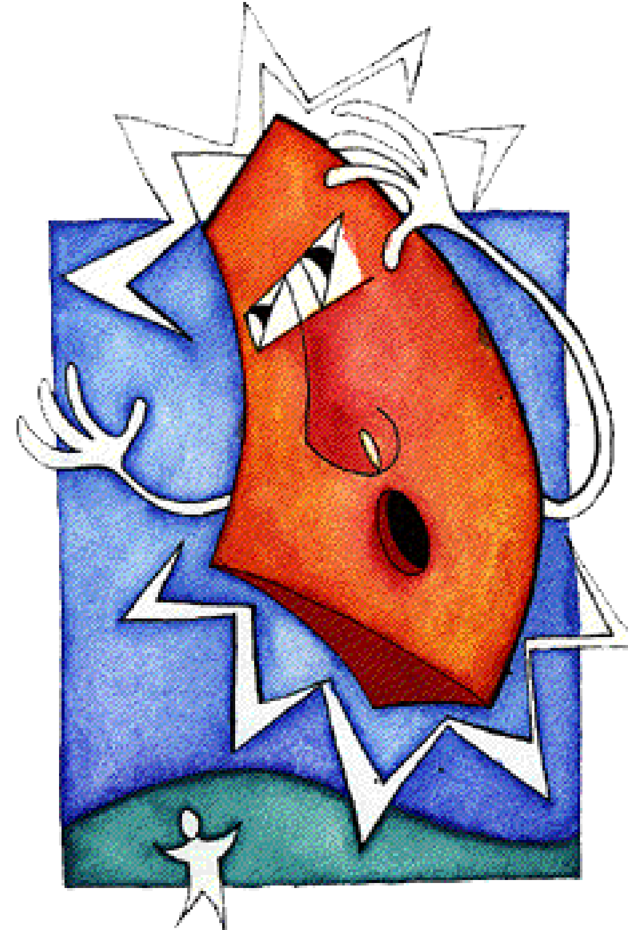
Don't Panic!



Appendix 2

Don’t Panic!

So far we have dealt with the mechanics of recording and presenting accounts information. Lets now introduce some of the devices you may need to tackle more thorny issues.

Compared with other types of software — like word processors or spreadsheets — an accounting application must adopt a more cautious approach to the direct editing or manipulation of information. This approach is vital in safeguarding the integrity of all completed entries — including any mistakes!

To guard against tampering with the figures, an accounts environment cannot allow deletion of mistakes (or anything). The audit trail must be complete — warts and all!

Therefore, one of the first things you will want to know is **‘when I put a foot wrong, how do I get back on track?’**

The first section of this chapter is designed with that question in mind and it describes some of the ways you can rectify any posting errors.

Having concentrated on the correction of individual book-keeping entries, the chapter then goes on to examine some of the corrections — or adjustments — that you may need to enter at the end of each period or financial year in order to produce an accurate and realistic set of accounts. These include…

- Provisions
- Stock adjustments
- Asset purchase and depreciation
- Bad Debts
- Year end adjustments
- Audit adjustments

There are many ways of preparing a set of accounts and there are also many ways of making adjustments to those accounts. We do not suggest that any of the procedures in this chapter (or anywhere else in this manual for that matter) are definitive ways of doing things.

While this chapter cannot address every accounting issue or predicament that you may encounter, it will hopefully keep you afloat until a professional — in the form of your accountant can come to your rescue.

Contra - when things go wrong…

Even the smallest business may have to deal with a startling number of accounting transactions during the financial year…

…what is less surprising is that the odd gremlin always manages to sneak its way into the system.

When misfortune strikes, most book-keeping errors can be rectified by entering a **contra** to completely reverse the original (and incorrect) posting. You may think of Contras as being some rebel force somewhere in Central America but we use the word here to mean a transaction which is the complete reverse of an earlier transaction — and so undoes it.

Having neutralised the initial error, you can then re-enter the transaction correctly. The following examples illustrate some of the ways in which you can use a contra to extricate yourself from the mire…

Correcting Sales and Purchase Ledger Transactions

Here, we look at the ways you can rectify some of the mistakes that can arise when posting transactions to your customer and supplier accounts.

1. Incorrect value posted during invoicing

When tackling this type of error, you can always enter an invoice or a credit note to make up the difference. The second and, perhaps, safer approach is to reverse the incorrect posting altogether then try again…

REFERENCE	DEBIT	CREDIT	BALANCE
1st (incorrect invoice)	350.00		350.00
Credit Note contra		350.00	0.00
2nd (correct) invoice	530.00		530.00

- Enter a credit note to cancel the original invoice
- Allocate it to neutralise the invoice
- Re-enter the invoice correctly.

This diagram illustrates how these transactions may look from the General Ledger’s point of view…

Description	Debit	Credit
1st (incorrect) invoice Goods purchased Purchase Ledger Control	 350.00 	 350.00
Credit Note Goods purchased Purchase Ledger Control	 350.00	 350.00
Final (correct) invoice Goods purchased Purchase Ledger Control	 530.00 	 530.00

2. Invoices posted to the wrong customer (or supplier) account

To resolve this particular dilemma, you should first 'contra' the original (incorrect) invoice by means of a Credit Note then re-enter the invoice correctly like this…

For the customer (or supplier) who has been incorrectly invoiced…

REFERENCE	DEBIT	CREDIT	BALANCE
1st (incorrect) invoice	500.00		500.00
Credit Note contra		500.00	0.00

- Enter a credit note, using the same itemised breakdown as the original invoice posting.
- Using the Allocate Unallocated Cash command, allocate the credit note to the invoice to cancel the transaction.

For the customer or supplier who should have been invoiced…

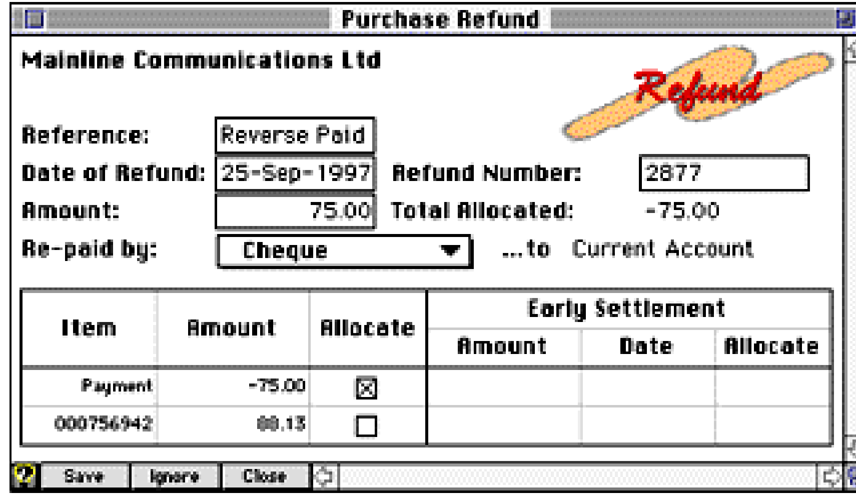
- Re-enter the invoice correctly.

Description	**Debit**	**Credit**
1st (incorrect) invoice		
Goods purchased	500.00	
Purchase Ledger Control		500.00
Credit Note		
Goods purchased		500.00
Purchase Ledger Control	500.00	
Final (correct) invoice		
Goods purchased	500.00	
Purchase Ledger Control		500.00

3. Correcting Payments

Wrong payment amount: If you need to correct a payment (usually on account) which, although entered against the right account, has been entered for the wrong amount…

- Cancel the original by entering a Refund for the same (incorrect) amount.
- Click the Allocate box to cancel the original payment.
- Re-enter the Payment correctly.



Wrong Supplier: If payments have been entered against the wrong supplier then use the refund command as above and re-enter the payment against the correct supplier like this…

- Enter a Refund then allocating it to the incorrect payment.
- Re-enter the Payment against the correct supplier account.

But! What happens if the correct payment has been made to the incorrect supplier and the payment has already been entered **and allocated**?……

Wrong supplier payment already allocated:

In these circumstances you will have cleared the original invoice and the payment — messy!

You may think that the best way to overcome this problem would be to simply re-enter the original invoice but you would be wrong because that would duplicate the actual purchase in the accounts.

To overcome this problem you would first need to reverse both aspects of the cleared transaction — in other words, the incorrect payment and the original invoice(s)…

REFERENCE	STATUS	DEBIT	CREDIT	BALANCE
Original Invoice	Paid	29.14		29.14
Incorrect Payment	Allocated		29.14	0.00
Credit note contra	Allocated		29.14	-29.14
Refund contra	Allocated	29.14		0.00
Reentered invoice	Outstanding	29.14		29.14

- Select the relevant supplier account.
- Referring to the original invoice(s), enter a credit note to reverse the invoice posting(s).
- Enter a Refund for the full cheque amount and, in the Refund window, allocating the refund to the credit note(s) that you have just entered.

Now! you can enter the invoice(s) for a second time so that the unsettled debt resurfaces in the books…

- Re-enter the original invoice details.

This is how the results filter through to the General Ledger

Description	Debit	Credit
1st (correct) invoice		
VAT Account	4.34	
Goods purchased	24.80	
Purchase Ledger Control		29.14
Incorrect Payment		
Current Account		29.14
Purchase Ledger Control	29.14	
Credit note reverses invoice		
VAT Account		4.34
Goods purchased		24.80
Purchase Ledger Control	29.14	
Refund reverses wrong payment		
Current Account	29.14	
Purchase Ledger Control		29.14
2nd (replacement) invoice		
VAT Account	4.34	
Goods purchased	24.80	
Purchase Ledger Control		29.14

4. Cheque Lost in the post

You have paid a supplier, entered the payment in the Purchase ledger - allocating against the supplier invoice then, later it appears that the cheque was never received.

- The first thing you do is cancel the cheque at the bank.
- Send out another cheque.

Regarding the accounts…

Either

- Do nothing - the new cheque forms the payment you have already entered except that the date and reference may be wrong

Or

- Enter the new Payment in the usual way making it clear in the reference box that it is a second payment.
- Enter a Refund, allocating it against the original payment and making it clear in the reference box that it is clearing a lost cheque.

5. Correcting Receipts

Incorrect receipts in the Sales ledger can be corrected in a similar way to the payments (above).

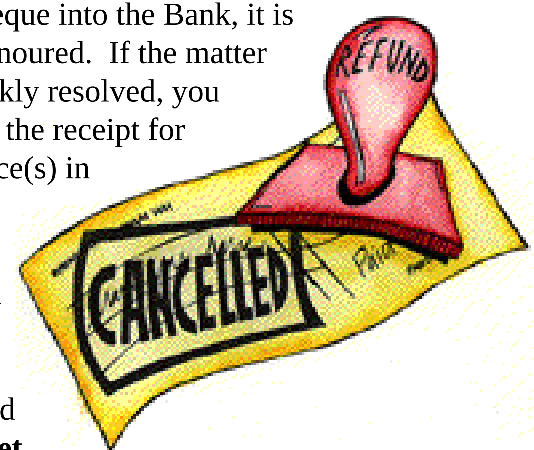
To do this, use the Refund command…

- Enter a Refund allocating it to the incorrect receipt.
- Re-enter the receipt against the correct customer account.

Similarly, use the Refund facility if you need to correct a receipt (usually on account) which, although entered against the right account, has been entered for the wrong amount…

- Cancel the original receipt by entering a Refund for the same (incorrect) amount, allocating it to the two entries.
- Re-enter the receipt correctly.

Cancelled cheques: You may find that having paid a customer's cheque into the Bank, it is returned dishonoured. If the matter cannot be quickly resolved, you should reverse the receipt for the sales invoice(s) in question.



This first case is unlikely, but if you have entered the money received but have **not yet** allocated it to the relevant invoices then all you need to do is cancel (or contra) the original cheque amount…

- Select the relevant customer account.
- Enter a Refund for the full cheque amount, allocating it to the original receipt.

This leaves the original invoice(s) sitting on the books — and still awaiting payment.

So far, so good! But what happens if you have already allocated the dishonoured cheque to the invoice(s) thereby clearing the transaction?

Cheque cancelled after payment allocated:

In these circumstances you will have cleared the original invoice and the receipt — tricky! You cannot overcome this problem by simply re-entering the original invoice(s) because that would duplicate the actual sales in the accounts.

To overcome this problem you would first reverse both aspects of the cleared transaction — in other words, the dishonoured receipt and the original invoice(s)…

REFERENCE	STATUS	DEBIT	CREDIT	BALANCE
Original Invoice	Paid	940.00		940.00
Bounced cheque	Allocated		940.00	0.00
Credit note contra	Allocated		940.00	-940.00
Refund contra	Allocated	940.00		0.00
Reentered invoice	Outstanding	940.00		940.00

- Select the relevant customer account.
- Referring to the original invoice(s), enter a credit note to reverse the invoice posting(s).
- Enter a refund for the full cheque amount then, in the Refund window, allocating it to the credit note(s) that you have just entered.

You can now enter the invoice(s) for a second time so that the unsettled debt resurfaces in the books…

- Re-enter the original invoice details but under a new number and with a reference which makes it clear that it is a repeat invoice.

Description	Debit	Credit
1st (correct) invoice		
VAT Account		140.00
Goods sold		800.00
Sales Ledger Control	940.00	
Receipt bounced cheque		
Current Account	940.00	
Sales Ledger Control		940.00
Credit note reverses invoice		
VAT Account	140.00	
Goods sold	800.00	
Sales Ledger Control		940.00
Refund reverses bounced receipt		
Current Account		940.00
Sales Ledger Control	940.00	
2nd (replacement) invoice		
VAT Account		140.00
Goods sold		800.00
Sales Ledger Control	940.00	

This is how the results filter through to the General Ledger

If there is any doubt whether this debt will be settled, you should enter a bad debt provision as described later in this chapter. That section also describes how you can remove the debt altogether once you have established there is no possibility of payment.

6. The ‘Penny out’ syndrome

There will be occasions when you pay on account (or are paid on account) only to find that when the final invoice surfaces, there is a rounding difference amounting to only a penny or a few pence.

You may also find that a customer will pay a few pence over or under the proper invoice amount and it is not worth the hassle of chasing up the difference. This doesn’t really matter in real terms but you will find that these small amounts make Statements and other reports look untidy and sometimes difficult to decipher.

Bottom Line only allocates exact amounts which leaves whole payments or receipts unallocated for want of a few pence littered about. You can use Miscellaneous Credits or Debits to clean up the litter for either Sales or Purchase accounts like this…

- Look at the Account Status report and assess the effect that the discrepancy is having on the balance.

If the balance needs to be reduced by the amount of the discrepancy then you will require a Miscellaneous Credit — and vice versa.

- Choose the Enter Other Transactions option from either the Sales or Purchase menu.
- Choose the transaction type as Misc. Credit or Misc. Debit
- The Analysis code should be the same as a code used on one the items on the original invoice.
- Enter the amount of the discrepency.
- Leave the VAT amount as zero.
- Allocate the miscellaneous debit or credit against the original invoice using the Allocate Unallocated Cash facility.

Correcting General Ledger Postings

Incorrect postings to the General Ledger accounts can arise in one of two ways…

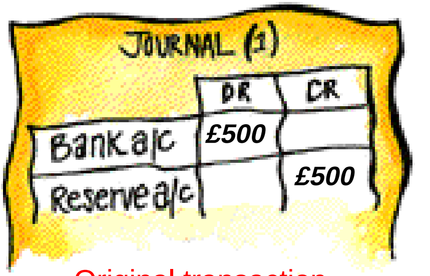
Journal entries

Using the double entry Journal facility, you are able to post a transaction directly to the General Ledger accounts by nominating the account numbers and amounts to be debited and credited. Once the Journal has been posted, you may discover that you have specified the wrong account number or amount — in which case…

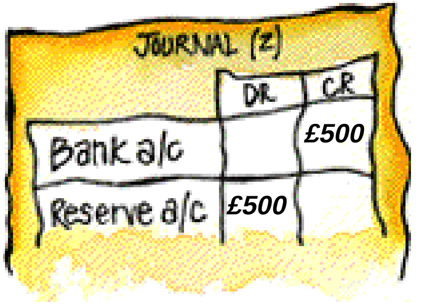
If the mistake has been identified in the same accounting period as it was entered, simply use the Journal facility to reverse the original (but incorrect) posting as shown here…

…then re-enter the transaction correctly.

If the mistake only comes to light in a subsequent accounting period then use a Prior Period Journal to reverse the error and re-enter the correct details.



Original transaction



Contra reverses the effect of the original

Posting from the Sales and Purchase Ledgers

When posting invoices or credit notes, analysis codes are used to map each type of item to the correct General Ledger account. Once a transaction has been posted to the General Ledger you may find that it fails to arrive at its correct destination account.

This could be due to two reasons:

1. When entering the invoice (or credit note), you inadvertently specified the wrong analysis code.

   In this situation, the error should be rectified by using a contra and a corrected transaction in the relevant Sales or Purchase ledger then allocating them together — as described above. If you were to use Journals to correct these transactions then, yes, you will correct the error in the General Ledger but you will still have an error in your Sales (or Purchase) analysis.

2. You used the correct analysis code but this has been linked to the wrong General Ledger account in the analysis code record.

   In this case…

   - Use a Journal (or Prior Period Journal) to contra the posting that has already occurred.
   - Enter a revised journal to simulate the correct posting from the Sales (or Purchase) ledger.
   - To prevent the same mistake happening again, open the offending analysis record and ensure that it is linked to the correct General Ledger account number.

Clever Contras

Having introduced the contra as a means of reversing a posting, here comes the clever stuff…

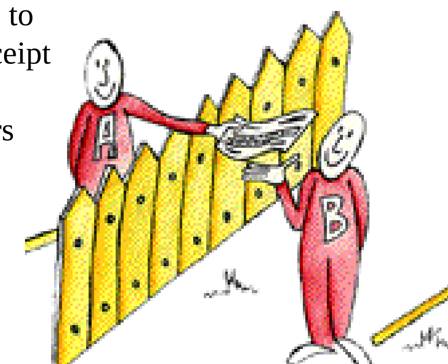
Suppose you owe money to a supplier who, at the same time, owes you money as a customer. Both of you may decide to settle the two debts by off-setting the common debts. A cheque may then change hands to settle any difference in the two outstanding balances.

Here's an example…

Imagine that you owe your supplier £2,000 — while the same party (as a customer) owes you £2,500. Imagine also that you have just received a cheque for £500 to settle the score.

The book-keeping entries must have the following effect…

- In the Purchase Ledger, **credit** £2,000 from the supplier's account to reduce the balance to zero.
- In the Sales Ledger, **credit** £2,000 from the customer's account to reduce the balance to £500. The supplementary receipt of £500 can then be entered thereby clearing the customers balance.



The two separate credits of £2,000 act as a supplier payment and customer receipt respectively.

This transaction can be carried out like this…

Contra’d False Payments

This contra relies on the normal Payment and Receipt procedures - you simply pretend that both the customer and supplier transactions have happened…

In the Purchase Ledger:

- Select the relevant supplier account
- Choose Payment and enter the value £2000, allocating the £2000 invoice.
- Ensure that the payment goes to the same General Ledger account (probably Current Account) as Cash Received.
- Make it clear in the Reference that this is a contra.

In the Sales Ledger:

- Select the relevant customer account
- Choose Receipt and enter the value £2000 (not the full £2500).
- Make it clear in the Reference that this is a contra.
- Choose Receipt again, enter the remaining £500 and allocate both the £2500 invoice and the previous £2000 contra.

This completes the transaction but you will notice if you visit the General Ledger that the bank (Current) account will show a false payment and a false receipt which cancel each other out.

If you have created a reconciliation file for this account…

- Open the reconciliation
- Group the two contras together
- Delete the group to clear the false payments

Although the payments have been cleared from the reconciliation they will still remain in the General Ledger. For auditing purposes, the transaction references will show that they form a contra charge.

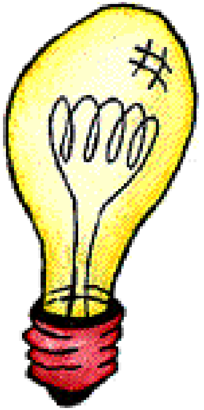
More Accounting Issues

Way back, in Chapter 1, we introduced the principle objectives of accounting — namely, the procedures to accurately record, summarise and present the financial position of your business. To briefly recap…

From simple Book-keeping… In Bottom Line, transactions can be posted directly to the General Ledger using the double entry Journal facility or posted indirectly via the Sales and Purchase Ledgers. This daily process of recording and balancing transactions is called **book-keeping** and it provides the bases from which your financial statements are derived…

…to Management and Financial Accounting… The Balance Sheet shows where you are in financial terms on a particular date — while the rôle of the Profit & Loss Account and History report is to explain how you got there. These two financial statements can be produced each period to provide the internal management accounts which enable you to plan and manage your business affairs effectively.

Furthermore, there will be times when you need to communicate the results of your endeavours to an external and diverse audience — such as the bank, Inland Revenue, shareholders, a prospective partner — so that they are able to assess your performance. Documents which are drawn up for external scrutiny are referred to as financial accounts and, in the case of limited companies, they need to be audited annually to ensure their compliance with the Companies Act.



To ensure that all recipients — whether internal or external — are presented with the true business facts, it is vital that the summarised statements present a realistic assessment of the profit (or loss) made. To this end, you may need to make certain adjustments and amendments to the trading profit — some of which are now described over the page…

Provisions

When you know that you have a liability, it is always a good idea to provide for it in the accounts.

Suppose that you have made a purchase or someone has carried out a service for you and, at the end of an accounting period or at the end of a year you have not yet had an invoice.

In this situation you should enter a **provision** in the account. A provision is simply a temporary adjustment, intended to take account of a known liability. It does not take the place of the real invoice when it finally arrives.

Entering a provision:

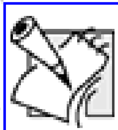
To enter a provision, you need a Balance Sheet account to show the liability…

- Enter a General Ledger account ‘Short Term Provisions” in the Current Liabilities category.

Use a Journal to create the provision like this…

- Debit the Profit & Loss account which would normally bear the cost and Credit the above ‘Short Term Provisions’ account.

Description	Debit	Credit
Provision for 4th Qtr Power charge		
Heat Light & Power	825.00	
Short Term Provisions		825.00



Anything goes

A provision, by its temporary nature can be entered using an estimated figure. Thus if you know that you are going to be hit by a large invoice for having the roof repaired then you would simply estimate what you think it is going to cost.

DONT FORGET to get rid of the provision…

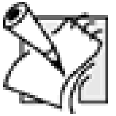
Reversing a provision:

Once the real invoice or charge comes to roost, get rid of the provision like this…

- Prepare a contra journal to reverse original provision(s).

Description	Debit	Credit
Reverse Provision for Power charge		
Heat Light & Power		825.00
Short Term Provisions	825.00	

- Enter the genuine invoice or charge in the usual way.

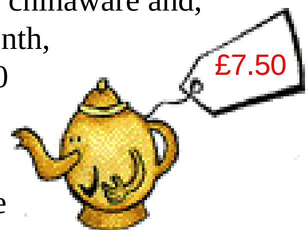


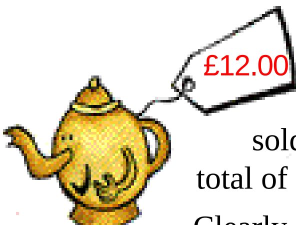
Special provisions

Some provisions are made under special contingencies, for example Bad Debt provisions or End of Year provisions described later in this chapter. These would be reversed whenever they no longer apply.

Stock Adjustments

In the pursuit of profits, many businesses generate income by acquiring goods with the intention of re-selling at a higher price. For example, imagine that you have set up an emporium selling chinaware and, at the beginning of your first month, you buy 20 teapots costing £7.50 each for a total of £7.50x20=£150.





Imagine also that, at the end of the month, you have sold 15 teapots for £12.00 each — a total of £12x15=£180.

Clearly, you have made a profit…

Gross Profit = Total sales - Cost of goods sold

…but how much?

Cost of Sales

Using the standard equation of calculating gross profit, you might be inclined to say that you have made £30 profit (£180 sales - £150 cost of sales).

However! The £150 spent on acquiring your initial stock also purchased 5 unsold teapots. While these unsold items have cost the business £37.50, they do not represent a direct sales cost for this period — they are a current asset available for sale in next accounting period.

If we add this factor to our calculations…

Sales:	
Total sales (15 teapots @ £12.00 ea.)	£180.00
Cost of Sales:	
Add opening stock (teapots purchased earlier)	0.00
Add stock purchased (20 teapots @ £7.50 ea.)	£150.00
Less unsold stock (5 teapots @ £7.50 ea.)	(£ 37.50)
Total Cost of Sales	£ 112.50

…then we arrive at the true gross profit of

£180.00 - £112.50 = £67.50!

Profit!

So! The definitive formula for calculating Cost of Stock at any point is:

Cost of Sales = Opening Stock value
+ Stock Purchased A
+ Stock Purchased B …
+ Stock Purchased N
- Current Stock value

Don't forget Opening Stocks

In the above, simple example you will notice that we added a line for opening stocks — with a value of zero. This is in case we had some pre-existing stock of teapots at the start of trading — this enables us to deduct our unsold teapots without worrying about the fact that some of them were already there at the outset.

In practice you will probably only want to record Opening Stocks at the start of a financial year (after a year-end stocktaking). Thereafter you will add purchases in this financial year under the relevant Direct Cost categories.

Stock accounts needed

Having said that any stock remaining at the end of the period represents a business asset, you need to ensure that you have the following Balance Sheet account…

- A 'Stock-in-hand' account (Current Assets)

When Bottom Line calculates gross profit for a particular period, it needs to account for **opening stock**, **stock purchases** and **current stock** values. You should ensure that you have the following Profit & Loss accounts (usually under Cost of Sales)…

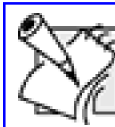
- An 'Opening Stock' account to record residual stocks at the start of your financial year.
- Stock Purchase accounts (of varying categories if necessary) to record the purchase of stocks throughout the year.
- A 'Current Stock' account to record the stock left unsold.

An example of the positioning of these accounts looks like this…

BALANCE SHEET
ASSETS
Fixed Assets
…
Current Assets
Stock
Stocks for Resale (Stock-in-hand)
…
…
Current Liabilities
LIABILITIES
CAPITAL
PROFIT & LOSS ACCOUNT
REVENUE
…
Direct Costs
…
Opening Stock
Purchase A for Resale
Purchase B for Resale
…
Current Stock
…
Gross Profit
EXPENSES
Profit or Loss

Having set up the required accounts…

- In the Purchase Ledger, create purchase analysis record(s) which link to the Stock Purchase accounts that you have just created.



Complicating the issue

We have noted the need for an Opening Stock and a Current Stock account — and, for simplicity, we continue to discuss just one account for each purpose. However, there is no reason why you should not have multiple opening or current stock accounts to track the variation of a variety of stock categories.

Set up Opening Stock Values

When you create a new set of accounts you will have to value your opening stocks at the outset.

- Debit the stock value to your 'Stock-in-hand' account in the Balance Sheet.

This should form part of the opening balances during the initial period. If you debit this value at a later date then you will have to enter the value via a Journal and, of course there will have to be a corresponding credit to balance it.

- Debit 'Opening Stocks' (in Expenditure) with the stock value.
- Credit 'Current Stocks' (in Expenditure) with the same value.

It is safe to assume that, at the point of time when you create your accounts the opening and current stock value will be the same.

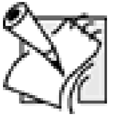
Everyday stock acquisitions

You are now ready to start recording the stock transactions for the period. Returning to our example, this involves…

- In the Purchase Ledger, enter the supplier Invoices using the analysis codes which map these purchases to the 'Stock Purchase' accounts —then post the transactions to the General Ledger.

Stock valuation

As you will appreciate from the above example, the value of stock remaining (the current stock) at any time is crucial to the accuracy of your profit calculation. As a result you should devise a way of recording the residual value of stock for accounting purposes. This may be done by means of a sophisticated Stock Control system or it might only be done by sticking a finger in the air and guessing the value of remaining stock.



Auditors like exact valuations

However accurate or inaccurate your stock valuation during the year, your end of year valuation should be spot-on for your official end of year accounts or audit. Your auditor may insist on witnessing a physical count of every item of stock. This is why many businesses drop everything to go through a stocktaking exercise.

Whatever method you use to value stocks you will probably only find it necessary to record a revised valuation at the end of each accounting period. The valuation may vary either up or down.

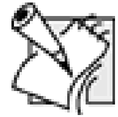
If the stock valuation has decreased during the period (stocks have been used up)…

- Use the journal facility to debit the 'Current Stock' account with the variation and credit it to the 'Stock-in-hand' account.

If the stock valuation has increased (stocks have been replenished)…

- Use the journal facility to debit the 'Stock-in-hand' account with the variation and credit it to the 'Current Stock' account.

The Profit & Loss Account now shows a more accurate gross profit for the period.



The art of being prudent…

You may be wondering why the unsold items in our example are valued at their cost price (£7.50) rather than their selling price (£12.00). After all. if some items have already been sold at the higher price then we can assume that the remaining stock will also sell for the same price… ..or can we?

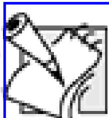
This introduces the **Prudence Concept** of accounting — and one aspect of this concept specifies that a profit cannot be anticipated before it has been real-ised.

Stock accounting in practice

Our example looked at the stock transactions for the first period of trading only — but how do you account for selling your remaining stock (and any new stock) in subsequent periods?

Moving swiftly into the second period of trading, let's assume that you want to top up your teapots in anticipation of further sales. This time, the manufacturer offers more generous terms and agrees to provide 100 more teapots at £6.00 each (instead of £7.50). By the end of the second period, you have sold 45 teapots at the same retail price of £12.00.

The cumulative gross profit calculations at the end of the period would look like this…



More about stock…

- In the world of accounts, it is common to assume that stock which is bought first is sold first.
- The above treatment of stock is one of many different ways of approaching the problem. You may prefer to talk to your accountant to see how he or she would prefer to see it done.

Sales:		
Total sales (15 teapots @ £12.00 ea.)	£180.00	
Total sales (45 teapots @ £12.00 ea.)	£540.00	
		£720.00
Cost of Sales:		
Add opening stock		0.00
Add stock purchased (20 teapots @ £7.50 ea.)		£150.00
Add stock purchased (100 teapots @ £6.00 ea.)		£600.00
		£750.00
Less current, unsold stock (60 teapots @ £6.00 ea.)		(£360.00)
Total Cost of Sales		£390.00
Gross Profit		£330.00

Fixed Assets

Purchasing a fixed asset

In the normal course of trading, a business is likely to invest some of its hard earned income in acquiring **fixed assets** — such as machinery, equipment, furniture or vehicles which are intended to be used within the business rather than resold.

When you purchase a fixed asset then the business is not immediately incurring any expense or loss of profit. What it is doing is exchanging one asset (cash) for another asset.

Whenever you purchase a fixed asset, this is what you do…

- Create a General Ledger account in the Fixed Assets category for the required type of asset.
- Ensure that you have set up a Purchase Analysis item which reports to the relevant Fixed Asset category in your Balance Sheet.
- Enter the purchase invoice via the Purchase Ledger using the above analysis code.

Purchasing a fixed asset by hire purchase

If you purchase a fixed asset through a hire purchase agreement, the objective is to create a new asset and to immediately exchange it for a down-payment and the remainder on credit.

There are a couple of points to remember with this type of transaction…

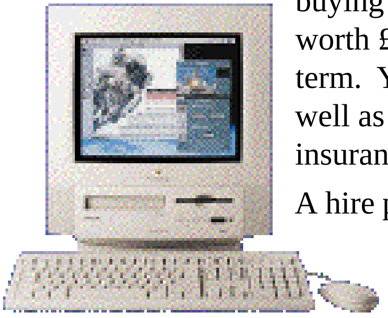
- **Down Payments:** There will be an initial cash down payment which is usually paid by cheque.
- **Additional Payments:** There may be other up-front payments like arrangement fees and perhaps credit insurance.
- **HP Credit:** It is usual in a set of accounts to categorise liabilities into:

  • Short Term Liabilities — which are due within the next 12 months

  • Long Term Liabilities — which are due after 12 months

  As a result, if your HP term is longer than one year then you can show 12 months’ repayments as Short Term and the remainder as Long Term. Work out the total instalments payable in the next 12 months (excluding the interest element of those payments).
- **VAT:** If VAT is payable, it is common for that to be paid up front as it is recoverable by your business in the current quarter.
- **HP Interest:** It is not necessary to record the interest payable over the HP period as a liability as this only becomes due on each instalment date.

To illustrate an HP transaction, lets assume that you are



buying some new equipment worth £9000.00 over a 3 year term. You have VAT to pay as well as an arrangement fee and insurance to protect the lender.

A hire purchase transaction needs the following General Ledger accounts…

- Ensure that you have entered the following accounts:

i) An account for the Asset category (in Fixed Assets).
ii) Finance costs (in Expenses).
iii) Insurance (in Expenses).
iv) Miscellaneous Debit/Credit (in either Current Assets or Current Liabilities).
v) Short Term Hire Purchase (in Current Liabilities).
vi) Long Term Hire Purchase (in Liabilities falling due after 12 months).

This diagram illustrates the typical positioning of these accounts in the General Ledger…

BALANCE SHEET
- ASSETS
  - Fixed Assets
    - Equipment
    - Furniture
    - Vehicles
    - …
  - Current Assets
    - …
    - Miscellaneous Debit/Credit
  - Current Liabilities
    - …
    - Short Term Hire Purchase
- LIABILITIES
  - …
  - Long Term Hire Purchase
- CAPITAL

PROFIT & LOSS ACCOUNT
- REVENUE
- Direct Costs
  - **Gross Profit**
- EXPENSES
  - …
  - Insurance
  - Finance Costs
    - **Profit or Loss**

- Enter Purchase Analysis Codes linking to i) - iv) above.

The HP purchase transaction can now be entered in 4 stages…

1. **The Invoice:**

   Enter the purchase invoice via the Purchase Ledger using the above analysis codes for:

   - The purchase sum (with VAT)
   - The arrangement fee
   - The Insurance

2. **The down payment:**

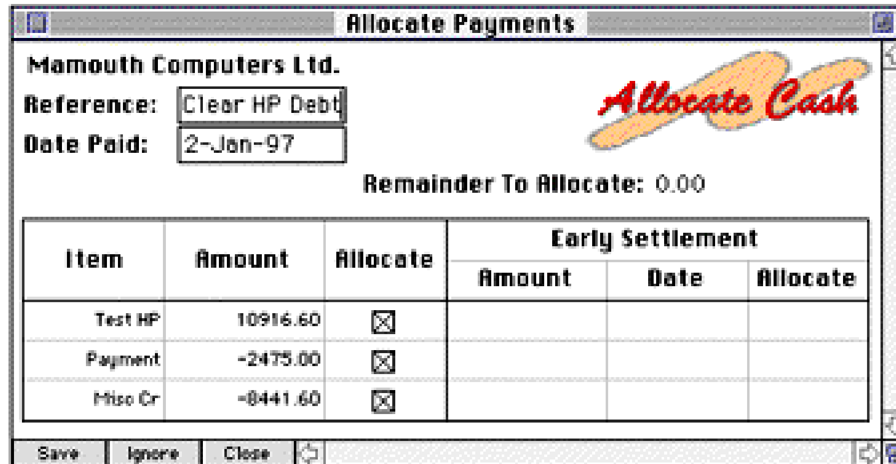
   Enter a payment in the normal way to cover the up-front cash payments.

   - The initial payment
   - Insurance premium
   - Arrangement fee

3. **Clear Debt from supplier:**

   Enter a Miscellaneous Credit for the remaining debt, use the purchase code to transfer it to the “Miscellaneous Debit/Credit” account that you have set up — leave the VAT as zero.

   Choose Allocate unallocated cash and allocate the purchase sum against the cash and credit amounts.

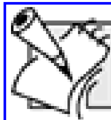


4. **Assign HP debts:**

   Prepare a journal debiting the “Miscellaneous Debit/Credit” account and crediting the relevant amounts to “Short Term Hire Purchase” and “Long Term Hire Purchase”.

The above stages amount to the following transactions in the General Ledger…

Description	Debit	Credit
Invoice for HP purchase		
VAT Control Account	1575.00	
Equipment	9000.00	
Finance costs	50.00	
Insurances	291.60	
Purchase Ledger Control		10916.60
HP up-front payment		
Current Account		2475.00
Purchase Ledger Control	2475.00	
Misc. Credit HP debt		
Miscellaneous Dr/Cr		8441.60
Purchase Ledger Control	8441.60	
Journal to assign HP debt		
Miscellaneous Dr/Cr	8441.60	
Short Term Hire Purchase		2813.87
Long Term Hire Purchase		5627.73



What about the Interest?

The above transactions cover the immediate transactions in setting up your HP purchase but there is also interest to pay.

Interest payments are only entered into the accounts when they fall due and they will be taken into account when the instalments are paid.

- Create a General Ledger account “Hire Purchase Interest” in the Expenses category.

Use a Cashbook Journal to enter the instalments like this…

- Pay the capital repayment to “Long Term (or Short Term) Hire Purchase”.
- Pay the Interest to “Hire Purchase Interest”.

Depreciating Fixed Assets

Why depreciate?

While fixed assets are of long-term benefit to the business, they do not last forever — they wear out or become obsolete. If this gradual decline is not accounted for the true value of these assets will not be shown on the Balance Sheet.

The loss in value of a fixed asset is called **depreciation** and it is recognised in the accounts by gradually writing off the cost of the asset as it wears out or becomes obsolete. Since depreciation represents a cost to the business which cannot be recovered, this loss is charged to the Profit & Loss Account at the end of each accounting period — as an **expense**.

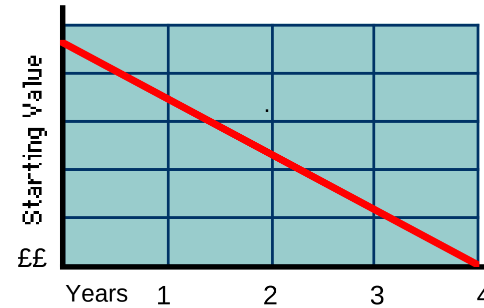
However! The difficulty is, how much you should charge each period since the loss in value of each fixed asset is usually spread over a number of years — but how many years exactly? Having reached the end of its useful life, can the asset be sold to recoup some of its cost — and, if so, how much can be recovered?

These questions cannot be accurately answered until the asset is finally put out of use. In the meantime, your only alternative is to estimate your depreciation costs…

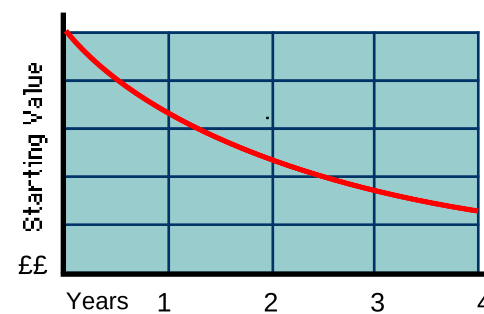
Calculating Depreciation

In accounts, there are two principle ways of calculating depreciation charges…

The Straight Line method: Here you estimate how long the fixed asset will last and what its value will be at the end of its useful life. Then divide the cost by the number of years to give the annual depreciation charge — like this…



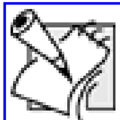
The Reducing Balance method: Using this method, deduct a fixed percentage from the cost price during the first year. Each subsequent year, deduct the same percentage from the previous year's balance (residual value) — like this…



Depreciation Example

Suppose you purchased a computer for £2,400 — depreciation each year at 25% will be…

	Straight Line	Reducing Balance
Year 1	£600.00	£600.00
Year 2	£600.00	£450.00
Year 3	£600.00	£337.50
Year 4	£600.00	£253.12
Residual value after 4 years	zero!	£759.38



Notes about depreciation methods

- While the Straight Line method assumes that an asset wears out evenly so its original cost is reduced by equal amounts each year, the Reducing Balance method recognises that assets depreciate more in the early years so the percentage reduction is based on the written down value, not the original cost.
- Residual value is supposed to reflect the value of the asset to the business as a usable tool of the trade — it is not strictly meant to track the resale value of the asset.
- Opinions vary over the relative merits of each method but your accountant will be able to advise which one and what percentage would best suit your particular business.

Whichever method you choose, calculate the annual depreciation amount for each fixed asset then divide this by the number of accounting periods over which the annual cost is to be spread.

Recording depreciation

Before we get down to the actual process of recording depreciation, it is important that you know where this information is recorded.

Whenever you purchase a fixed asset, its cost price is posted (usually via the Purchase Ledger) to the relevant fixed asset account on the Balance Sheet.

Each accounting period, the calculated loss in value of the fixed asset can be debited to a relevant Profit & Loss account thereby reducing the trading profit…

…and a corresponding credit is made to the Balance Sheet thereby reducing the book value of the fixed asset.

Now, here comes the catch! It is customary that fixed asset accounts show the value of those assets **at cost.** As a result, it would be wrong to directly credit the loss in value from the fixed asset accounts themselves. Instead, the depreciation cost is shown accumulating in a separate “Provision for Depreciation” account on the Balance Sheet and it is this account which is credited. Therefore, before recording depreciation, you should ensure that you have set up the following General Ledger accounts…

In the Fixed Assets category (Balance Sheet):

- A General Ledger account “Provision for Depreciation” to record the loss In value of fixed assets (it appears as a negative value).

In the Expenses category (Profit & Loss Account):

- A General Ledger account “Depreciation” to record the depreciation costs for each type of fixed asset.

Using your chosen method of calculating depreciation, work out the total cost to be charged in each accounting period for the fixed assets on your books — a spreadsheet application is particularly suited to this purpose.

Depending on the structure of your accounts, you may then want to break down the total depreciation figure into the amounts to be charged for each type of fixed asset. These costs can then be entered each accounting period as follows…

- Open a Journal in the General Ledger.
- For each type of fixed asset, debit the depreciation cost to the relevant Profit and Loss account(s).
- Credit the total depreciation cost for the period to the ‘Provision for Depreciation’ account.

Description	Debit	Credit
Depreciation of Equipment	903.12	
Provision for Depreciation		903.12
Depreciation of Furniture	70.75	
Provision for Depreciation		70.75
Depreciation of Vehicles	342.98	
Provision for Depreciation		342.98

Disposal of a fixed asset

To conclude our examination of depreciation, it is worth noting how you record the disposal of a fixed asset when it finally reaches the end of its useful life.

Let’s return to our original illustration of an ageing computer. Imagine that, at the end of the third year, you have found a buyer willing to take it off your hands for the sum of £800. Imagine also that the computer (originally costing £2400) is shown on the Asset Register as being worth £1012 once the estimated depreciation cost of £1388 has been taken into account.

One way to record the disposal of this asset would be as follows…

In the General Ledger:

- Create a General Ledger account, “Gain or Loss on Asset Sale” in the Expense category.

In the Sales Ledger:

- Create a sales analysis record which links to the “Gain or Loss on Asset Sale” account that you have just created.
- Invoice the sale of the asset to the relevant customer account using the above sales analysis code.
- Post the transaction to the General Ledger.

Now an adjustment…

Description	Debit	Credit
Sales invoice - asset disposal Gain or loss on asset sale Sales Ledger Control	 800.00	 800.00
Journal, Original Cost of Asset Equipment Gain or loss on asset sale	 2400.00	 2400.00
Journal, Depreciation of Asset Provision for depreciation Gain or loss on asset sale	 1388.00 	 1388.00

In General Ledger:

- Using the Journal facility, credit the original cost price of the asset from relevant Fixed Asset account and debit it to the “Gain or Loss on Asset Sale” account.
- Debit the amount of depreciation already charged for this asset to “Provision for Depreciation” and credit it from the “Gain or Loss on Asset Sale” account.

These transactions will have…

- Recorded the Sale
- Reduced the Asset value
- Reduced the depreciation provision
- Recorded a gain or loss on the asset disposal

The resulting balance recorded in the “Gain or Loss on Asset Disposal” account represents the profit or loss made on actual sale of the fixed asset — a debit balance shows a loss on the sale as we have done here, while a credit balance represents a profit.

Bad Debts

In addition to the depreciation, there are other losses which you may need to set against your trading profit. For example…

Provisions for Bad Debts

Many sales are made on a credit basis — you supply goods or services on the condition that the customer promises to pay you within an agreed period of time. These debts are accumulated in the Sales Control account which appears as an asset on the Balance Sheet…

…unfortunately, there is no absolute guarantee that you will receive all the money.

Alarm bells may start ringing when a customer ignores all entreaties to cough up or issues a cheque which goes into your bank account only to bounce straight out again.

As soon as you start to suspect that a customer cannot (or will not) settle its debts, you need to provide for a possible loss so that the value of your debtors in the Balance Sheet is not overstated. This involves crediting a bad debt provision to the Balance Sheet which is then debited (or charged) to a Profit & Loss "Bad Debts" account — like this…

You will have to ensure that you have the following General Ledger accounts:

- "Bad Debt Provision" (in Current Assets — it appears as a negative value)
- "Bad Debts" (in Expenses, in the Profit & Loss account)

To enter a Bad Debt Provision:

- Create a Journal to credit the bad debt value to "Bad Debt Provision" and debit the value to "Bad Debts" in the Profit & Loss account.

Description	Debit	Credit
Bad Dept Provision		
Bad Debts (P&L)	564.00	
Bad Debt Provision		564.00

After further chasing, you may conclude there is no possibility of recovering the debt. At that point, you will need to reverse the provision and write-off the debt completely as described in the next section.

The debt still stands

By entering a bad debt provision, you have not let the errant customer off the hook. The debt still resides in the Sales Ledger, represented in the Balance Sheet in the Sales Control account.

Play safe

It is prudent to ensure that anticipated losses such as depreciation, possible bad debts, whatever — must be accounted for **as soon** as they are foreseen. This ensures that the assets owned by the business are never overstated — nor the liabilities owed by the business understated.

When combined, these two aspects ensure that the management and financial accounts always err on the side of caution and that the users of this information (including you) are not beguiled by wild flights of optimism.

VAT relief on Bad Debts

Under some circumstances it is possible to claim back VAT which is part of a bad debt. Check your VAT handbook to check in each circumstance whether you can claim back the VAT you have paid (Bad Debt Relief). At the time of publishing this document, the conditions were that the debt should be more than six months old, you should have paid the VAT and the debt should be written off.

Notice that we do not include VAT in a Bad Debt Provision, because you should not claim Bad Debt Relief for VAT unless the debt is actually written off. However, in the next section on Write-offs you will see that there is a facility to enter VAT which is to be claimed.

Writing off a Bad Debt

Once you have established that there is no possibility of recovering an outstanding debt, you need to permanently remove it…

- Clear it from the customers balance in the Sales Ledger
- Remove its value from the Balance Sheet (from the 'Sales Control' account)
- Charge the corresponding cost to a Profit & Loss 'Bad Debts' account.

This process is called **writing off**.

But First, if you have already entered a provision for this particular debt you should reverse it…

- In the General Ledger, reverse the bad debt provision by entering a 'contra' journal as described earlier In this chapter.

Description	Debit	Credit
Bad Dept Provision Contra Bad Debt Provision Bad Debts (P&L)	 564.00 	 564.00

Don't forget to reverse the provision otherwise you may be accounting for the same bad debt twice.

Prepare to Write Off

Before you enter a write-off, print or preview the Open Invoices to check the exact amounts that are involved. You may be writing off a single invoice, a number of invoices or even a proportion of a single invoice.

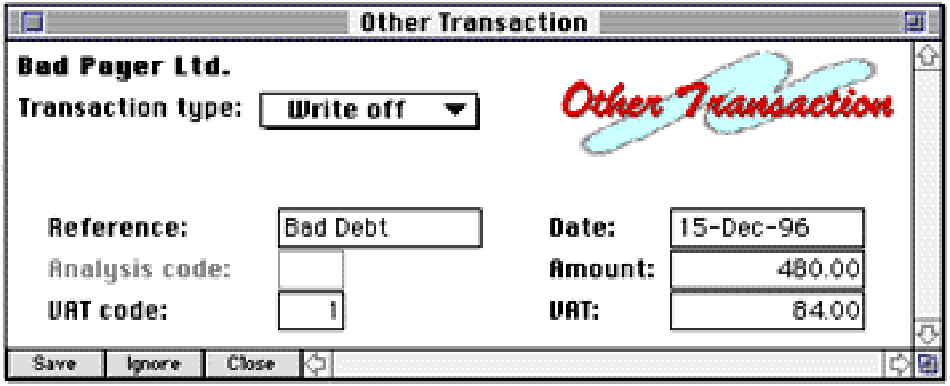
Establish whether you are able to claim Bad Debt Relief from Customs and Excise.

- If you cannot claim relief then establish the gross total amount that you are writing off (Sales + VAT).
- If you can claim relief then calculate the Net total (excluding VAT) and totals for each VAT rate (Standard, Fuel etc.).

Actual Write-off

The next steps are to transfer the relevant customer balance (which is now deemed worthless) to the "Bad Debts" account as follows…

- Ensure that a General Ledger account "Bad Debt" is available in the Profit & Loss accounts and that you have entered its account number correctly in the Sales Account Details.



- Use Allocate Unallocated Cash, to match the write-off to the relevant Invoice(s).

The balance for the offending customer is now reduced by the value written off. On posting the write-off to the General Ledger, Bottom Line…

In the Sales Ledger:

- Select the relevant customer account then choose Enter Other Transactions.
- Set the transaction type to Write-Off
- Enter the amount to be written off (this is usually Net of VAT but may be gross if you cannot claim Bad Debt Relief).
- If you are eligible to claim back VAT, enter the relevant VAT analysis code and the VAT amount to be claimed.

  Note: If there are two or more VAT totals then you should enter additional Write-offs with VAT only.

Description	Debit	Credit
Write off Bad Debt		
Bad Debts (P&L)	480.00	
Sales Ledger Control		480.00
VAT Account	84.00	
Sales Ledger Control		84.00

- Credits the “Sales Control” account thereby reducing its value as an asset on the Balance Sheet.
- Debits the written off amount to the “Bad Debts” account showing an increased loss.
- Debits the VAT account reducing the amount of VAT that you will have to pay.

Year End Adjustments

The purpose of drawing up the final accounts is to present an accurate view of the business’s performance over the past year. This involves…

- Recording all transactions for each accounting period in the year.
- Making certain adjustments to the profit for each accounting period so that opening and current stock levels are correctly accounted for — and that fore-seen losses (such as depreciation of fixed assets and bad debts) are provided for.

However, you may need to carry out some further adjustments to the final accounts before you can arrive at the true profit & loss figure for the year. For example…

Prepaid expenses

Very often you will find yourself making advanced payments for goods or services whose benefit extends to a number of accounting periods — such as annual insurance premiums, local business rates, rent, etc..

Having charged the full cost of a benefit to this year’s profit, the benefit itself may carry over into the next year. To illustrate this point, take a look this example…

End of year

Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug

Insurance Premium paid

Here, the business has taken out 12 months’ cover to insure its premises. The annual premium of £2400 was paid in advance on the 1st September.

Now! If the accounting year ends on 31st December, the business has paid £2400 but has only received 4 months’ insurance cover in return — the remaining 8 months’ cover will be used up in the next financial year.

In these circumstances, you should make an adjustment to apportion the full expense already recorded in the accounts so that only 4 months’ cover (£800) is charged to this year’s profit…

…while the £1600 prepaid un-expired insurance is carried forward to the next year as a current asset on the Balance Sheet.

To deal with this example…

- Ensure that you have a General Ledger account for “Prepayments” in Current Assets.
- Prepare a journal to Credit the ‘Insurances’ account with the prepaid £1600 and Debit the “Prepayments” account with the same sum.

NOTE: This journal must be reversed in the first period of the following financial year.

Outstanding expenses

The converse of the above is that you may need to make adjustments for expenses, paid in arrears which you have **incurred but not yet paid for**. These outstanding expenses may include items such as electricity, gas, telephone.

If you are running a limited company, you will also need to make provision for the liability for **corporation tax** due on this year’s profit and the **cost of auditing this year’s accounts** even though the audit cannot be performed until the next financial year.

The final accounts should include all these expenses (even if the figures are only estimates). These unpaid expenses are also referred to as **accrued** expenses.

As for prepayments, Journals are used to record each adjustment like this…

- Create a General Ledger account for “Accruals” in Current Liabilities.
- Prepare a journal to Debit the provisions to the relevant Profit & Loss account(s) and Credit the “Accruals” account with the same sum(s).

NOTE: These journals must be reversed in the first period of the following financial year.

Work in Progress

If your company provides services or manufactures things then there may be work which has been carried out for customers but has **not yet been invoiced**.

This work does have real value and should be accounted for in the year in which it was carried out — otherwise your profits will be understated.

Like prepayments and accruals, a Journal is used to record the adjustment like this…

- Create a General Ledger account for “Work in Progress” in Current Assets.
- Prepare journal(s) to Credit the value from the relevant Sales (revenue) account(s) and Debit the “Work in Progress” account with the same sum(s).

NOTE: These journals must be reversed in the first period of the following financial year.

The Accruals Concept

Prepaid and accrued expenses introduce the Accruals Concept. This concept recognises that in order to present a fair view of the final profit and loss, income and expenses must be matched to the accounting period in which they are earned or incurred rather than in the period when cash is received or paid out.

There is some overlap between this concept and the concept of prudence which calls for the accounts to be prepared on a conservative basis. To comply with both concepts, it may be argued that an outstanding liability, such as corporation tax or asset, such as Work in Progress should be recognised as soon as it arises at the end of each accounting period rather than being entered as a single lump sum at the end of the year.

If one were to be precise about accruals and prepayments on a monthly basis then this may add unacceptably to your book-keeping workload.

If you are unsure as to which items should be attended to each accounting period and which at the year end, your accountant will be able to advise on how to prepare a set of accounts which meets your business and management needs.

Starting a New Financial Year

As described in the previous section, your final Balance Sheet for the year may include a number of items — such as prepaid and accrued expenses — which have been transferred from the Profit & Loss Account in order that they may be carried forward into the next financial year.

Having arrived at the beginning of your new financial year, these items should be removed from the Balance Sheet and returned to the Profit & Loss Account since they now affect the calculation of the new year’s profit. This means using the Journal facility to reverse (or ‘contra’) the following…

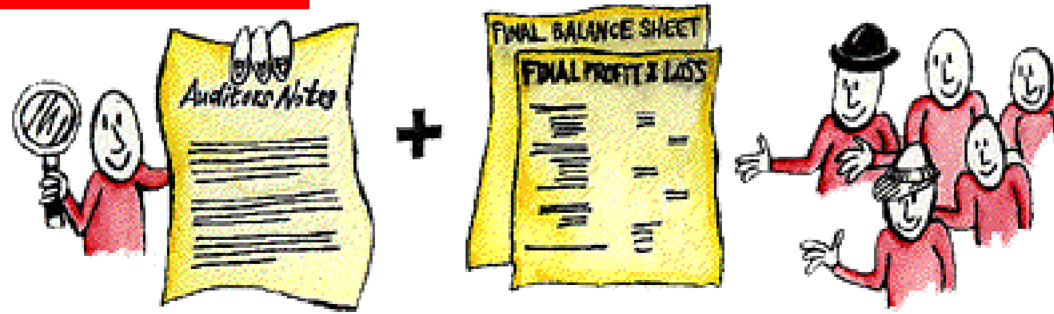
- For each prepaid expense carried over from the previous year, credit the “Prepayments” account (Balance Sheet) and debit the relevant expense account (Profit & Loss).
- For each accrued expense carried over from the previous year, credit the relevant expense account (Profit & Loss) and debit the “Accruals” account (Balance Sheet).
- For each work in progress adjustment carried over from the previous year, debit the relevant revenue account (Profit & Loss) and credit the “Work in Progress” account (Balance Sheet).

Once the start of year adjustments have been entered into the first period of the new year, you are now ready to record the normal periodic adjustments which affect the calculation of profit…

- Transfer “Current Stock” from the previous year’s Balance Sheet to the “Opening Stock” account
- Update depreciation costs and provisions for bad debts.

…and, of course, all purchase and sales transactions for the period.

Audit Adjustments



If you are running a limited company and your turnover is above a certain threshold then, by law, you are obliged to have your annual accounts independently checked — or audited — by an authorised person. This external inspection is important for the following reasons...

- The owners of a limited company — its shareholders — enjoy limited liability. This means that if the company were to cease trading because it had insufficient assets to cover the debts owed to its creditors, the shareholders are under no obligation to settle those debts from private means.
- Some, if not most, of the company's shareholders are not involved directly in the day-to-day running of the business. Consequently, having invested money in the company, the annual accounts may be the only source of information which tells them whether they have invested wisely.
- In addition to shareholders, a number of the other parties depend on an accurate assessment of the company's profits — the Inland Revenue, future investors and the Bank, to name but just a few.

To ensure the system of limited liability is not abused and to safeguard all parties which need to make important judgements based on the company's performance, it is the job of the qualified auditor to ensure that the financial accounts comply with a number of legal regulations and that they present a 'true and fair' view of the company's financial activities.

So! Having arranged the annual ordeal of having your final accounts put under the microscope, the auditor may conclude his or her inspection by presenting you with a list of adjustments which need to be made.

Since these adjustments now relate to the previous year's accounts, they should be entered using the Prior Period facility in the General Ledger.

To do this, prepare Prior Period Journals (as described fully in Chapter 15) then post each audit adjustment to the relevant period in the previous year and/or the first period of the new financial year. On posting each debit and credit, Bottom Line dutifully adjusts the nominated General Ledger account balances for the relevant period and also where applicable, in later periods.

next chapter