

CHAPTER 5

PURCHASES & PAYABLES - IMPROVE YOUR MARGINS!

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|---------------------------------------------------|-------------------------------------------------------------|
| 1 BOOKS OF ACCOUNTS-A QUICK RECAP | 5 OTHER SITUATIONS IN PURCHASE CYCLE |
| 2 WHAT ARE PURCHASES? | |
| 3 WHY IS IT IMPORTANT TO RECORD PURCHASES? | 6 CASH FLOW & COST MANAGEMENT STRATEGIES – SOME TIPS |
| 4 PURCHASE CYCLE | |

29 BOOKS OF ACCOUNTS – A QUICK RECAP

We have talked about the Books of Accounts in Chapter 3 which are normally used by a Business to record Accounting transactions. Of these, the following Books of Accounts are used for Purchase & Payable Accounting:

- Purchase Day Book.
- Purchase Ledger (also called Payable Ledger).
- Cash & Bank Book.
- Inventory Ledger.
- General Ledger.

In this chapter, wherever Accounting entries are required to be shown, we will use these Books of Accounts for illustration purposes.

30 WHAT ARE PURCHASES?

Purchase is a term used in broad contexts to refer to any expenditure incurred by a Business. Generally speaking, Purchases are classified between:

- Inventory items (raw material, tools, spare parts etc.).
- Non-inventory items (expenses or overheads, e.g. electricity, telephone).

Accounting entries for both types of Purchases is similar except that, in case of inventory items, entries are also recorded in an Inventory Ledger. The non-inventory items are recorded only in General Ledger in their respective accounts opened with the title of their name. In this Chapter we shall refer to Purchases to mean purchase of inventory items only – accounting of expenses or overheads will be discussed in Chapter 12.

31 WHY IS IT IMPORTANT TO RECORD PURCHASES?

We all agree that making profits is the primary objective of every Business! Main determinants of profitability are Income and Expenses – while income may not be directly in a Business's control, expenses can be directly managed by each Business.

If we look at expenses for any Business, we will see that Purchases are the largest chunk of expenses. Therefore, managing Purchases directly affects a Business's profitability.

Recording of Purchase facilitates a Business to consider the following:

- Price of these items was lesser when I bought them last month.
- Previously, the supplier delivered the items within 3 days, why is he taking 7 days this time?
- I received a 10% discount once from this supplier for paying early.

- What is the name of the supplier who gave us a sample of similar items but at cheaper prices?
- Why are we paying the freight charges? We should send our own van to pick up these items?
- Are items getting stolen, or damaged?

Similarly, many other useful indicators can also be derived from recording of Purchases.

A Business should have a firm grip on the broad spectrum of items required to be purchased. Purchasing is not just about buying inventory items and supplies needed to produce and sell; there is a whole range of other matters to be considered. The person responsible for purchasing has to ensure uninterrupted inflow of all such items which will then ensure that the Business's activities can proceed smoothly.

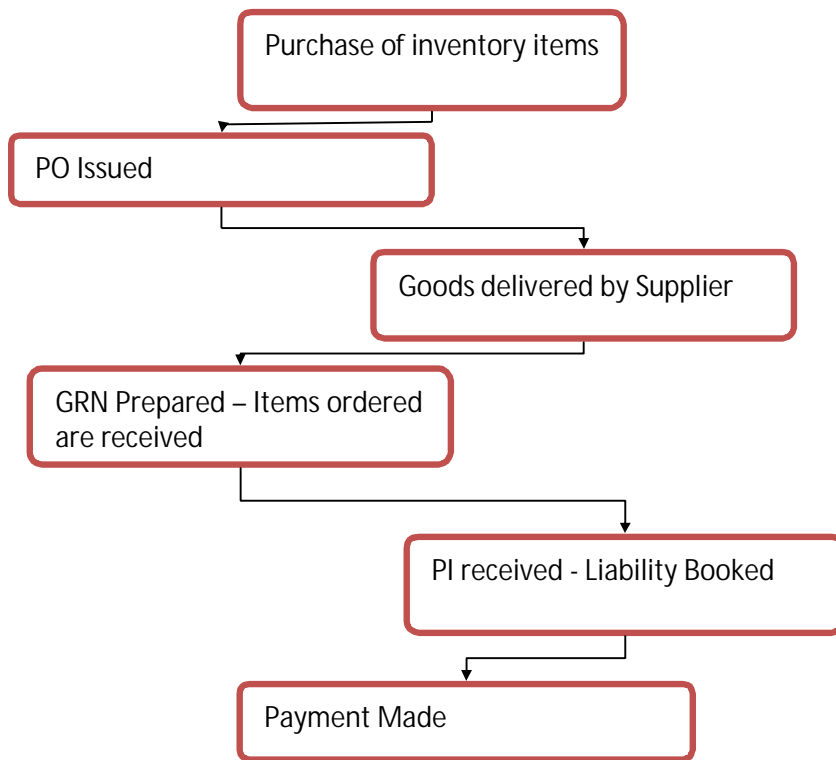
32 PURCHASE CYCLE

Purchase cycle refers to the complete process which starts from the time when an order is placed to the time when payment is made against that order. Within this process, a number of different procedures are used, e.g. purchase requisitions are prepared, quotations are called for from different vendors, comparative statements are prepared to evaluate, purchase order is issued, gate inward pass is prepared when delivery is received etc. The choice of whether some or all of these procedures should be adopted depends on the size of the Business, number of people employed, complexity of accounting system put in place etc.

However, many of these procedures will be redundant for Small & Medium Enterprises (SMEs) and, therefore, have not been addressed here. In our described Purchase Cycle, the following procedures are considered to be adequate for an SME Business:

- Placing an order - Purchase Order (PO).
- Receiving items ordered - Goods Received Note (GRN).
- Booking a liability to pay - Purchase Invoice (PI).
- Making a payment.

By way of a flowchart, the relationship and timing of these documents in a Purchase Cycle can be shown as:



The purpose of these documents along with the procedures is now explained below:

32.1 ORDERING ITEM - PURCHASE ORDER (PO)

PO is the starting point for an inventory-based Purchase cycle. PO is issued by a Buyer in favor of a Seller, and is especially important because:

- It is a confirmation that an order has been placed by the Buyer.
- It mentions the various terms and conditions which the Buyer and Seller have agreed upon.
- An accepted PO establishes a contract between the Buyer and Seller.

A PO normally has the following features:

- Specifications.
- Quantity ordered.
- Unit price.
- Packing, freight, discounts and local taxes.
- Address for shipment & address for invoicing / payment is mentioned.
- Other important terms & conditions.

Let us consider the following example:

EXAMPLE # 5.1**Placing an Order**

On 2/8/05, Hussain Khaddar orders 50 bags of 20/s yarn from Resham Textile costing Rs. 50,000, which is expected to be delivered by 6/8/05. Bags of yarn will be delivered directly to the factory on Sheikhpura Road and the invoice will be received at the office in Lahore. Payment will be made on 15/8/05.

Based on this example, Hussain Khaddar will issue a PO in favor of Resham Textile which will appear as follows:

PURCHASE ORDER					
Issued To: Resham Textile Limited 2 Empress Road Lahore Issue Date: 2/8/05 PO No: 001 / 05			Issued By: Hussain Khaddar & Looms (Pvt) Limited 14 Gulberg Industrial Area Gulberg III, Lahore		
Payment Due Date: 15/8/05			Shipment Due Date: 6/8/05		
Invoice To: Head Office, Lahore			Shipment To: Sheikhpura Road		
Others Terms & Conditions: Four copies of commercial invoice Packing List Packing list and invoices to carry PO #					
Item Code		Item Description	Bags Ordered	Rs. per Bag	Total Amount Rs.
IL-2		20/s yarn	50 bags	1,000	50,000
Value Ex. Sales tax, freight etc.					50,000
Prepared By: _____					Accepted By: _____
Approved By: _____					

Issuing a PO does not require any Accounting entries in Books of Accounts. The PO is sent to the supplier and a copy is retained for own record which will then be used at the time when the shipment arrives.

32.2 RECEIVING ITEMS - GOOD RECEIVED NOTE (GRN)

An important document, as the name implies, a GRN helps Businesses to:

- Record delivery of items received.
- Check that correct quantity is received.
- Check that correct items have been received.

GRN is a simple document which serves an important control function by ensuring that items are checked at the time of delivery, in the presence of supplier's representatives, so that any short shipments or non-conformances to specifications are highlighted on the spot.

EXAMPLE # 5.2

Receiving Items Ordered

Continuing from Example # 5.1, the 50 bags of 20/s yarn were received at the Factory from Resham Textile on 6/8/05. A GRN is prepared and inventory ledger & Bin Card is updated.

GOODS RECEIVED NOTE (GRN)		
Date :6/8/05		
GRN No:001		
Vehicle No:LOP-9999	Time:11:30 am	PO No:001/05
Received From: Resham Textile		
Sr. No	Item Description	Quantity
01	20/s yarn bags	50 bags
Prepared By:		Reviewed By:

At this stage, it is important to explain why both "Bin Cards" and "Inventory Ledger" are maintained when the type of information contained in both these documents is essentially the same.

Every factory has a store keeper who has custody and responsibility for all items received and issued from the store – storekeeper maintains inventory records by way of Bin Cards which only give quantitative information on inventory items.

On the other hand, Inventory Ledger is maintained by the Accounts Department to ensure that the Books of Accounts also show similar movement of inventory. Besides the quantitative information, Inventory Ledger also has price / cost data on those

inventory items.

Below is an example of a Bin Card which shows the receipt of 50 bags of 20/s yarn:

BIN CARD					
Commodity:20/s Yarn					
Date	Reference (GRN)	Receipt (Bags)	Issue (Bags)	Balance (Bags)	Signatures
6/8/05	001	50	0	50	

At the same time, GRN is also passed to the Accounts Department to update the Inventory Ledger.

INVENTORY LEDGER										
20/s Yarn										IL-2
Date	Ref No.	Receipt			Issue			Balance		
		Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)
6/8/05	GRN 001	50 bags	1,000	50,000				50 bags	1,000	50,000

It may be worthwhile to remember that Inventory Ledger is not part of the Double Entry System of Accounting as was explained in Chapter 2. Transactions recorded in the Inventory Ledger are only a memorandum record, which provide further information on balances appearing in the respective Control Accounts.

32.3 BOOKING LIABILITY FOR ITEMS RECEIVED - PURCHASE INVOICE (PI)

PI is issued by the supplier at the time of supply of items. This represents the amount that the Business owes against purchase of inventory items.

The per unit cost of items and quantity on PI should be matched with the PO and the GRN to confirm that the quantity ordered has indeed been received and correctly billed by supplier in accordance with the terms originally agreed upon (and mentioned on the PO).

PI can be received by a Business at the same time that items are delivered or can be received later – irrespective of when the PI is received, Accounting entries are same.

EXAMPLE # 5.3**Updating Control Account**

Again, taking the receipt of 50 bags of 20/s yarn in Example # 5.2, invoice # 002/05 dated 6/8/05 was received from Resham Textile on the same day i.e. 6/8/05 which was entered on Page 53 of the Purchase Day Book. The following entries are passed to book the liability:

The double entry is passed in the General Ledger through control accounts:

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT							GL-3
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				6/8/05	GL-10	Inventory Control Account	50,000

GENERAL LEDGER							
INVENTORY CONTROL ACCOUNT							GL-10
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
6/8/05	GL-3	Suppliers Control Account	50,000				

The memorandum record, Purchase Ledger, is also updated:

PURCHASE LEDGER					
RESHAM TEXTILE			PL-3		
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
6/8/05	53	50 bags of 20/s yarn		50,000	50,000

You will remember from our discussion in Chapter 3 that the balance on Control Accounts should always match with the balances on their respective Ledgers. By processing the entries, you will note that the balance on Suppliers Control Account and that on Purchase Ledger remains equal.

32.4 MAKING PAYMENTS

It is preferred that all payments for inventory purchases should be by way of a crossed cheque, pay order or demand draft; cash payments should be discouraged.

Income Tax and Sales Tax regulations have laid down certain requirements (see Chapter 16 & 17, respectively) which require such payments not to be made in cash. Failure on a Business's part to follow these requirements can result in penalties being levied.

EXAMPLE # 5.4

Recording Payments

Following on from Example # 5.3, a cross cheque # 200760 was prepared on 15/8/05 and payment sent to Resham Textile on the same day.

Payment entry is passed through the General Ledger:

CASH & BANK BOOK							
BANK ACCOUNT Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				15/8/05	GL-3	Suppliers Control Account	50,000

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
15/8/05	GL-20	Bank Account	50,000				

Purchase Ledger is also updated with the payment made:

PURCHASE LEDGER					
RESHAM TEXTILE			PL-3		
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
15/8/05	BPV21	Cheque # 200760 against PI # 002/05	50,000		50,000 Nil

33 OTHER SITUATIONS IN PURCHASE CYCLE

What we have described so far is the normal purchase cycle i.e. order placed, goods received, no differences, invoice received and payment is made. We will use this section to describe some other situations which Businesses are also faced with as part of their day to day operations.

33.1 ADVANCE PAYMENTS

Depending on the commercial arrangements mutually agreed between the Buyer and Seller, a Business may be required to make an advance payment, partial or complete, before receiving delivery of ordered items.

EXAMPLE # 5.5

Advance Payments

On 10/8/05, Mr. Hanif had to place an order for one Fan on an urgent basis for a repair job. He called the manufacturer, Omer Engineering, and was told that he will have to pay in advance to get delivery the next day. The Fan costs Rs. 3,500 and Mr. Hanif sent a pay order immediately. Fan was received on 12/8/05.

The accounting entries will be recorded in two parts:

First Part:

The advance payment is sent to Omer Engineering. The double entry is passed as follows:

CASH & BANK BOOK							
BANK ACCOUNT				GL-25			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				10/8/05	GL-3	Suppliers Control Account	3,500

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT							GL-3
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
10/8/05	GL-25	Bank Account	3,500				

The Purchase Ledger is also updated

PURCHASE LEDGER					
OMER ENGINEERING			PL-8		
Date	Ref	Description	Amount (Rs.)		Balance (Rs.)
			Debit	Credit	
10/8/05	BPV23	Advance payment through PO # 325764	3,500		(3,500)

Second Part:

On 12/8/05, when the fan is received from Omer Engineering and Invoice is received there against, the following entries are passed:

GENERAL LEDGER							
REPAIRS ACCOUNT				GL-7			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
12/8/05	GL-3	Suppliers Control Account	3,500				

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT				GL-3			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				12/8/05	GL-7	Repairs Account	3,500

The memorandum record, Purchase Ledger, is updated with the invoice:

PURCHASE LEDGER					
OMER ENGINEERING			PL-8		
Date	Folio	Description	Amount (Rs.) Debit	Credit	Balance (Rs.) (3,500)
12/8/05	54	PI # 12676		3,500	

After the invoice has been entered in the Purchase Ledger, balance on Omer Engineering's account stands at "Nil" and the Rs. 3,500 of Fan purchase has been booked as an expense in the Repair Account in General Ledger.

33.2 INCORRECT INVOICING BY SUPPLIER

There are many reasons which may have resulted in this:

- Wrong number of items received.

- Incorrect unit rate applied.
- Calculation mistake on the invoice.

Following are some examples of common mistakes in invoicing:

Accounting entries are made at the time that the items are received because, at that stage, the Business has a liability to pay – the question is; where the purchase invoice is incorrect, what liability should be booked? In such situations, “Debit Notes” or “Credit Notes” are used to record reasons for differences and the Debit Note or the Credit Note, as the case may be, is also sent to the supplier for his record. Alternatively, a Business could also make corrections on the purchase invoice and enter the correct amounts directly in the Books of Accounts – however, it is preferred that minimum cuttings be made on original documents and for that reason Debit Notes or Credit Notes are recommended to be used.

You will remember that amounts payable by a Business for purchases (also called Accounts Payable) normally have credit balances. If you remember the Debit & Credit rule, you will also remember that for accounts which normally have a credit balance:

- A credit entry will further increase the balance; and
- A debit entry will decrease the balance.

Therefore, if the correction to the supplier’s invoice results in decreasing the amount payable, a Debit Note will be issued. On the other hand, for increase in amounts payable, a Credit Note will be issued.

Now, let us see an example in which the supplier has sent an incorrect invoice.

EXAMPLE # 5.6

Incorrect Invoicing

On 9/8/05, Hussain Khaddar ordered 3 loom beams via PO # 002/05 issued to Atif Engineering. On 10/8/05, loom beams were received but on the purchase invoice, price was incorrectly mentioned as Rs. 5,000 instead of Rs. 4,500 per loom beam.

Since the number of items received is correct, no amendment is required to the entry in Bin Cards. Price has been incorrectly charged, therefore, all entries relating to price or per unit price will be affected.

The following entries will have been passed until the time that supplier invoice was received for 3 loom beams totaling Rs. 15,000.

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT							GL-3
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				10/8/05	GL-2	Inventory Control Account	15,000

GENERAL LEDGER							
INVENTORY CONTROL ACCOUNT							GL-2
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
10/8/05	GL-3	Suppliers Control Account	15,000				

And, the following Ledgers will have also been updated:

PURCHASE LEDGER					
ATIF ENGINEERING					PL-5
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
10/8/05	24	3 Loom Beams		15,000	15,000

INVENTORY LEDGER										
LOOM BEAMS								IL-5		
Date	Ref No.	Receipt			Issue			Balance		
		Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)
10/8/05		3	5,000	15,000				3	5,000	15,000

Correction:

Hussain Khaddar will issue a Debit Note to Atif Engineering for the difference in price i.e. Rs. 500/- per Loom Beam totaling Rs. 1,500/-. This will be done through a Debit Note, say, # 001/05.

Debit Note # 001/05 entered in Control Accounts:

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT							GL-3
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
10/8/05	GL-2	Inventory Control Account	1,500				

GENERAL LEDGER							
INVENTORY CONTROL ACCOUNT							GL-2
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				10/8/05	GL-3	Suppliers Control Account	1,500

Inventory and Purchase ledgers are also updated with Debit Note 001/05:

PURCHASE LEDGER					
ATIF ENGINEERING				PL-5	
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
10/8/05	34	Debit Note # 001/05 issued	1,500		15,000 13,500

INVENTORY LEDGER										
LOOM BEAMS								IL-5		
Date	Ref No.	Receipt			Issue			Balance		
		Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)	Quantity	Rate (Rs.)	Amount (Rs.)
10/8/05	001/05			(1,500)				3	5,000	15,000
								3	4,500	13,500

33.3 DISCOUNTS RECEIVED

Discounts received from suppliers result in reducing the amount payable by a Business. This is like receiving money which means that discounts received become income for a Business, and all types of income normally have credit balances.

An example to illustrate how discounts received are recorded now follows:

EXAMPLE # 5.7

Discount received

On 29/8/05 Hussain Khaddar purchased 20 more 20/s yarn bags costing Rs. 20,000 from Resham Textile on 10 days credit. Resham Textile offered a discount of Rs. 1,000 if payment is made within 2 days.

At the time when 20 more 20/s yarn bags have been purchased & received and Resham Textile's invoice entered, the Purchase Ledger would appear as follows:

PURCHASE LEDGER					
RESHAM TEXTILE				PL-3	
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
29/8/05	67	20 bags of 20/s yarn		20,000	20,000

Hussain Khaddar decided to avail the discount and payment was made on 30/8/05. The entries will be as follows.

Payment of Rs. 19,000 to settle the liability, explained in the following table:

CASH & BANK BOOK							
BANK ACCOUNT Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/8/05	GL-3	Suppliers Control Account	19,000

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/8/05	GL-20	Bank Account	19,000				

The memorandum Purchase Ledger is also updated:

PURCHASE LEDGER					
RESHAM TEXTILE				PL-3	
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance
30/8/05	BPV54	Payment through cheque # 2345 against PI # 234	19,000		20,000 1,000

Now, an adjustment entry (through a Journal Voucher) needs to be made to reflect the discount availed on this payment.

The Double entry will be as follows:

GENERAL LEDGER							
DISCOUNT RECEIVED ACCOUNT							GL-6
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/8/05	GL-3	Suppliers Control Account	1,000

GENERAL LEDGER							
SUPPLIERS CONTROL ACCOUNT							GL-3
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/8/05	GL-6	Discount Received Account	1,000				

And, the memorandum Purchase Ledger is also updated:

PURCHASE LEDGER					
RESHAM TEXTILE				PL-3	
Date	Ref	Description	Amount (Rs.) Debit	Credit	Balance (Rs.)
30/8/05	JV01	Discount Received Account	1,000		1,000 Nil

After recording these transactions, the balance on Resham Textile's Account in the Purchase Ledger will stand at "Nil".

33.4 RETURN OUTWARDS

There may be situations where items ordered and received were subsequently checked for quality and were found to be defective or were not of the quality and specifications as was ordered. In such situations, such items will need to be transported back to the supplier. These are normally referred to as "Return Outwards".

In case of Return Outwards, the entries are similar to those explained in 5.3 with the addition that since the quantities are also being changed, the Bin Card will be amended accordingly.

34 CASH FLOW & COST MANAGEMENT STRATEGIES – SOME TIPS

34.1 SHORT TERM LIQUIDITY IMPROVEMENT

Stretching your payables i.e. delaying payments to suppliers is an inexpensive strategy to improve your cash flow position in the short run. When a Business's cash position is tight (because customers have delayed), the Business can also delay its payments to suppliers to make maximum use of available cash resources.

This is an inexpensive way of generating liquidity because suppliers do not normally charge for delay in payments.

34.2 REDUCED COST OF PURCHASE

In most Businesses, prices of items vary depending on payment terms that a Seller offers. Full payment in cash will normally always cost you lesser than if the purchase was on extended credit terms.

While some Businesses might feel more comfortable with larger bank balances, where this cash is not immediately required for another use, it may make more financial sense for the Business to pick up items on cash payments. Market credit is always more expensive than the amount of profit that a Bank offers for keeping large deposit accounts.

CHAPTER HIGHLIGHTS

What have we covered?

- | | |
|-------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------|
| 1. Purchase refers to any expenditure incurred by a Business. | 6. Purchase Invoice is the document that is issued by the vendor at the time of supply of items. |
| 2. Purchases could be on inventory & non-inventory items. | 7. Corrections in Purchase Invoice should be recorded by way of Debit or Credit Notes. |
| 3. Purchase cycle refers to the complete process which starts from placing an order to the time that payment is made for those purchases. | 8. Discounts received from suppliers are income for a Business. |
| 4. Issuing Purchase Orders is the starting point for inventory-based Purchase Cycle. | 9. Delaying payments to suppliers can provide liquidity to Businesses. |
| 5. GRN is a simple document which serves an important control function by ensuring that items are checked at the time of delivery. | 10. Where a Business has surplus cash, purchases can be made on "cash" which will reduce costs. |