

**FINANCIAL ACCOUNTING
WEEK 5 (LECTURE FIVE)**

**RECORDING TRANSACTIONS AND EVENTS AND SUMMARISING ACCOUNT
DATA (INFORMATION)**

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Learning Objectives:

Upon completion of this chapter, you will be able to:

- Understanding the accounting Equation
- Classify transactions
- Understand Debit and Credit entries
- Understand meaning of source documents
- Draw the books of Original Entry

Introduction

A business can be set up in two ways-

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

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

Case one: owner supplying all the resources

In this case we say that-

Resources in the business = Resources supplied by the owner..... (i)

Resources in business are called assets and resources supplied by the owner are called Capital.

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

ASSETS = CAPITAL

Case two: resources supplied by owner and outside parties

In this case we say that-

Resources in business = Resources supplied by the owner + Resources supplied by outside parties..... (ii)

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

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

ASSETS = CAPITAL + LIABILITIES..... (ii)

Components of accounting equations

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

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

Assets are classified into two main categories:

- Non-current assets (formerly called fixed assets).
- Current assets.

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

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

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

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

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

Liabilities are also classified into two main classes.

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

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

Key examples include:

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

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

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

SOURCE DOCUMENTS AND BOOKS OF ORIGINAL ENTRY

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

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

SOURCE DOCUMENTS

Source documents show the evidence that a transaction has taken place. They are collected, filed and posted in the books of prime entry. Example, if a firm sells goods on credit, then an invoice is raised. The source documents as shown in the above include:

- Sales Invoice
- Purchases invoice
- Credit note
- Debit note
- Receipts,
- Cheques

- Petty Cash vouchers
- Other correspondences

Sales Invoice

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

- Name and address of the firm
- Name and address of the buying firm
- Date of making the sale – invoice date.
- Invoice number
- Amount due (net of trade discount)
- Description of goods sold
- Terms of sale

Purchases Invoice

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

- Name and the address of the creditor/seller
- Name and address of the firm
- Date of the purchase (invoice date)
- Invoice number
- Amount due
- Description of goods sold
- Terms of sale

Credit Note

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

- Name and address of the firm
- Name and address of the debtor
- Amount of credit
- Credit note number
- Reason for credit e.g. if goods sent but of the wrong type.

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

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

Debit Note

This is raised by the creditor and issued to the firm when the firm returns some goods to the

creditor. It includes the following items:

- Name and address of the firm
- Name and address of the creditor
- Amount of debit
- Debit Note number
- Reason for the debit

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

Cash Receipts

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

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

Cheques/ Bankers draft

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

- Name and account number of the firm (account holder)
- The date of the cheque
- Name of the payee (creditor)
- Name of the firm's bank
- Amount payable in words and figures
- The cheque number
- The authorized signature(s)

NB: Cheques are frequently used modes of payment but could have some limitations. Some of the limitations includes a cheque being dishonoured.

Reasons for dishonouring a cheque.

- Having insufficient funds in the drawer's account
- Mismatching signatures
- Notice of death of drawer
- Mismatch in amount in figures and words
- Overwriting
- Damaged cheque

- The date of the cheque

Petty Cash Vouchers;

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

- Date of payment
- Amount paid
- Reason for payment
- Authorized signature(s):
- Person approving
- Person receiving

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

Other correspondences

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

Examples are:

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

BOOKS OF PRIME/ORIGINAL ENTRY

In the practice of accounting and processes, the recording of transactions all the way to the analysing and reporting of the financial information, a series of steps is followed. This follows from the identifying transactions (source documents), recording (books of prime entry and subsidiary books) summarizing in the information using a trial balance and then building up the Income statement and the statement of financial position among other financial statements.

The first records of transactions in an entity or any organisation, starts in the books of prime entry followed by the subsidiary books.

The books of prime entry include:

- The Sales Day Book/Sales Journal
- The Sales Returns Day Book/Sales Returns Journal

- The Purchases Day Book/The Purchases Journal
- The Purchases returns Day Book/Purchases Returns Journal
- The Cash Book
- The General Journal/The Journal Proper

The Subsidiary Books of Financial Accounting include:

- The sales Ledger
- The sales returns ledger
- The purchases Ledger
- The purchases Returns Ledger
- The Cash Book
- The General Ledger

SALES JOURNAL

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

Example 5.1

| THE SALES JOURNAL | | | |
|--------------------------|-------------------------------------|--------------|---------------------|
| Date | Details | Folio | USD (Amount) |
| 01/04/2022 | ABC enterprises | SL01 | 374,000 |
| 03/04/2022 | Horizon Traders | SL02 | 3,320,000 |
| 05/04/2022 | Diamond Stores | SL03 | 24,000 |
| 11/04/2022 | ABC enterprises | SL01 | 110,000 |
| 18/04/2022 | Horizon Traders | SL02 | 578,000 |
| 20/04/2022 | Poncon Enterprises | SL04 | 132,000 |
| 25/04/2022 | Poncon Enterprises | SL04 | 56,000 |
| 30/04/2022 | Diamond Stores | SL03 | 156,000 |
| Total | Total Cr. To Sales A/C in GL | | 4,750,000 |

SL: (Sales Ledger) is for references purposes

The individual entries in the Sales journal are posted to the Debit side of the debtor’s accounts in the Sales ledger and the total is posted to the Credit side of Sales accounts in the general ledger

THE SALES LEDGER (EXTRACT-ACCOUNTS PAYABLES A/C)

| Dr. | ABC Enterprises | | Cr. |
|------------|------------------------|-----------|------------|
| | | \$ | \$ |
| 01/04/2022 | Sales | 374,000 | |
| 11/04/2022 | Sales | 110,000 | |
| | | | |

| Dr. | | Horizon Traders | | Cr. |
|------------|-------|-----------------|--|-----|
| | | \$ | | \$ |
| 03/04/2022 | Sales | 3,320,000 | | |
| 18/04/2022 | Sales | 578,000 | | |
| | | | | |

| Dr. | | Diamond Stores | | Cr. |
|------------|-------|----------------|--|-----|
| | | \$ | | \$ |
| 05/04/2022 | Sales | 24,000 | | |
| 30/04/2022 | Sales | 156,000 | | |
| | | | | |

| Dr. | | Poncon Enterprises | | Cr. |
|------------|-------|--------------------|--|-----|
| | | \$ | | \$ |
| 20/04/2022 | Sales | 132,000 | | |
| 25/04/2022 | Sales | 56,000 | | |
| | | | | |

THE GENERAL LEDGER (SALES A/C)

| Dr. | | Sales A/C | | Cr. |
|-----|--|-----------|------------|------------------------------|
| | | \$ | | \$ |
| | | | 30/04/2022 | Total Credit Sales 4,750,000 |
| | | | | |

The Purchases Journal

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

Example of a Purchases Journal

| THE PURCHASES JOURNAL | | | |
|-----------------------|-------------------------------------|-------|------------------|
| Date | Details | Folio | USD (Amount) |
| 03/04/2022 | Highlands dealers | PL15 | 420,000 |
| 11/04/2022 | Nairobi Suppliers | PL220 | 150,000 |
| 18/04/2022 | Territorial Enterprises | PL501 | 850,000 |
| 25/04/2022 | Highlands Dealers | PL15 | 560,000 |
| 30/04/2022 | Nairobi Traders | PL220 | 120,000 |
| Total | Total Cr. To Sales A/C in GL | | 2,100,000 |

The individual entries in the purchases journal are posted to the credit side of the creditor's accounts in the purchases ledger and the total is posted to the debit side of purchases account

of the general ledger. This is shown below:

The Purchases Returns Journal (Returns Inwards Journal)

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

Example of a Purchases Returns Journal (PRJ)

| THE PURCHASES RETURNS JOURNAL | | | |
|-------------------------------|---|-------|----------------|
| Date | Details | Folio | \$ |
| 09/04/2022 | Highlands dealers | | 20,000 |
| 18/04/2022 | Nairobi Suppliers | | 80,000 |
| 21/04/2022 | Territorial Enterprises | | 50,000 |
| 30/04/2022 | Highlands Dealers | | 80,000 |
| 30/04/2022 | Motors Shop | | 20,000 |
| Total | Total Cr. To purchases returns A/C in GL | | 250,000 |

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

The Sales Returns Journal (Return Inwards Journal)

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

Example of a Sales Returns Journal (SRJ)

| THE PURCHASES RETURNS JOURNAL | | | |
|-------------------------------|---|-------|----------------|
| Date | Details | Folio | \$ |
| 09/04/2022 | ABC Enterprises | | 42,000 |
| 18/04/2022 | Poncon Enterprises | | 65,000 |
| 21/04/2022 | Diamond Stores | | 55,000 |
| Total | Total Cr. To sales returns A/C in GL | | 162,000 |

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

NB: The posting of transactions from the journals to the ledger accounts in ledgers, follows the

same procedure as the one shown in the sales ledger and general ledger above.

THE GENERAL JOURNAL

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

Some of the transactions recorded here are:

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

Example: The general journal/the journal proper

| Date | Detail | DR (\$) | CR. (\$) |
|------------|--|---------|----------|
| 01/05/2023 | Motor Vehicle Motor Ltd. Motor vehicle bought n credit From Motor Ltd. | 25,000 | 25,000 |
| 03/05/2023 | Bad debts N Smart-Debtors (Amount due from N Smart) Written off as bad | 48,700 | 48,700 |
| | | | |

THE CASH BOOKS

The cash book is both a ledger and a prime book of entry in the financial accounting cycle. Cash receipts and cash payments out of an entity must be captured by the cash book.

There are several types of cash books:

- The single column cash book (single amount column-cash in hand only)
- The Double Column Cash Book (Two amount columns-Cash & bank)
- The Three/Triple column cash book (3 amount columns-cash, bank & Discounts)
- The Petty Cash Book (Deals with Petty (small) cash issues in an organisation)

NB: In this lesson we shall concentrate on the Three Column cash book and the Petty Cash Book.

THE THREE COLUMN CASH BOOK

This type of cash book is preferred because it carries with it three accounts and hence helps in summarizing many transactions in one account. Below is an illustration of this.

Example:

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

Year: 2022-March

- Mar 1 Balances brought forward: Cash \$.230; Bank \$.4,756.
- “ 2 The following paid their accounts by cheque, in each case deducting 5% discounts: R Burton \$.140; E Taylor \$.220; R Harris \$.800.
- “ 4 Paid rent by cheque \$.120.
- “ 6 J Cotton lent us \$.1,000 paying by cheque.
- “ 8 We paid the following accounts by cheque in each case deducting a 2.5% cash discount: N Black \$.360; P Towers \$.480; C Rowse \$.300.
- “ 10 Paid motor expenses in cash \$.44.
- “ 12 H Hankins pays his account of \$.77, by cheque \$.74, deducting \$.3 cash discount.
- “ 15 Paid wages in cash \$.160.
- “ 18 The following paid their accounts by cheque, in each case deducting 5% cash discount: C Winston \$.260; R Wilson & Son \$.340; H Winter \$.460.
- “ 21 Cash withdrawn from the bank \$.350 for business use.
- “ 24 Cash Drawings \$.120.
- “ 25 Paid T Briers his account of \$.140, by cash \$.133, having deducted \$.7 cash discount.
- “ 29 Bought fixtures paying by cheque \$.650.
- “ 31 Received commission by cheque \$.88.

NB: The figures given here are in \$ “000”

| CASH BOOK | | | | | | | |
|-----------|---------|---------|---------|------|--------|---------|---------|
| Bank | D..A-\$ | Cash-\$ | Bank-\$ | | D.R-\$ | Cash-\$ | Bank,\$ |
| Bal b/d | | 230 | 4756 | Rent | | | 120 |

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

NB: D.A; Discount Allowed, D.R. – Discount Received

PETTY CASH BOOK AND IMPREST SYSTEM OF ACCOUNTING.

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

- Postage and stationery
- Traveling
- Cleaning expenses.

Example of a Petty Cash Book

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

| | | | | | | | | |
|--|--|--|--|--|--|--|--|--|
| | | | | | | | | |
|--|--|--|--|--|--|--|--|--|

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

THE IMPREST SYSTEM

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

This is demonstrated as follows:

| | | |
|---------------------------|---------------------|--|
| | \$. | |
| Start with (float) | 1,000 | |
| Expenses paid | <u>(720)</u> | |
| Balance | 280 | |
| Reimbursement | <u>720</u> | |
| Cash float | <u>1,000</u> | |

Illustration:

A cashier in a firm starts with **\$2,000** in the month of March 2023 (that is the cash float). In the following week, the following payments are made:

- 1st March -bought stamps for \$80
- 2nd March paid bus fare for: \$120
- 2rd march-Bought cleaning materials for: \$240
- 3rd March Bought Fuel for: \$150
- 3rd March-Paid cleaning wages: \$300

4th march-Bought stamps for: \$200
 4th March-Paid Thompson (Creditor): \$400
 5th March-Paid Fuel costs: \$150.

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

Required:

Prepare a detailed petty cash book showing the balance to be carried forward to the next period and the relevant expense accounts, as they would appear on the General Ledger. Use appropriate columns to represent the various petty expenditures.

Suggested Solution:

The petty Cash Book (Imprest)

| Receipts (\$.) | Date 2023 | Detail | Payments Amount (\$.) | Expenses | | | THE LEDGER (\$) |
|-------------------|--------------|-----------------------|-----------------------------|-----------------|-------------------|------------------|-----------------------|
| | | | | Postage (\$) | Cleaning (\$.) | Travel (\$\$) | |
| 2000 | 1/3 | Bal b/d | | | | | |
| | 1/3 | Stamps | 80 | 80 | | 120 | |
| | 2/3 | Bus Fare | 120 | | 240 | | |
| | 2/3 | Cleaning Materials | 240 | | | | |
| | 3/3 | Fuel | 150 | | | 150 | 400 |
| | 3/3 | Cleaning wages | 300 | | 300 | | |

| | | | | | | | |
|-------------|-----|------------|-------------|---------------|---------------|------------|---------------|
| | 4/3 | Stamps | 200 | 200 | | | |
| | 4/3 | L Thompson | 400 | | | | |
| | 5/3 | Fuel | <u>150</u> | <u> </u> | <u> </u> | <u>150</u> | <u> </u> |
| | | | 1640 | <u>280</u> | <u>540</u> | <u>420</u> | <u>400</u> |
| <u>1640</u> | 5/3 | | | | | | |
| | 5/3 | Bal c/d | <u>2000</u> | | | | |
| <u>3640</u> | | | <u>3640</u> | | | | |
| 2000 | 6/3 | Bal b/d | | | | | |

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McCallig, J. (2008). Introductory financial accounting: Using international financial reporting standards. John McCallig.

Williams, J., Haka, S., Bettner, M. S., Meigs, R. (2002). Financial accounting. Irwin/McGraw-Hill.