transaction is not recorded in one of the day books and consequently the amount is not posted to any ledger account. To correct such an error the transaction as described on the source document will be processed as if the transaction has just taken place now. Therefore, the rule of double entry must be applied to correctly record the transaction in the ledger accounts.

**Example**

At the time of preparing the sales day book, the accounts assistant flipped two duplicate invoices at one go. One of the invoices was therefore not recoded in the sales day book. The invoice value is K320.

The effect of this omission is that a debit entry is missing in the trade Receivables and a credit entry is missing in the sales account. To correct the error the same entries have to be made for the K320 as if the transaction has just taken place.

1. **Errors of Commission**

A purchase of goods from Mwene Mutondo, for example, may be credited to Mwene Kahare in the personal accounts. This is an error of commission. When an entry which should have been debited to rent account was erroneously debited to Repairs account. A purchase of a motor vehicle may be taken to machinery account instead of a motor vehicles account.

From the above examples, we define an error of commission as one occurring in the same category of accounts. The amount would be on the correct side of the account but in a wrong account altogether.

**(c) Errors of principle**

They arise when the account assistant fails to correctly apply concepts, principles and standards of accounting. The common ones are failure to appreciate the distinction between capital and revenue expenditure and capital income and revenue income. For example, a cash purchase of motor car and correctly credited to cash account may be taken to a motor repairs account. The effect of this error is that capital expenditure will be understated whereas revenue expenditure will be overstated. The trial balance totals will be equal but with wrong figure of motor repairs and no record in motor vehicles account.

**(d) Compensating errors**

Compensation is a cover-up for a deficiency in a value on some account. An error in one account may create a value deficit, which coincidentally is covered up by an amount of equal value in another account, created by a different error. The two amounts are of equal magnitude existing on the opposite sides to each other in the affected accounts. In effect the errors cancel out each other, and the trial balance columns come to the same total.

**(e) Trans-positioning errors**

This occurs when digits of a number on a source document are inadvertently swapped when the entry is made in a day book. The wrong amount in the day book is eventually taken to the correct sides of the accounts in the ledger. For example, a receipt for cash sales of K 2014 is recorded as K2041 in the cash book. The double entry will be completed using the wrong amount in the column total for cash sales which will be taken to the account for sales. This error will therefore not affect the trial balance.

**(f) Errors of Complete reversal of entries**

They occur when double entry for a transaction is reversed in the accounts. An account that should have been debited is credited and the account that should have been credited is debited. When correcting such an error, the amounts are doubled and put on the correct sides of the affected accounts. In practice there may be multiple errors affecting a number of accounts at the same time. So it is important to understand accounting as a system so that you can trace the origin of each one at a time, and correcting them like isolated transactions.

### 4.6.3 ERRORS THAT AFFECT THE TRIAL BALANCE

An error will affect the trial balance when it causes an imbalance in the totals of the debit column and that of the credit column. The trial balance will be forced to balance by inserting the difference on the side where there is a short fall. This difference is described as being held in the Suspense account, as shown below:

TRIAL BALANCE (Extract)

DR CR

Trial Balance sub-totals 21 597 24 018

Suspense 1 421

TOTALS 24 018 24 018

The trial balance above implies that presuming the amounts of the errors were seated in the suspense account, they have created a net debit balance in that account. Since the suspense account is not one of the accounts that are normally prepared in the ledger, then it is an irregular account that should be cleared to zero balance when all errors are subsequently corrected. The activity that follows this description or errors will illustrate how errors are corrected, whether they affect the trial balance or not. The exercise will also test your ability to identify the type of error that is being corrected. I would like to mention to you that correcting entries are actually transactions and double entry must be applied strictly. Remember that transactions can be original transactions or account transfers. To assist you in understanding how double entry is applied to correct errors, I will outline below the steps that you should follow –The thinking process:

Hachisala is a retailer of hardware and electrical items. His financial year ends on 31 March each year. The business has few credit customers, and so their personal accounts form part of the complete accounting system.

At 31 March 2014 a trial balance was extracted and it revealed a shortfall of K1 518 on the debit side. This was resolved by opening a suspense account, and financial statements were prepared and showed a profit of K14 280.

In April 2014 the investigation revealed that:

1. A page of sales day book totalling K575 had not been posted to sales account.
2. An accrual of rates K370 had not been taken into account
3. A repayment part of the loan from the bank K350 had been entered on the loan interest account
4. The petty cash balance had been included as K49 instead of K94.
5. Irrecoverable debts of K135 had been entered in the customers' account but not in the expense account.
6. Drawings K190 had been entered in the sundry expenses account
7. An invoice for car repairs K395 had been entered in the wages account.
8. The rent received account balance of K630 had been entered on the wrong side of the trial balance and income statement.
9. Advertising account with a balance of K2 845 had been omitted from the trial balance altogether.
10. Closing inventory had omitted some items valued at cost K2 014. (xi) Discount allowed of K164 had been credited to discounts received.

**Required**:

(a) Identify and classify the type of error each one is. Describe as ‘Incomplete double entry’ or ‘Incorrect double entry’ if the error affect the trial balance.

(b) Show by means of journals how correction of the errors would be posted in the accounts (narratives are not required).

(c) Prepare the suspense account with a zero balance after the correction of errors and

(d) Draw up a revised Statement of Profit or Loss, showing the corrected amount of the profit that takes into account the adjustments to the processed individual accounts.

**STEPS (The thinking process):**

1. First identify the business activity involved, e.g. Sales of goods, payment for wages, etc.
2. Be sure of the correct way the business activity (or transaction) is processed in the accounts. This means that you must be competent enough to accurately post any entry to the correct accounts using the knowledge you have acquired from the preceding units
3. Critically examine the error at hand. Can it be sub-divided into two or three transactions? How many accounts have been affected by it? Are all accounts wrongly affected? If some accounts are correctly affected, then do not take an entry there to make them wrong!
4. Do what is necessary to put the wrongly affected accounts right. What is ‘necessary’ can vary according to the scenario. In some cases, doubling the amount, for example, becomes necessary besides applying double entry in the process of correcting the error. Please remember, an error that does not affect the trial balance is corrected between two or more regular accounts, whereas an error that affect the trial balance is corrected between one regular account and the suspense account (the irregular account).

SOLUTION

a) Identification and classification of errors:

1. Incomplete double entry
2. Error of omission
3. Error of principle
4. Error of transposition
5. Incomplete double entry
6. Error of principle
7. Error of commission
8. Incorrect double entry
9. Omission from reporting
10. Inaccurate valuation
11. Incorrect double entry

b) The Journal

Dr Cr

(i) Suspense account 575

Sales account 575

(ii) Rates account 370

Rates accrued (SOFP) 370

(iii) Bank loan account 350

Interest account 350

(iv) Petty cash account 45

Suspense account 45

(v) Irrecoverable debts 135

Suspense account 135

(vi) Drawings account 190

Sundry expenses account 190

(vii) Car repairs account 395

Wages account 395

(vii) Rent Received account 1 260

Suspense account 1,260

(ix) Advertising expenses 2 845 `

Suspense account (advertising) - 2845

(x) Closing Inventory account 2,014

Purchases Trading P&L a/c 2 014

(xi) Discount allowed account 164

Discount received account 164

Suspense account 328

(b) Dr Suspense account Cr

Balance 1 518

Sales 575

Petty cash 45

Rent 1 260

Bad debts 135

Advertising 2 845

Discount all. 164

\_\_\_\_ Discount rec. 164

3,353 3,353

1. Revised Statement of profit or loss:

Add: CREDIT ENTRIES K K

Net profit before adjustments 14 280

Sales omitted 575

Loan repayment entered in loan interest 350

Drawings entered in sundry expenses 190

Rent received entered on wrong side 1260

Omitted inventory 2014 4 389

Less: DEBIT ENTRIES

Rates accrual 370

Irrecoverable debts 135

Advertising omitted 2 845

Discount allowed (164 x 2) 3283 678

Adjusted profit 14 991

**DEBRIEF**

The journals written have demonstrated that entries to correct errors are actually transactions, because the journal could not be complete without applying double entry. Some transactions link Suspense account with the Statement of profit or loss account, others are actually balances carried forward to the following period and to be reported on the Statement of Financial Position (SoFP). The rationale of the steps outlined above can be used every time you are handling a transaction, especially when a scenario is described in ordinary language and you are expected to crystallise transactions from it.

### 4.6.4**ACTIVITIES**

Attempt to answer the following question. Then send your solution for marking as part of continuous assessment by end of the month. The trial balance of Mr Rogers as at 31 July 2017 did not agree, there being a shortage of K 874 on the debit side. A suspense account was opened for the difference. Subsequent investigation showed:

1. Discount allowed K520 had been entered on the credit side of discount allowed account. (ii) The bank statement balance of K490 overdraft had been included in trial balance instead of the cashbook balance of K63 debit.
2. The provision for bad debts account of K172 had been entered on wrong side of the trial balance
3. Rent receivable account was over cast by K65
4. Drawings of K340 had been included in purchases account
5. The sale of furniture (non-current asset) had been included in sales account of K285 (vii) Payment for insurance of K85 was entered in insurance account as K58
6. Discounts received were overstated by K100.
7. A cheque for K230 for car repairs had been posted to the building repairs account
8. Provision for depreciation account K250 was entered on wrong side of trial balance
9. The scrapping of an old lorry with net book value of K440 was omitted from the books.

Required:

(a) Correct the errors via the journal

(b) What was the balance on suspense account before the errors were corrected?

Submit the solution to this exercise for marking within one week of completing this unit.

### 4.6.5 UNIT **SUMMARY**

In this unit I discussed types of error and their classification. The correction of errors depends on the type it is: errors that affect the trial balance are corrected between one regular account and the suspense, whereas errors that do not affect the trial balance are corrected between two or more regular accounts. I trust that by now you understand that everything about accounting settles down to transactions and the application of accruals basis of accounting and the rule of double entry. In the next unit I will discuss the topic of incomplete records. If you are incompetent at writing books up to trial balance you should revise those units before proceeding to the next unit.

# UNIT 5: PREPARATION OF FINANCIAL STATEMENTS

## 5.1 Unit Introduction

Welcome to Unit 1 of module two! Congratulation on your progress you have made this far. At this stage, you now know how to come up with two account names for each transaction, identify the subject matter that was given or received and apply the Rule of Double Entry by debiting the receiving account and crediting the giving account. You now know how to apply double entry to the type of transaction called Account Transfers at the time of closing accounts. You noted that amounts are transferred either to the Trading, Profit & Loss Account (which in later units I will call Statement of Profit or Loss), or to the same account but for the following period (balance carried down and balance brought down). By now you know that a Trial Balance is extracted for the purposes of proving the arithmetical accuracy of records, and for serving as a basis for preparing financial statements (originally called final accounts). According to International Accounting Standard (IAS 1), financial statements comprises the Statement of Profit or Loss, Statement of Financial Position, Statement of Cash Flows and Statement of Changes in Equity. Therefore, in this unit you are going to learn about the purpose of each financial statement (excerpt the Statement of Changes in Equity).

Outcomes

## 5.2 Unit Aim

The aimof this unit is to equip you with knowledge and understanding of each financial statement.

Outcomes

## 5.3 Unit Objectives

At the end of this unit you should be able to do the following

1. Explain the nature and purpose of each financial statement.
2. explain why profit is calculated
3. calculate cost of goods sold, gross profit, and net profit
4. explain the difference between gross profit and net profit
5. explain the relationship between the trading account and the profit and loss account
6. explain how to deal with closing stock when preparing a Trading and Profit and
7. Loss Account
8. explain the meanings of the terms fixed asset, current asset, current liability, and long-term liability
9. describe the sequence in which each of the five main categories of items appear in the balance sheet
10. describe the sequence in which each fixed asset is entered in the balance sheet
11. describe the sequence in which each current asset is entered in the balance sheet
12. draw up a statement of profit or loss and statement of financial position from information given in a trial balance

Time

## 5.4 Time Required

You will have to spend four hours in total to complete and fully understand this concept. Preferably you should study it on two alternate days for two hours each.

## 5.5 Unit Topics

### 5.5.1 Preparation of Statement of Profit or Loss

**Reflection**

Think for a moment: What really constitute profit made? What is the purpose of calculating profit for a business?

**Discussion**

As you may be aware, the main reason you may wish to set up a business is to make profits. Of course, if your business is not successful, it may well incur losses instead. The calculation of such profits and losses is probably the most important objective of the accounting function in a business. As a business owner, you will want to know how the actual profits compare with the profits you had hoped to make. The Statement of Profit or Loss provides information of whether a business is making a profit or not. As you may wish to know, a profit is a measure of performance of a business and only include revenue and expenses. It does not include capital expenditure. You may wish to know that knowledge of what profits you are making would help you achieve make tasks as highlighted by Wood and Sangster (2005) below:

1. planning ahead
2. obtaining loans from banks, other businesses, or from private individuals
3. telling prospective business partners how successful the business is
4. telling someone who may be interested in buying the business how successful the business is
5. calculating the tax due on the profits so that the correct amount of tax can be paid to the tax authorities.

The Statement of Profit or Loss does not include capital expenditure but revenue expenditure. You may wish to know that Capital expenditure is incurred when a business spends money either to

1. buy fixed assets, or
2. add to the value of an existing fixed asset.

Included in such amounts should be spending on:

* acquiring fixed assets
* bringing them into the business
* legal costs of buying buildings
* carriage inwards on machinery bought
* any other cost needed to get a fixed asset ready for use

However, you may wish to know that revenue expenditure is expenditure which is not spent on increasing the value of fixed assets, but on running the business on a day-to-day basis.

Let us look at a format of a Statement of Profit or Loss below:

**Statement of Profit or Loss for the year ended 31 December, 2017**

K K

Sales revenue 180,000

Cost of sales:

Opening Inventory 30,000

Purchases 120,000

Cost of goods available for sale 150,000

Closing Inventory (40,000)

Cost of Sale 110,000

**Gross Profit 70,000**

Other income:

Rent received 10,000

Interest received 1,000 11,000

81,000

Expenses:

Rent 5,000

Electricity 3,000

Telephone 2,000

Wages and salaries 15,000

Motor expenses 6,000

31,000

**Net profit 50,000**

However, you need to take note that for a Corporate we will need to include taxation. We will cover preparation of company accounts in Unit……

We may split the calculation of the profit into two parts as follows:

1. **Calculation of Gross Profit**

You may wish to know that the Gross profit is the excess of sales revenue over the cost of goods sold (Cost of Sale). Where the cost of goods sold is greater than the sales revenue, the result is a gross loss. By taking the figure of sales revenue less the cost of goods sold to generate that sales revenue, it can be seen that the accounting custom is to calculate a trader’s profits only on goods that have been sold (Wood and Sangster, 2005).

Let us look at an example below on how we can calculate the gross profit or Loss:

**Example 1**

*Cost of goods purchased Sales Gross profit/(Gross loss)*

K K K

A 12,730 13,574 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

B 10,531 17,209 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

C 13,600 22,381 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

D 12,980 12,450 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

E 11,750 10,250 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Solution

A= K844 Gross Profit

B= K6,678 Gross Profit

C= K8,781 Gross Profit

D= (K530) Gross Loss

E= (K1,500) Gross Loss

**Concept of Cost of Sales**

You may wish to know that the cost of sales figure for a period can be identified in different ways. For instance, in some businesses the cost of sales is identified at the time a sale has been made. Sales are closely matched with the cost of those sales and so identifying the cost of sales figure for inclusion in the income statement is not a problem (Atrill and McLaney, 2013). As you may have noticed that many large retailers (for example, supermarkets) around the country have point-of-sale (checkout) devices that not only record each sale but also simultaneously pick up the cost of the goods that are the subject of the particular sale. Other businesses that sell a relatively small number of high-value items (for example, an engineering business that produces custom-made equipment) also tend to match sales revenue with the cost of the goods sold at the time of the sale (Atrill and McLaney, 2013). However, some businesses (for example, small retailers) do not usually find it practical to match each sale to a particular cost of sales figure as the accounting period progresses. They find it easier to identify the cost of sales figure at the end of the accounting period.

For you to understand how this is done, it is important to recognise that the cost of sales figure represents the cost of goods that were *sold* during the period rather than the cost of goods that were *purchased* during the period. As you may recall from Module 1, accrual concept requires that revenue is matched with expenses used to generate that revenue.

As you may be aware, not all the goods purchased would be sold part of the goods purchased during a particular period may remain in the business, as inventories, and not be sold until a later period. For you to derive the cost of sales for a period, it is necessary to know the amount of opening and closing inventories (stocks) for the period and the cost of goods purchased during the period.

Let us look at an example below on how to calculate cost of sales:

**Example 2**

Kaka Ltd began the accounting year with unsold inventories of K40, 000 and during that year purchased inventories at a cost of K189, 000. At the end of the year, unsold inventories of K75, 000 was still held by the business. The Company recorded sales of K450,000 during the year. Calculate the Cost of Sales and Gross profit.

**Discussion**

You may wish to know that as you calculate the cost of sales, the opening inventories at the beginning of the year *plus* the goods purchased during the year will represent the total goods available for resale. Thus:

K

Opening inventories 40,000

*Plus* Goods purchased 189,000

Goods available for resale 229,000

‘*Less* Closing inventories (75,000)

Cost of goods sold (or cost of sales) 154,000

The closing inventories will represent that portion of the total goods available for resale that remains unsold at the end of the period. Thus, the cost of goods actually sold during the period must be the total goods available for resale *less* the inventories remaining at the end of the period. The calculations above may be shown on the face the Statement of Profit or Loss

Now we calculate the Gross profit as follows:

K

Sales 450,000

Less: Cost of sales (154,000)

Gross Profit 296,000

1. **Calculating Net Profit**

**Discussion**

Let us now look at the second part of the profit which is the calculation Net profit. You may wish to know that the Net Profit is found by subtracting the operating expenses from the gross profit plus any revenue other than that from sales such as rents received or commissions earned. The operating expenses include the total costs used up during the period other than those already included in the ‘cost of goods sold’. Where the costs used up exceed the gross profit plus other revenue, the result is said to be a **net loss**. Atrill and McLaney (2013) provides same examples of operating expenses such as:

1. salaries and wages;
2. rent and rates;
3. motor vehicle running expenses;
4. insurances;
5. printing and stationery;
6. heat and light;
7. telephone and postage, and so on.

However, you may wish to know that according to the International Accounting Standard (IAS 1) expenses may be classified either by their nature (such as the ones given above) or by function e.g distribution, administrative, marketing & Selling.

Let us look at an example where you calculate the net profit below:

**Example 3**

Assume Kaka Ltd *(from example 2)* incurred the following operating expenses:

1. salaries and wages; K85,000
2. rent and rates; K10,000
3. motor vehicle running expenses; K5,600
4. insurances; K4,000
5. printing and stationery; K1,200
6. heat and light; K3,500
7. telephone and postage; K600

Calculate the Net Profit.

**Solutions**

K K

Sales 450,000

Less: Cost of sales (154,000)

Gross Profit 296,000

Less: Operating Expenses

Salaries and wages 85,000

Rent and rates 10,000

Motor vehicle running expenses 5,600

Insurances 4,000

Printing and stationery 1,200

Heat and light 3,500

Telephone and postage 600 109,900

Net Profit 186,100

### 5.5.2 Purpose of Statement of Financial Position

You may wish to know that the Statement of Financial Position provides information about the financial position of a company as at a certain point in time. You learnt from Module 1 that the Statement of Financial Position contain details of assets, liabilities and capital. The items and amounts to be entered in the statement of financial position are found in the accounting books as captured in the Trial balance.

Let us look at a layout of Statement of Financial Position below:

**Statement of Financial Position as at 31 December, 2017**

**K K**

**ASSETS**

Non-current assets:

Land and Buildings 100,000

Plant and Equipment 50,000

Fixtures and Fittings 20,000

Motor Vehicles 30,000

200,000

**CURRENT ASSETS**

Inventories 10,000

Accounts receivable 12,000

Prepayments 3,000

Cash 4,000

29,000

**TOTAL ASSETS 229,000**

**CAPITAL AND LIABILITIES**

Capital

Capital at 1 January 2017 130,000

Profit for year to 31 December 2017 50,000

Less: withdrawals (10,000)

170,000

Non-current liabilities

8% Loan 25,000

Current liabilities

Accruals 2,000

Accounts payable 20,000

Bank overdraft 12,000

34,000

**TOTAL CAPITAL AND LIABILITIES 229,000**

Let us look at some terminology used in the statement financial position below:

1. **Asset:** anything owned (or controlled) by the business
2. **Non-current asset:** an asset the business intends to keep (longer than 12 months)
3. **Current asset:** not a non-current asset.
4. **Inventory:** an asset bought by the business intended for sale
5. **Accounts receivable:** amount owed to the business by customers
6. **Prepayment:** a payment made by the business in advance
7. **Capital:** amount owing by the business to the proprietor (owner)
8. **Drawings (or withdrawals):** anything taken from the business by the owner. This is associated with sole tradership business
9. **Liability:** amount owing by the business
10. **Current liability:** a liability due within 12 months of Statement of Financial Position date
11. **Non-current liability:** a liability due more than 12 months from the date of the Statement of Financial Position
12. **Accounts payable:** liability due to suppliers
13. **Bank overdraft:** liability due to the bank (a “negative” bank balance or Credit balance in the ledger)

Now that you have known the layout of statement of financial position, let us now look at an example of how to prepare a simple statement of financial position below:

The following Trial Balance relates to Kaka enterprises as at 31st December, 2017

Dr Cr

K K

Fixtures and fittings 5,200

Receivables 6,600

Payables 8,200

Stock 3,100

Bank 15,000

Cash 300

Capital 22,000

30,200 30,200

Prepare the Statement of Financial Position As At 31st December,2017.

**Solution**

Kaka enterprises

Statement of Financial As at 31st December, 2017

K K

Non-Current Assets:

Fixtures and fittings 5,200

Current Assets:

Receivables 6,600

Stock 3,100

Bank 15,000

Cash 300 25,300

**Total Assets 30,200**

Capital 22,000

Liabilities:

Payables 8,200

**Total Capital and Liabilities 30,200**

As you can see from example above, a Statement of Financial Position is basically a listing of Assets, Liabilities and Capital as per Balance sheet Equation *(You covered balance sheet equation in Module 1).*

**STATEMENT OF CASH FLOWS**

**Reflection**

Try to think for a minute meaning of cash shown in the Statement of Financial Position.

**Discussion**

You now know that we ascertain the amount of profits in a statement of profit or loss. We also show what the assets, capital and liabilities are at a given date by drawing up a statement of financial position. As you might be aware the statement of financial position shows the cash balance (see definition later) at a given date, but it does not show us how we have used our cash funds during the accounting period. What we really need, to help throw some light on to the cash situation, is some form of statement which shows us exactly where the cash has come from during the year, and exactly what we have done with it (Wood and Sangster,2005). The cash flow statement fulfils these needs by showing cash inflows and outflows. Cash flows are prepared by corporates in line with IAS 7. Although small companies, partnerships and sole traders do not have to prepare them, cash flow statements can be of considerable use to all organisations(Wood and Sangster,2005). Therefore, we cover preparation of statement of cash flows in Unit…

5.6 Unit Activity

1. Which of the following is the correct formula for cost of sales?
2. Opening inventory – purchases + closing inventory.
3. Purchases – closing inventory + sales.
4. Opening inventory – closing inventory + purchases.
5. Opening inventory + closing inventory – purchases.
6. If an owner takes goods out of inventory for his own use, how is this dealt with?
7. Credited to drawings at cost
8. Credited to drawings at selling price
9. Debited to drawings at cost
10. Debited to drawings at selling price
11. A business starts trading on 1 September 2010. During the year, it has sales of K500,000, purchases of K250,000 and closing inventory of K75,000. What is the gross profit for the year?
12. K175,000
13. K675,000
14. K325,000
15. K250,000

4 Mario's trial balance includes the following items: non-current assets K50,000, inventory K15,000, payables K10,000, receivables K5,000, bank K110,000, allowance for receivables K1,000.

What is the figure for current assets?

1. K180,000
2. K170,000
3. K129,000
4. K134,000

5 Using the information in Question 4 above, what is the figure for total assets?

1. K184,000
2. K179,000

summary5.7 Unit Summary

Financial Statements includes three primary statements which are; the Statement of Profit or Loss, Statement of Financial Position and Statement of Cash Flows. Statement of Profit or Loss shows performance of a business (calculates the profit). This statement consists of revenue and expenses and does not include capital expenditure. Statement of Financial Position shows the financial position of business as at a certain point in time. This statement is basically a listing of Assets, Liabilities and Capital (Equity). Statement of Cash Flows shows how the cash fund were raised and used by a business.

As you may know, there are three forms of businesses which include Sole Trader, Partnership and Corporate (Limited Company). In the next Unit , you are going learn how to prepare the financial statements specifically for a sole trader.

**UNIT 6: PREPARATION OF FINANCIAL STATEMENT FOR A SOLE TRADER**

**6.1 Unit Introduction**

Welcome to Unit 2! In Unit 1 you have learnt the nature and purpose of each of the three primary financial statements (Statement Profit or Loss, Statement Financial Position and Statements of Cash Flow). In addition you looked at the layout of Statement of Profit or Loss and Statement of Financial Position and how to prepare them.

However, as you might be aware, there three forms of business which include Sole Trader, Partnership as well as a Corporate and each of these businesses have some a slightly different way of preparing the financial statements. In this Unit, you are going to learn how to prepare financial statements of a Sole Trader taking in account the adjustment for depreciation, provisions and accruals.

Outcomes

**6.2 Unit Aim**

The aim of this unit is to equip you with the knowledge and skills of how to prepare financial statements for a Sole Trader.

Outcomes

**6.3 Unit Objectives**

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

1. Compute depreciation
2. Prepare the statement of profit or loss of a sole trader.
3. Prepare the statement of financial position of a sole trader
4. Make adjustments for accruals and provisions to the financial statements

Time

**6.4 Unit Time frame**

To successfully go through this unit, you will do well by spending at least 4 hours.

**6.5 Unit Topic**

**6.5.1 Preparation of Statement of Profit or Loss and Statement of Financial Position**

As you may be aware already, financial statements are reports that are prepared for presentation to the owner of the business to inform him or her of the profit of loss made in the period, and the value of assets and liabilities the business has at the end of the period. Before we look at the preparation of financial statements, let us look at some important concepts we need to take into account.

**6.5.1.1 Depreciation**

**Reflection**

Capital expenditure such purchase of equipment is NOT included in the statement of profit or loss. Try to of the reasons for this.

**Discussion**

As highlighted by Atrill and McLaney (2013), you need to know that non-current assets (with the exception of freehold land) do not usually have a perpetual existence. They are eventually used up in the process of generating revenue for the business. As you may recall, we indicated that the cost of capital expenditure such equipment or motor vehicles are not expensed in the statement of profit or loss but shown in the statement of financial position as assets. However, these assets are used to generate revenue for the business. Therefore, depreciation is used as an attempt to measure that portion of the cost (or fair value) of a non-current asset that has been used up in generating the revenue recognised during a particular period. You may wish to know that the depreciation charge is considered to be an expense of the period to which it relates. Depreciation tends to be relevant both to property, plant and equipment (tangible non-current assets) and to intangible non-current assets.

To calculate a depreciation charge for a period, four factors have to be considered:

* the cost (or fair value) of the asset;
* the useful life of the asset;
* the residual value of the asset;
* the depreciation method.

There are several methods of calculating depreciation. The methods that you are expected to be aware of are the following:

1. straight line method
2. reducing balance method

These are the most common methods in practice.

1. **Straight line method**

Under this approach we charge an equal amount of depreciation each year.

The depreciation charge each year is calculated as:

Original cost – residual value

Estimated useful life

**Example 2.1**

To illustrate this method, let us assume a business has a machine which is costing K40,000 with an estimated residual value at the end of its useful life K1,024 and estimated useful life of 4 years. Calculate the annual depreciation and Net Book Value (NBV) of the machine.

**Solution**

Annaul Depreciation = K40,000 – K1,035 = K9,741.25

4

Therefore, the annual depreciation charge that you should put in the income statement in relation to this asset will be K9,741.25 for each of the four years of the asset’s life. The NBV is K30, 258.75 (K40,000 – K9,741.25) will be shown in the Statement of Financial Position.

You must take note that the amount of depreciation relating to the asset will be accumulated for as long as the asset continues to be owned by the business. This accumulated depreciation figure will increase each year as a result of the annual depreciation amount charged to the income statement. This accumulated amount will be deducted from the cost of the asset on the Statement of Financial Position. Thus, for example, at the end of the second year the accumulated depreciation will be K9,741.25 × 2 = K19,482.5, and the asset details will appear on the balance sheet as follows:

K

Machine at cost 40,000

*Less* Accumulated depreciation 19,482.5

NBV 20,517.5

1. **Reducing Balance Method**

As you may be aware, the reducing balance method applies a fixed percentage rate of depreciation to the written-down value of an asset each year. The effect of this will be high annual depreciation charges in the early years and lower charges in the later years. Using the example above, let us assume that the depreciation rate is 25% per year on a reducing balance basis. Calculate the annual depreciation for the first and second year as well as the NBV.

**Solution**

**K**

Cost of Machine 40,000

First year deprecation (25%x K40,000) (10,000)

Written Down Value (or NBV 1 year) 30,000

Second year depreciation (25% x K30,000) (7,500)

Written Down Value (or NBV 2 year) 22,500

**6.5.1.2 Accruals**

As you may be already away, the term ‘Accruals’ is frequently used to refer to the matching concept, which is the bedrock or foundation of accounting. It is also used to refer to year-end adjustments which are transactions that are processed at that time probably because there was an error to correct, omission or need to take into account requirements of certain accounting standards. For instance a businesses which pay rent for buildings amounting to K5,000 and the rent for building is K6,000 a year. The business will be expected to accrue for the K1000 (K6000 – K5000) such that K6000 will be shown as rent in Statement of Profit or Loss and K1, 000 as an outstanding in the Statement of Financial Position.

**6.5.1.3 Irrecoverable debts and Allowances**

As you may already know with many businesses a large proportion, if not all, of the sales are on credit. The business is therefore taking the risk that some of the customers may never pay for the goods sold to them on credit. This is a normal business risk and such **bad debts** are a normal business expense. Before we look at the treatment of irrecoverable debts and allowances, let us look at the definition below:

An **irrecoverable debt** is where we are reasonably certain that the receivable is not going to pay. For example, the customer may have died leaving no assets, or may have disappeared without trace.

A **doubtful debt** is where we are worried that the receivable might not pay. For example, the debt may have been outstanding for some time and the customer may not be replying to letters.

(Note that obviously if a customer refuses to pay we are at liberty to take them to court. However, it may be that the costs of going to court will be more than the amount of the debt and that therefore we decide not to do so.)

Let us look at the accounting treatment as follows:

**Irrecoverable debts:**

These are removed completely, and will no longer appear as part of accounts receivable.

**Doubtful debts:**

We will leave the debt outstanding as part of accounts receivable (because we are still trying to collect the money), but we will deduct from receivables an “allowance for receivables” equal to the amount of any doubtful ones, so that the net figure left in the Statement of Financial Position is the total receivables for which we foresee no problem.

**Specific allowance for receivables:**

This is an allowance for particular (or specific) debts, where we know that there is a problem (for example, the debt has been owing for a long time).

**General allowance for receivables:**

It may be that in our company it is the nature of the business that on average (say) 5% of our debtors end up not paying. To be prudent, we will deduct 5% from receivables to leave only the amount we are reasonably certain of. As this 5% does not relate to any specific customer, we call it a general allowance for receivables.

Let us look at how we can prepare the financial statements for a Sole Trader below:

**Example 2.2**

The following trial balance was extracted from the ledger of Bwalya Zulu, a sole trader, as at 31 December 2015 – the end of his financial year.

BWALYA ZULU

TRIAL BALANCE AS AT 31 DECEMBER 2015

*Dr Cr*

K’ K’

Property, at cost 120,000

Equipment, at cost 80,000

Provisions for depreciation (as at 1 January 2015)

– on property 20,000

– on equipment 38,000

Purchases 250,000

Sales 402,200

Inventory, as at 1 January 2015 50,000

Discounts allowed 18,000

Discounts received 4,800

Returns out 15,000

Wages and salaries 58,800

Irrecoverable debts 4,600

Loan interest 5,100

Other operating expenses 17,700

Trade payables 36,000

Trade receivables 38,000

Cash in hand 300

Bank 1,300

Drawings 24,000

Allowance for receivables 500

17% long term loan 30,000

Capital, as at 1 January 2015 121,300

**667,800 667,800**

The following additional information as at 31 December 2015 is available.

(a) Inventory as at the close of business has been valued at cost at K42,000.

(b) Wages and salaries need to be accrued by K800.

(c) Other operating expenses are prepaid by K300.

(d) The allowance for receivables is to be adjusted so that it is 2% of trade receivables.

(e) Depreciation for the year ended 31 December 2015 has still to be provided for as follows.

Property: 1.5% per annum using the straight line method; and

Equipment: 25% per annum using the reducing balance method.

***Required***

Prepare Bwalya Zulu income statement for the year ended 31 December 2015 and his statement of financial position as at that date.

**Solution**

BWALYA ZULU

INCOME STATEMENT

FOR THE YEAR ENDED 31 DECEMBER, 2015

K’ K’

*Sales* 402,200

*Cost of sales*

Opening inventory 50,000

Purchases 250,000

Purchases returns (15,000)

285,000

Closing inventory 42,000

243,000

*Gross profit* 159,200

Other income – discounts received 4,800

164,000

*Expenses:*

Operating expenses

Wages and salaries (K58,800 + K800) 59,600

Discounts allowed 18,000

Irrecoverable debts (W1) 4,860

Loan interest 5,100

Depreciation (W2) 12,300

Other operating expenses (K17,700 – K300) 17,400

117,260

*Net profit for the year* 46,740

BWALYA ZULU

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2015

*Accumulated Net book*

*Cost depn. value*

K’ K’ K’

*Non-current assets*

Property 120,000 21,800 98,200

Equipment 80,000 48,500 31,500

200,000 70,300 129,700

*Current assets*

Inventory 42,000

Trade receivables net of allowance for receivables

(K38,000 – 760 (W1)) 37,240

Prepayments 300

Bank 1,300

Cash in hand 300

81,140

Total Assets 210,840

*Capital*

Balance at 1 June 20X0 121,300

Net profit for the year 46,740

168,040

Drawings (24,000)

144,040

*Non-current liabilities*

17% loan 30,000

*Current liabilities*

Trade payables 36,000

Accruals 800

36,800

Total Equity & Liabilities 210,840

***Workings***

1. *Irrecoverable debts* $

Previous allowance 500

New allowance (2% × 38,000) 760

Increase 260

Per trial balance 4,600

Income statement 4,860

2. Depreciation

a) Property

Opening provision 20,000

Provision for the year (1.5% × 120,000) 1,800

Closing provision 21,800

b) Equipment

Opening provision 38,000

Provision for the year (80,000 - 38,000) x 25% 10,500

Closing provision 48,500

Total charge in Income statement (1,800 + 10,500) 12,300

**6.6 Unit Activity**

The following is the trial balance of Kaka Enterprises as at 31 December 2017. Draw up a set of financial statements for the year ended 31 March 20X9.

*Dr Cr*

K K

Inventory 1 January 2017 52,800

Sales 276,400

Purchases 141,300

Carriage inwards 1,350

Carriage outwards 5,840

Returns outwards 2,408

Wages and salaries 63,400

Business rates 3,800

Communication expenses 714

Commissions paid 1,930

Insurance 1,830

Sundry expenses 208

Accumulated depreciation-Buildings 410

Accumulated depreciation- Fixtures 106

Buildings 125,000

Receivables 45,900

Payables 24,870

Fixtures 1,106

Cash at bank 31,420

Cash in hand 276

Drawings 37,320

Capital 210,000

514,194 514,194

Notes:

1. Inventory at 31 December 2017 was K58, 440.
2. Depreciation is charged on buildings at 5% on cost straight line and Fixture at 15% reducing balance
3. Doubtful debt on receivable should be provided at 5%.
4. There is an outstanding balance on insurance amounting to K200.
5. The business had prepaid on business rates amounting to K214

Required

Prepare the statement of profit or loss for the year ended 31st December, 2017 and the Statement of Financial Position as at 31st December, 2017.

summary**6.7 Unit Summary**

In this unit, you have looked at how prepare the financial statements(Statement of Profit or Loss and Statement of Financial Position) of a Sole Trader taking into account the adjustment for depreciation, irrecoverable debt and allowances and accruals.

In the next unit, you are going to look at the preparation of financial statements of a Partnership and the rules that governs partnerships.

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