SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING AND FINANCE

FUNDAMENTALS OF ACCOUNTING - I

(ACFN 211)

ADDIS ABABA, ETHIOPIA

DECEMBER, 2023

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CHAPTER ONE

1. INTRODUCTION TO ACCOUNTING AND BUSINESS

1.1. Nature of Business and Accounting

A **business** is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers.

The **objective** of most businesses is to earn a profit.

Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services.

Type of Business:

Service Business - Provide services rather than products to customers.

Merchandising Business- Sell products they purchase from other business tocustomers.

Manufacturing Business- Change basic input into products that are sold tocustomers

1.2. Types of business organizations in Ethiopia

The Commercial Code of Ethiopia defines a business organization as follows: A Business organization is any association arising out of a partnership agreement. According to this definition there are eight forms of business organizations:

Partnership: is where two or more persons who intend to join together make contributions for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out thereof, if any. According to the Commercial Code of Ethiopia, contributions in partnership are possible in the following conditions.

Each person shall make a contribution, which may be in money, debts, other property or skill; Property or the use of property may form a contribution;

Unless otherwise agreed, contributions shall be equal and of the nature and extent required for carrying out the purposes of the partnership.

Joint venture: is an agreement between partners on terms mutually agreed and is subject to the general principles of law relating to partnerships stated above.

General partnership: consists of partners who are personally, jointly, severally and fully liable between themselves and to the partnership firm's undertakings. This means that each partner is responsible for and must assume the consequences of the actions of the other partner(s). All members share the management of the business. The death or withdrawal of a general partner, or the expiration of the term of the general partnership, will dissolve the partnership. Continuation of the partnership following such events may be dealt with, however, in the partnership agreement. Since a partnership is generally a “voluntary” association, any general partner who no longer desires to be associated with the partnership may withdraw and force dissolution. Dissolution of a partnership, as a general rule, requires the winding up of its affairs and a liquidation of the partnership’s assets.

Limited partnership: Some members are general partners who· control and manage the business and may be entitled to a greater share of the profits, while other partners are limited and contribute only capital. Limited partners take no part in control or management and are liable for debts to a specified extent only. A Legal document, outlining specific requirements, must be drawn up for a limited partnership.

Company limited: by share is a company whose capital is fixed in advance and divided into share and whose liabilities are met only by the assets of the company. The members shall be liable only to the extent of their shareholding. Formation of a share company shall be by a public memorandum – memorandum of association, which consists of:

- Names, nationality and address of the members, the number of shares which they have subscribed, provided that a member may not subscribe to less than one share;
- Name of the company;
- Head office and the branches, if any;
- Business purpose of the company;
- Amount of capital subscribed and paid up;
- Par value, number, form and classes of shares;
- Value of contributions in kind, their objects, the price at which they are accepted, the designation of the shareholder and the number of shares allocated to him by way of exchange;
- Manner of distributing profits;
- Number of directors and their power.

Sole proprietorship: This is the simplest way to set up a business. A sole proprietor is fully responsible for all debts and obligations related to his or her business. A creditor with a claim against a sole proprietor has a right against all of his or her assets, whether business or personal. This is known as unlimited liability. If the proprietor chooses to carryon a business under a name other than his/her own, he/she must register with the concerned local authorities. Your business name registration, or renewal of registration, will be valid for a certain period of time. A sole proprietorship is the cheapest and easiest form 0f business where most 0f the MSEs prefer to register their business in. Under a sole proprietorship, the entrepreneur is the owner as well as the manager of the business.

The sole proprietorship terminates by law upon the death of\the sole proprietor, with very few exceptions. Estate planning documents for the sole proprietor may grant the others of the sole proprietor the right to continue the business.

Co-operatives: This is where people associate on a voluntary basis to promote their economic interests, whereby resources are pooled together and used. People with financial constraints, especially, tend to form co-operatives to benefit from joint efforts and external support facilities. A co-operative business structure provides:

- Democratic control based on one member one vote;
- Open and voluntary membership;
- Patronage dividends.

Each form of business stated above has its own advantages and disadvantages. You can make your choice based on the following factors:

- Ease of registration;
- Number of owners;
- Financial responsibility of owners;
- Degree of freedom in decision making; and
- Mode of lax payment.

For more information on forms of business organizations and their establishment, refer to the Commercial Code of Ethiopia (1960).

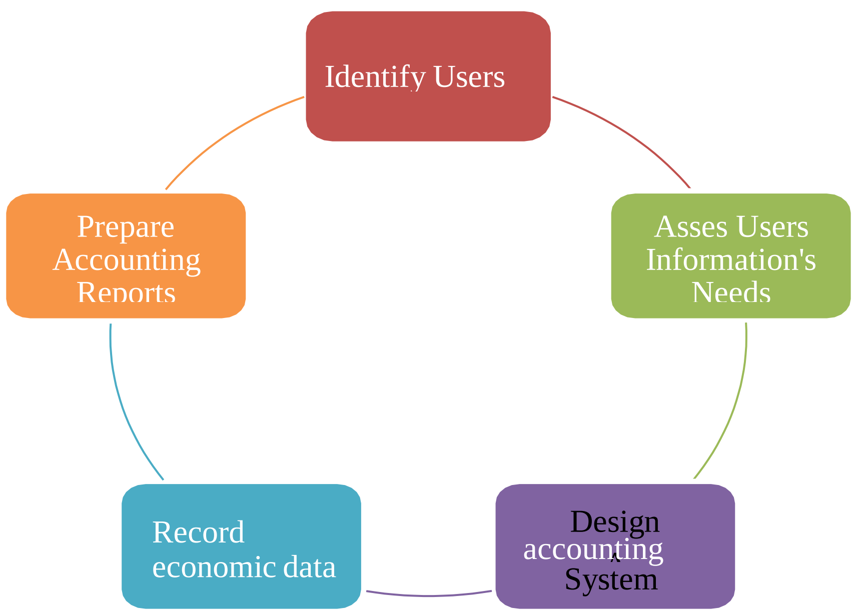
1.3. The Role of Accounting in Business

There is more than definition

Accounting is the art of recording, summarizing, classifying and reporting financial transactions and other events of an enterprise.

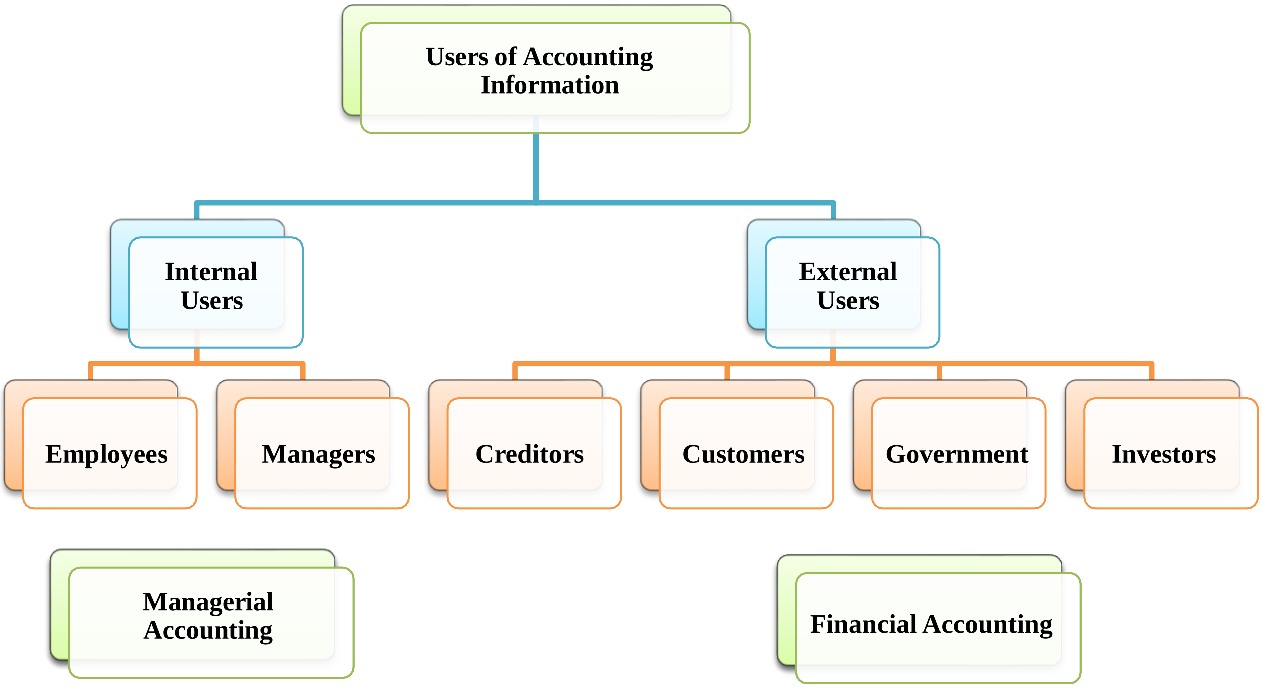
Accounting can be defined as an information system that provides reports to users about the economic activities and condition of a business.

The process by which accounting provides information to users :



Users of accounting can be divided into two groups:

- Internal Users
- External Users



Form of Business entity

Managerial Accounting the area of accounting that provides internal users with information.

Financial Accounting the area of accounting that provides external users with information.

The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside of the business.

General-purpose financial statements are one type of financial accounting report that is distributed to external users.

Generally Accepted Accounting Principles

- Financial accountants follow generally accepted accounting principles (GAAP) in preparing reports.
- Within the U.S., the Financial Accounting Standards Board (FASB) has the primary responsibility for developing accounting principles.
- Many countries adopted the International Financial Reporting Standards (IFRS) that are issued by the International Accounting Standards Boards (IASB) .
- Within Organization for certified public accountant (SOCPA) has the primary responsibility for developing accounting principles.

These reports allow investors and other users to compare one company to another

Proprietorship	Is owned by one individual (Small Businesses)
Partnership	Is owned by two or more individuals
Corporation	Is owned by shareholders or stockholders (Large Firms)

Some of Accounting Concepts GAAP

Business entity concept	• The activities of a business are recorded separately from the activities of its owners, creditors, or other.
The cost concept	• Amounts are initially recorded in the accounting records at theircost or purchase price.
The objectivity concept	• Requires that the amounts recorded in the accounting records be based on objective evidence.
The unit of measure concept	• Requires that economic data be recorded in dollars or riyals.
The accountingperiod concept	• Requires that revenues and expenses be reported in the properperiod.
The revenue recognition concept	• Supporting the reporting of revenues when they are earned regardless of when cash is received.
The matchingconcept	• Supporting reporting revenues and related expenses in the same period.

The Accounting Equation

The resources owned by a business are its assets.
The rights of creditors are the debts of the business and are called liabilities.
The rights of the owners are called owner's equity.
The equation Assets = Liabilities + Owner's Equity is called the accounting equation.
Assets = Liabilities + Owner's Equity
Assets = Liabilities + Capital – Drawings + Revenues - Expenses
Drawings + Expenses + Assets = Liabilities + Capital + Revenues

Debit Accounts — **If ↑ Debit, and if ↓Credit**

Credit Accounts — **If ↑ Credit, and if ↓Debit**

Elements of Accounting Equation :

All business transactions can be stated in terms of changes in the elements of the accounting equation.

ASSETS == Resources owned by the business Type off Assets

Fixed Assets == Land, Buildings, Furniture, Cars, Machinery and Equipment.

Current Assets == Cash, Marketable Securities, Accounts Receivable, Notes receivables, Merchandise Inventory, Supplies, Prepaid Expenses, and Accrued Revenues.

Intangible Assets == Goodwill, Copy Right, Patent, Trade Mark.

LIABILITIES == the rights of creditors Type of Liabilities

Long-Term Liabilities == Bonds and Long-Term Loans.

Short-Term Liabilities == Accounts Payable, Notes Payable, Short-Term Loans, Accrued Expenses, and Unearned Revenues.

OWNER'S EQUITY == the rights of the owners capital and Net Income (Revenues – Expenses)

Business Transaction = is an economic event or condition that directly changes an entity's financial condition or its results of operations.

Account payable = is liability created by a purchase on account. Account receivable = is a claim against a customer, which is an asset. Expenses = Assets used in this process of earning revenue.

Revenue =the Amount of money that A business earned by selling goods or services to its customers.

Examples of revenue

- Fees earned -Revenue from providing services.
- Sales - Revenue from the sale of merchandise
- Rent revenue
- Interest revenue.

Some Notes before solving the transactions

- Account payable = creditor = suppliers = purchase on account
- Account receivable = customer = client = billed on account
- Revenues in services business called Fees earned but in merchandising business called sales
- Revenues always credit account and the debit account can be cash, account receivables, or note receivables
- Expenses always debit account and the credit account is cash, account payable, or note payable

On November 1, 2011, Chris Clark begins a business that will be known as **Net Solution:**

Transaction

A: On November 1, 2011, Chris Clark deposited $25,000 in a bank account in the name ofNet Solutions.

(Assets ↑ (cash) **=** Owner equity ↑ (capital)**)**

B: On November 5, 2011, Net Solutions paid $20,000 for the purchase of land as afuture building site.

(Assets ↑(cash) **= Assets** ↑(Land)**)**

C: On November 10, 2011, Net Solutions purchased supplies for $1,350 and agreed to paythe supplier in the near future.

(Assets ↑(supplies) **= Liabilities** ↑(Account Payable)**)**

D: On November 18, 2011, Net Solutions received cash of $7,500 for providing servicesto customers.

(Assets ↑ (cash) **= Owner equity** ↑ (Fees earned)**)**

E: On November 30, 2011, Net Solutions paid the following expenses: wages, $2,125; rent, $800; utilities, $450; and miscellaneous, $275.

(Assets ↑ (cash) **= Owner equity** ↑ (Expenses)**)**

F: On November 30, 2011, Net Solutions paid creditors on account, $950.

(Assets (cash) **= Liabilities** (Account payable)**)**

G: On November 30, 2011, Chris Clark determined that the cost of supplies on hand atthe end of the period was $550.

(Assets □ (supplies) **= Owner equity □** (supp. Exp.)**)**

H: On November 30, 2011, Chris Clark withdrew $2,000 from Net Solutions for personaluse.

(Assets □ (cash) **= Owner equity □** (Drawing)**)**

Instructions: Indicate the effect of each transaction using the following tabularheadings:

Transitions	**Assets**			**= Liabilities**		**+**				**Owner Equity**				
	Cash	+Supplies	+Land	=	Accounts Payable	+	Chris Clark Capital	- Chris Clark Drawing	+Fees Earned	Wages Exp.	- Rent Exp.	Supplies Exp.	Utilities Exp.	- Misc. Exp.
a.	+25,000			=		+	25,000							
b.	-20,000		+20,000	=		+								
c.		+1,350		=	+1,350	+								
d.	+7,500			=		+			+7,500					
e.	-3,650			=		+				-2,125	-800		-450	-275
f.	-950			=	-950	+								
g.		-800		=		+						-800		
h.	-2,000			=		+		-2,000						
	5,900	**+ 550**	**+ 20,000**	**=**	**400**	**+**	**25,000**	**– 2,000**	**+ 7,500**	**– 2,125**	**- 800**	**– 800**	**– 450**	**- 275**

26,450

26,450

Financial Statements -after transactions have been recorded and summarized, reports are prepared for users. The accounting reports providing this information are called financial statements.

Order Prepared	Financial Statement	Description of Statements
1	**Income Statement**	A summary of the revenue and expenses for a specific periodof time, such as a month or a year.
2	**Statementof Owner's Equity**	A summary of the changes in the owner's equity that have occurred during a specific period of time, such as a month or a year.
3	**BalanceSheet**	A list of the assets, liabilities, and owner's equity as of a specific date, usually at the close of the last day of a month ora year.
4	**Statement of Cashflows**	A summary of cash receipts and cash payments for a specificperiod of time, such as a month or a year.

*** Matching concept:**
This concept is applied by matching the expenses incurred during a period with the revenue that those expenses incurred during period with the revenue that those expenses generated
The excess of the revenue over the expenses is called net income, net profit or earnings If the expenses exceed the revenue, the excess is a net loss.

1.4. Profession of Accountancy

There are two types of Profession of Accountancy

i. Private (managerial) and
ii. public accounting

Difference	Private accounting	Public accounting
Officer service For	their employers	General public
Employed for	Single firm	Whole public
necessity for CPA	Not	Must
Call as	Internal	External accounting
Take activities like	Cost, Budgeting, Tax Accounting	Auditors, Taxation and management consulting

1.5. Overview of International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are a set of accounting standards that govern how particular types of transactions and events should be reported in financial statements. They were developed and are maintained by the International Accounting Standards Board (IASB). The IASB’s objective is that the standards be applied on a globally consistent basis to provide investors and other users of financial statements with the ability to compare the financial performance of publicly listed companies on a like-for-like basis with their international peers. IFRS are now used by more than 100 countries, including the European Union and by more than two-thirds of the G20. IFRS are sometimes confused with International Accounting Standards (IAS), which are older standards that IFRS replaced in 2000.

In November 2008, the U.S. Securities and Exchange Commission (SEC) issued a proposed "Roadmap" for a possible path to a single set of globally accepted accounting standards. The roadmap generated significant interest and comment from investors, issuers, accounting firms, regulators, and others regarding factors that the SEC should consider as it moved forward in its evaluation of whether and how to incorporate IFRS into the financial reporting system for U.S. issuers.

The SEC issued a statement in support of convergence and global accounting standards in February 2010. It said: "The Commission continues to believe that a single set of high-quality globally accepted accounting standards will benefit U.S. investors and that this goal is consistent with our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. As a step toward this goal, we continue to encourage the convergence of U.S. GAAP [generally accepted accounting principles] and IFRS and expect that the differences will become fewer and narrower, over time, as a result of the convergence project."

The SEC then sponsored a series of roundtables in the summer of 2011 to help determine whether incorporating IFRS into the U.S. financial reporting system was in the best interest of U.S. investors and markets. At that time, there was limited discussion about the possible methods of implementing any incorporation, i.e., through the wholesale adoption of IFRS as issued by the IASB, or by regional or national incorporation of IFRS through convergence or endorsement or some combination. The discussion centered mostly on matters regarding how investors use financial statements, investor education, and who should interpret the principles-based standards. There was, however, considerable discussion regarding the role that various stakeholders, such as regulators and public accounting firms, play in interpreting principles-based standards. And rather than leaving the interpretation of the standards to these stakeholders, perhaps the IASB should fund and support a more robust interpretation effort.

But the momentum of the issue slowed following the release of a 2012 SEC Final Staff Report (Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers) that questioned the funding of the IASB and the timeliness of responses to widespread accounting issues by the IFRS Interpretations Committee. The report also said adoption of IFRS would be costly for U.S. public companies.

The SEC emphasized in the report, however, that its publication did not imply that the SEC had made any policy decision as to whether IFRS should be incorporated into the financial reporting system for U.S. issuers, or how any such incorporation should be implemented. It added that additional analysis and consideration of the threshold policy question—the question of whether

transitioning to IFRS is in the best interests of the U.S. securities markets generally and U.S. investors specifically—is necessary before any decision by the SEC can occur.
SEC noted that feedback it received as it formulated the Work Plan indicated a large majority of constituents opposed a requirement to adopt the standards of the IASB outright. However, the staff said there is substantial support for exploring other methods of incorporating IFRS into U.S. GAAP and focused its efforts accordingly.
One of CFA Institute's central missions is the improvement of corporate financial reporting and disclosure standards. The increased globalization of the capital markets emphasizes the need for consistent and high-quality information.
Useful information should possess two fundamental qualities, relevance and faithful representation.

i. Relevance –

Provide accurate expectations about the future, and has confirmatory value, that is, confirms or corrects prior expectations.

ii. Faithful representation-

Information must be complete (nothing important has been omitted), neutral (is not biased toward one position or another), and free from error

Bookkeeping versus Accounting

Bookkeeping	Accounting
Mechanical process that represents the art ofrecording	Accountants analyze and interpret financial statements, conduct audit, design accounting systems, prepare special business and financial studies, prepareforecasts and budgets and provide tax services
Bookkeeping is one and the simplest part of Accounting	Accounting includes bookkeeping

- Are the guidelines or framework for accounting and reporting the financial affairs of an economic? This is called international financial reporting standards (IFRS), which primarily established by the IASB.
- These include general
- concepts, assumptions, principles, specific accounting and reporting procedures, policies and methods used to produce and present accounting information
- in order to ensure high quality financial reporting accountants present financial statements in conformity with accounting standards that are issued by standard setting bodies
- Presently there are two primary accounting standard setting bodies the IASB and FASB. More than 140 countries are follow these standards referred to as IFRS
- IFRS are determined by the IASB.

- The IASB is head quarter in London with its 15 board members drawn from around the world.
- Most companies in the us follow standards issued by the FASB referred to as GAAP.
- as market become more global it is often desirable to compare the results of companies from different countries that report using different accounting standards
- in order to increase comparability in recent years the two standard setting bodies have made efforts to reduce the difference between IFRS and GAAP; this process is referred to as convergence
- As the results of this convergence it is likely that someday there will be a single setoff high quality accounting standards that are used by companies around the world.
- international accounting standard board (IASB)
- international financial reporting standards(IFRS)
- financial accounting standard(FASB)

Cost Principle

- The cost principle dictates that assets are recorded at their cost.
- Cost is the value exchanged at the time something is acquired.
- Cost is used because it is both relevant and reliable.

i. **<u>Assumption</u>**

1. Economic Entity or business entity concepts

Business entity must be different from his/her owner. Includes; any organization or unit in society.

2. Going Concern –
    - Assumes organization will continue into foreseeable future.
    - The life of Business entity is indeterminate continue in operation as long as possible using existing objectives and commitments
3. Monetary Unit –
    - Only transaction data that can be expressed in terms of money is included in the accounting records.
4. Time Period
    - Life of a business can be divided into artificial equal intervals of time called accounting periods and that useful reports.
    - Notice that the income statement, statement of owner's equity, and cash flows all cover periods of one year, and balance sheet is prepared at the end of each year.

ii. **<u>Concept</u>**

Accrual - revenue should be recorded and reported when goods are delivered or services are rendered to customers, and expenses should be recognized when goods and services are consumed. The timing of the in/out flows of associated cash, which may happen in advance, immediately or sometime in the future,

- Accrual basis:- recognized when revenue is earned and expenses is incurred, if measurable and available.

- Cash basis:- recognized when revenue is received and expenses is paid
- Modified accrual basis:- is the hybrid of the two.

iii. <u>Principle</u>

1. Objectivity

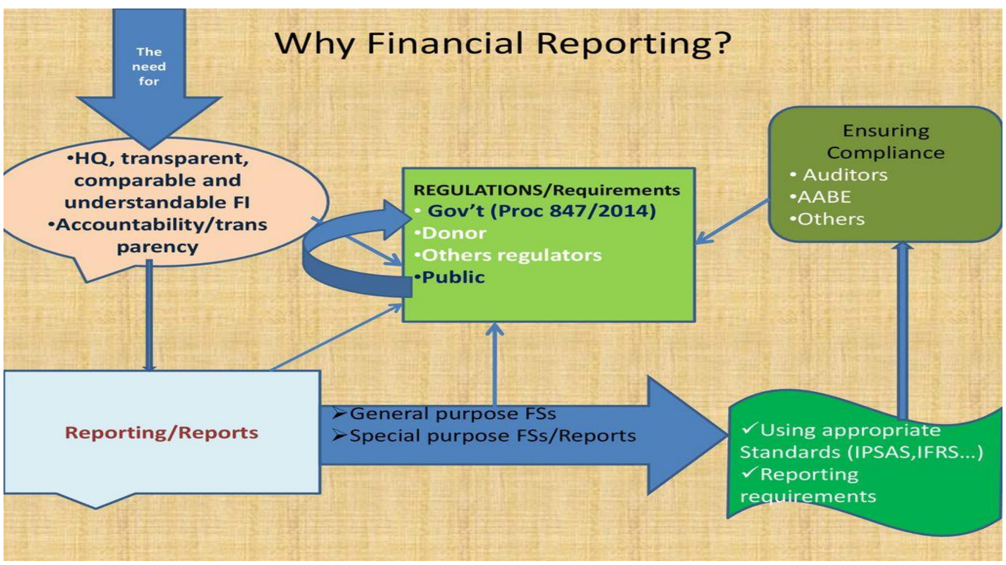
This means that the independent individual should be able to arrive at the same information using the source documents such as invoices, vouchers, checks, contracts and physical counts of resources, on the information in the accounting records and reported on the financial statements.

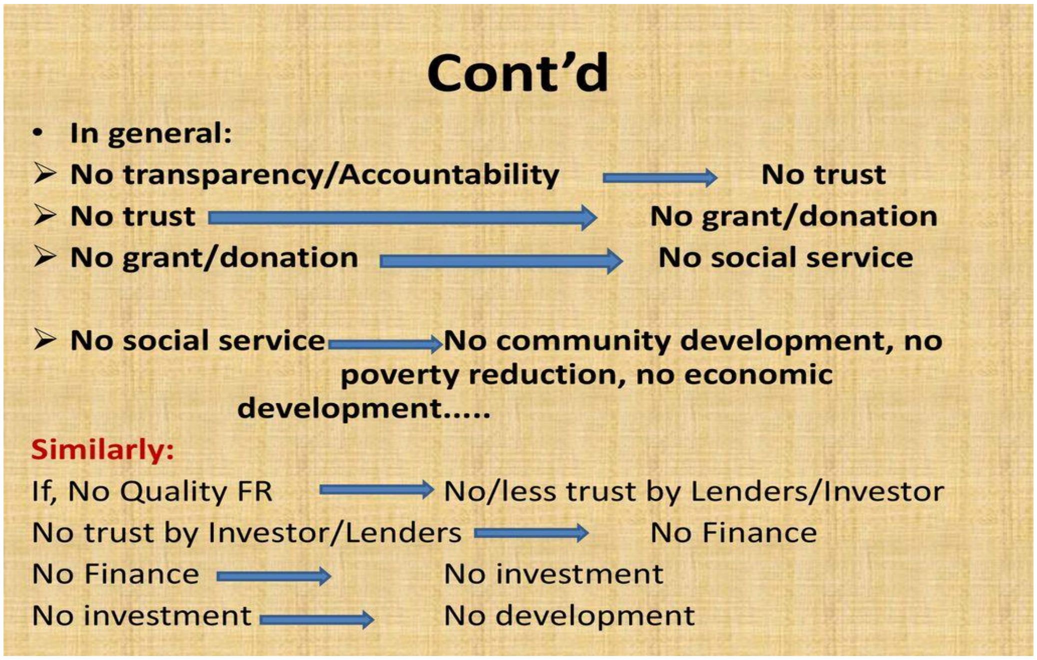
2. Historical Cost Principle or cost principle

Accounting records and then reported on the financial statements at the initial amount of cash or cash equivalent given up to acquire them or received in exchange for selling them rather than on an estimated/appraised/assessed or market value

3. Fair Value Principle
    - indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability

1.6. Overview of financial reporting requirements in Ethiopia and AABE





Ethiopia may have achieved economic lift-off, but flying high requires a fuel that is scarce in the country. If it's to attract the foreign investment that will keep the development boom going and help pull the population out of poverty (per capita gross national income is under US$1,000), the country needs a pool of professional accountants able to deliver international standards-compliant financial statements.

This is where the Ethiopian accountancy regulator, the Accounting and Auditing Board of Ethiopia (AABE), created in 2015, comes in. Hikmet Abdella, who had previously been the founding head of ACCA in Ethiopia, was appointed its director general in November 2019, shortly after the government decided it was time to open up the economy to the rest of the world.

'Ethiopia had been a closed economy for many years, but as we came out of the socialist regime after 1992, we saw the development of the private sector,' Hikmet explains. 'Financial institutions, such as banks and insurance companies, led the way, and we saw the beginning of wealth creation. However, it was not until four years ago that the new home grown economic reform strategy was announced, paving the way to begin the process of opening up the economy.'

Imbalance

She adds: 'My fear is that we do not have enough accountants on the ground to sustain the growth we are experiencing. In the past, qualified accountants were not absorbed into the economy as there was little demand, so there was a lot of migration to other countries. But now, with all the reforms, there will be companies looking to list on our capital market, including banks and insurance companies, and their CFOs will need to be qualified accountants. But the demand and supply of such professionals do not match.'

As the body that licenses and monitors the preparers of the financial statements that all capital market transactions rely on, it is fitting that AABE's chief has a seat on the board of the newly established Ethiopian Capital Markets Authority (ECMA).

1.7. The accounting equation and elements of the accounting equation

What is the accounting equation?

A double-entry accounting system is based on the accounting equation:

Total Assets = Liabilities + Equity

In this case, assets represent any of the company's valuable resources, while liabilities are outstanding obligations. Combining liabilities and equity shows how the company's assets are financed.

This basic equation offers a way for businesses to ensure that their financial statements are balanced. Any entries made on the debit side of a balance sheet should have a corresponding entry on the credit side.

What is the purpose of the accounting equation?

To understand the purpose of the accounting equation, it's first helpful to take a closer look at double-entry accounting. At the heart of this is the balance sheet, which shows a balance of total assets, total liabilities, and shareholder equity.

The accounting equation ensures that all uses of capital (assets) remain equal to all sources of capital (debt and equity).

Double-entry accounting requires that every business transaction be marked in at least two financial accounts. For example, if a business buys raw materials using cash, it would first mark this in the inventory accounts. The raw materials would be an asset, leading to an increase in inventory. The transaction should also be marked as a reduction of capital due to the spending of cash. According to double-entry accounting, this single transaction would require two separate accounting entries.

Similarly, when a company takes out a business loan, the borrowed money leads to an increase in assets. At the same time, this increases the company's liability in the form of debt. As you can see from the examples above, double-entry accounting keeps the books balanced.

This is where the idea of the accounting equation comes in. The two sides of the equation must always add up to equal value. Assets must equal the sum of equity and liabilities. By making this an international standard, it's easier for global corporations to keep track of their accounts. It's also helpful on a lower level by keeping all transactions in balance, with a verifiable relationship between each expense and its source of financing.

Elements of accounting equation formula

There are three main elements of the accounting equation:

1. Assets - A company's assets could include everything from cash to inventory. This consists of all equipment, prepaid expenses, receivables, and property – anything the business owns that reflects its value.
2. Liabilities - The second component of the accounting equation is liabilities. This category includes any obligations the company might have to third parties, such as accounts payable, deferred revenue, or other debts.

3. Equity - The final component is equity. This category includes the value of any investments made in the organization, whether through the owners or shareholders. Owner's equity will equal anything left from the assets after all liabilities have been paid.

These three elements of the accounting equation are what constitute a balance sheet. As a result, the equation is sometimes referred to as the balance sheet equation.

How to balance the accounting equation

The equation provides an easy way for accounting teams to verify transactions. When determining how to balance the accounting equation, you must look at each of the three elements:

Step 1: Locate the company's total assets for the accounting period in question.

Step 2: Add up all the liabilities from this same accounting period.

Step 3: Locate the shareholder's equity and add this figure to the liabilities.

Step 4: Ensure that the total assets equal the sum of total equity and liabilities.

1.8. Business transactions and its effect on accounting equation

Accounting Equation in Business

It is initially helpful to look more closely at double-entry accounting to comprehend the goal of the accounting equation. The cash balance, which balances total liabilities, assets, and shareholder equity, is also at the center of this. With that being said, the accounting equation ensures that almost all capital (asset) origins and uses are equivalents (debt and equity).

Every company transaction must be recorded in at least 2 distinct financial accounts to comply with double-entry accountancy. For instance, a company would initially record the cash purchase of raw materials in the inventory valuation. The raw resources would be valuable, which would result in more inventories.

Due to the expenditure of cash, the transactions must also be recorded as a loss in capital. Double-entry accounting dictates that this one transaction calls for two different accounting entries.

Likewise, when a firm borrows money, the assets grow due to the borrowed funds. Additionally, this raises the company's debt-related obligation. The examples above demonstrate how double-entry accounting maintains the books' balance. That's where the financial accounting concept comes into play. The sum of 2 sides of the equation should always be the same. Equity plus liabilities must be equivalent to the value of assets.

Making this a worldwide norm would make it simpler for multinational firms to manage their finances. Additionally, it helps on a more basic level by maintaining the equilibrium of all transactions & establishing a clear connection between each spending and its funding source.

What about Drawings, Income, and Expenses?

We now know that the accounting equation is: Assets = Liabilities + Equity.

But what about when we have drawings, income, or expenses in our business? How do these affect the equation?

- Drawings are when a business owner takes money out of business for personal use. This reduces the equity of the business.
- Income is money that comes into the business from sales or other sources. This increases equity.
- Expenses are payments made by the business, such as rent, supplies, or salaries. This reduces equity.

The accounting equation stays in balance because when one element changes, another must change to compensate. So, if assets go up, either liabilities or equity must also go up.
This is why the accounting equation is so important in business. It shows us at a glance whether our business is in financial trouble or not. If the equation is out of balance, we know we need to take action to fix it.

How to Balance the Accounting Equation

Accounting teams may easily check transactions using the equation. You should take into account every one of the three components to figure out how to balance the accounting equation:
Step 1: Find the company's total assets for the relevant accounting period.
Step 2: Add all the obligations from that very same accounting period.
Step 3: Find the shareholder equity and include it with the liabilities.
Step 4: Verify that total assets are equivalent to the total equity plus total liabilities.
Whether the calculation doesn't work, it's time to examine the financial records to see if any transactions were entered improperly. The equation can also be rearranged to determine any missing components. For instance, let's say you know that Company A has £10 million in total assets and £8 million in equity. The obligations must thus equal £2 million after deducting the equity from the assets. The accounting equation provides a straightforward guideline for maintaining the balance this way.

1.9. Financial statements

- Are reports prepared by a business to provide financial information about its economic affairs to users for decision making? Business organizations prepare four basic financial statements:
    1. Income Statement,
    2. Statement of Changes in Owner’s Equity (Capital),
    3. Balance Sheet and
    4. Statement of Cash Flows.

1. Income Statement

- Is used to provide information about financial performance of a business over time. The statement summarizes the revenues earned and expenses incurred in a specific period of time such as a month or a year. Expenses are deducted from revenues on the income statement to determine whether the business earned a net income or incurred a net loss. Excess of revenues over expenses is called net income, while excess of expenses over revenues is called net loss.

XYZ Company

Income Statement

For The Month Ended March 31, 2021

Revenue, sales, Fees earned… xx

Expenses:

Salary expense… xx

Rent expense…...................... xx

Supplies expense…..................xx

Depreciation expense…......... xx

Insurance expense…................ xx

Miscellaneous expense xx

Total expenses… .... (xx)

Net income.. xxx

2. **Statement of Changes in Owner's Equity/capital**

- is a summary of changes (increases and decreases) in owner's equity that have occurred during a specific period of time such as a month or a year. The statement includes beginning and ending capital balances, additional investment, withdrawal and net income/loss.

XYZ Company

Statement owner's equity

For The Month Ended March 31, 2021

xyz, Capital, March1........................... xx

Add: Investing during the month…… xx

Net income…………………………..xx

xx

Less: Drawings…………………………….. (xx)

XYZ, Capital, March 31…………………..XX

3. **Financial Position or Balance Sheet**

- is used to provide information about amounts and types of assets a business owns and amounts and types of resources contributed by its owner/s and creditor/s.
- Elements of the balance sheet include assets, liabilities and capital. The balance sheet lists assets, liabilities and capital of a business on a specific date, usually at the end of a month or a year. There are two forms of a balance sheet: *report* form and *account* form.

- *Report form* - lists assets first followed by liabilities and capital in report writing form
- *Account form* - lists assets on the left side and liabilities and capital on the right side ofthe balance sheet

Balance sheet XYZ Company

Balance sheet

For The Month Ended March 31, 2021

Assets		Liabilities & Owner's Equity	
Cash ……………….	X	Liabilities	
Accounts receivable…	x	Accounts Payable….	x
Supplies ………..….	X	Notes payable………	x
Equipment ………….	x	Total Liabilities…..............	x
		Owner's Equity	
		XYZ, Capital	x
Total assets …………….	xx	Total Liabilities & Owner's Equity……	xx

4. **Statement of Cash Flows**

- Is used to provide information about sources and uses of cash over a specific period of time such as a month or a year. Cash flows are classified based on the activities of an organization:operating, investing and financing.

i. Operating activities - refer to cash activities of a business that are entered into determination of net income/loss. Examples include cash collections from customers for goods and services sold to them and cash paid for goods and services (such as utilities, supplies and rent) consumed in operating a business.

ii. Investing activities - refer to cash activities of a business that involve acquisition and sale of relatively long-term assets such as furniture, fixtures, vehicles, buildings and machines.

iii. Financing activities - refer to cash activities of a business that affect equities of owner/s and long-term creditors of the business. Examples include money invested and withdrew by owner/s, proceeds from bank loans and repayment of principal part of bank loan

XYZ Company

Statement of Cash Flows

For The Month Ended March 31, 2022

Cash flows from operating activities:

- Cash received from customers........................... x
- Cash payments for wages expense ....(x)
- Cash payments for rent expense… ....(x)
- Cash payments for purchase of supplies…...... (x)

Net cash flows used by operating activities…..................... xx

Cash flows from investing activities:

- Cash payment for purchase of equipment ....(x)

Net cash flows used by investing activities… xx

Cash flows from financing activities:

- Loan from bank… x
- Investment by owner….......................................x
- Withdrawal of cash by owner ....(x)

Net cash flows provided by financing activities.................... xx

Net cash flows for December xx

Add: Cash, March 1, 2022... xx

Cash, March 31, 2022…... xxx

Illustration

The analysis of transactions in terms of the basic accounting equation can be observed by studying the following selected business transactions for Admass Company during its first month of operation.

1. **Owner Invested Cash-** When Admass Company was organized on December 1, 2022, the owner invested Br.30, 000 cash in the business. This transaction increased assets (cash) of the company by Br.30, 000 and increased owner's equity by Br.30, 000. Consequently, the transaction yields the following basic accounting equation:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
	Beginning Balances	-0-	-0-	-0-	-0-	=	-0-	-0-	+	-0-
1	Investment by owner	+30,000				=			+	+30,000
	Balance	30,000	-0-	-0-	-0-	=	-0-	-0-	+	30,000

2. *Borrowed Money*. The company borrowed Br.6, 000 from Dashen Bank; a note was signed for the loan bearing 10% interest. After including the effects of this second transaction, the basic equation is:

		Assets				=	Liabilities		+	Owner's Equity
Explanation		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
2	Borrowed Money	+6,000						+6,000		
	Balance	36,000	-0-	-0-	-0-	=	-0-	6,000		30,000

3. *Purchased equipment for cash.* Admass bought (by paying cash) supplies for Br.6,000, cleaning equipment for Br.14,000, and office equipment for Br.1,500. Equipment items are assets because they are used to earn revenues in the future. Note that this transaction does not change the totals in the basic equation but only changes the composition of the assets. Cash was decreased, and the supplies, cleaning equipment, and office equipment (assets) were increased by the total amount of the cash decrease. Three assets were received, and one asset of equal value was given up. The accounting equation now is:

		Assets				=	Liabilities		+	Owner's Equity
Explanation		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
3	Purchased equipment for cash	-21,500		+6,000	+15,500					

4. *Purchased equipment on account (for credit).* Admas purchased Br.1,000 of office equipment on account, agreeing to pay within 10 days after receiving the bill. (To purchase an item "on account" means to buy it on credit.) This transaction increased assets in the form of office equipment and liabilities in the form of accounts payable by Br.1,000. As stated earlier, accounts payable are amounts owed to suppliers for items purchased on credit. The increase inthe assets and the liabilities of Br.1,000 is shown as follows:

		Assets				=	Liabilities		+	Owner's Equity
Explanation		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admass, Capital
4	Purchased equipment onaccount				+1,000		+1,000			

5. *Paid an account payable.* Eight days after receiving the bill, Admass paid Br.1,000 for the office equipment purchased on account (transaction 4). This transaction reduced cash by Br.1, 000 and reduced the debt owed to the equipment supplier-shown as an account payable-by Br.1, 000. Thus, the assets and liabilities both are reduced by br.1,000, and the equation wouldbe affected as follows:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
5	Paid on account payable	-1,000					-1,000			

6. *Earned service revenue and received cash.* Admass performed cleaning services for a large motel chain and received Br.4,800 cash. This transaction increased the cash balance by Br.4,800. Owner's capital also increased by Br.4,800, and the accounting equation is again in balance. The Br. 4,800 is revenue earned by the business and, as such, increases owner's equity because the owner prospers when the business earns profits. Likewise, the owner would sustain the losses if the business fails. The effects of this transaction on the financial status of Admass are:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admass, Capital
6	Service revenue	+4,800								+4,800

7. *Service revenue earned on account (for credit).* Admass performed services for a customer who agreed to pay Br.900 at a later date. The company granted credit rather than requiring the customer to pay cash immediately. This is called earning revenue on account. The transaction consists of an exchange of services for a promise by the customer to pay later. This transaction is similar to the preceding transaction in that owner's equity is increased because revenues have been earned. But the transaction differs because cash has not been received. Instead, another asset, called an account receivable, has been received. As noted earlier, an account receivable is the amount due from a customer for goods or services already provided. The company has a legal right to collect from the customer in the future. In accounting, such claims are recognized as assets. The accounting equation, including this Br.900 item, is as follows:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
7	Service revenue		+900							+900

8. *Collected cash on account receivable.* Admas collected Br.200 on account from the customer in transaction 7. The remaining Br.700 will be received later. This transaction affects only the balance sheet and consists of giving up a claim on a customer in exchange for cash. The effects of the transaction are to increase cash by Br.200 and to decrease accounts receivable by Br.200. note that this transaction consists solely of a change in the composition of the assets. The revenue was recorded when the services were performed.

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
8	Collected cash on account	+200	-200							

9. *Paid wages.* Admas paid employees Br.2,600 in wages, which is an exchange of cash for employee services. Typically, employees are paid for their services after their work is performed. Wages are costs incurred by the company to produce revenues and are considered an expense. Thus, the accountant treats the transaction as a decrease in an asset (cash) and a decrease in owner's equity because an expense has been incurred. Expense transactions reduce net income. Since net income becomes a part of the owner's capital balance, expense transactions reduce the owner's capital.

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
9	Wages expense	-2,600								-2,600

10. *Paid rent.* Admass paid Br.400 cash for office space rental. This transaction causes a decrease in cash of Br.400 and a decrease in the owner's equity of Br.400 because of the incurrence of rent expense. This transaction has the following effects on the amounts in the accounting equation:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
10	Rent expense	-400								-400

11. *Received bill for electricity and water used.* At the end of the month, Admas received a Br.600 bill for electricity and water consumed during the month. This transaction involves anincrease in accounts payable (a liability) because the bill has not yet been paid and a decreasein owner's equity because an expense has been incurred. Adma‟s accounting equation no reads:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admas, Capital
11	Utilities expense						+600			-600

12. Supplies used. A count of supplies on December 31 indicates that Br. 500 of supplies have been used in rendering services for clients.

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admass, Capital
12	Supplies expense			-500						-500

13. Withdrawal of cash by owner. The owner withdrew Br.500 cash. This transaction involves a decrease in cash and decrease in owner's equity. Though the transaction reduces owner's equity it cannot be treated as an expense because the cash is not used for business activities rather it is taken to meet personal needs. The effect of this transaction on the accounting equation would be as follows:

Explanation		Assets				=	Liabilities		+	Owner's Equity
		Cash	A/R	Supplies	Equipment	=	Accounts Payable	Notes payable	+	Admass, Capital
13	Owner Withdrawal	-500								-500

The effects of all the preceding transactions on the assets, liabilities, and owner's equity of Admass in the month of December, 2016 are summarized below.

	Explanation	Assets				=	Liabilities		+	Owner's Equity
		Cash	AR	Supplies	Equipment	=	AP	NP	+	Admass, Capital
	Beginning Balances	-0-	-0-	-0-	-0-	=	-0-	-0-	+	-0-
1	Investment by owner	30,000				=			+	30,000
2	Borrowed Money	6,000						6,000	+	
3	Purchased equipment for cash	(21,500)		6,000	15,500	=			+	
4	Purchased equipment on account				1,000	=	1,000		+	
5	Paid on account payable	(1,000)				=	(1,000)		+	
6	Service revenue	4,800				=			+	4,800
7	Service revenue		900			=			+	900
8	Collected cash on account	200	(200)			=			+	
9	Wages expense	(2,600)				=			+	(2,600)
10	Rent expense	(400)				=			+	(400)
11	Utilities expense					=	600		+	(600)
12	Supplies expense			(500)						(500)
13	Owner withdrawal	(500)				=			+	(500)
	End of month balances	15,000	700	5,500	16,500	=	600	6,000	+	31,100
		37,700				=	37,700			

Admass Company prepares the following basic financial statements from the summarized accounting data.

1. **The Income Statement**

The income statement reports the success or profitability of the company's operations over a specific period of time. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement. The income statement lists revenues first, followed by expenses. Finally, the statement shows net income (or net loss). When revenues exceed expenses, results are net income. When expenses exceed revenues, results are a net loss.

Note that the income statement does not include investment and withdrawals transactions between the owners and the business in measuring net income. For example the cash withdrawal from Admass Company was not regarded as a business expense. This type of transaction is considered a reduction of owner's equity. The income statement is sometimes referred to as the statement of operations, earningsstatement, or profit and loss statement.

Admass Company
Income Statement
For the month ended December 31, 2022

Revenues			
Service Revenue		Br. 5,700	
Expenses:			
Wages expense	Br. 2,600		
Utilities expense	600		
Supplies expense	500		
Rent expense	400		
Total expense		(4,100)	
Net income			Br. 1,600

2. The Statement of Owner's Equity

Admass Company
Statement owner's equity
For the month ended December 31, 2022

Admass, Capital, December 1	Br. 30,000
Add: Net income	1,600
	31,600
Less: Drawings	(500)
Admass, Capital, December 31	Br. 31,100

3. The Statement of Financial Position (or Balance Sheet)

Admass Company's balance sheet reports the assets, liabilities, and owner's equity at a specific date (December 2022). The company prepares the balance sheet from the column headings and the month-end data shown in the last line of the tabular summary. Observe that the balance sheet lists assets at the top, followed by liabilities and owner's equity. Total assets must equal total liabilities and owner's equity.

Admass Company
Balance Sheet
December 31, 2022

Assets	
Cash	Br. 15,000
Accounts receivable	700
Supplies	5,500
Equipment	16,500
Total assets	Br. 37,700
Liabilities & Owner's EquityLiabilities	
Accounts Payable	Br.600
Notes payable	6,000
Total Liabilities	6,600
Owner's Equity	
Admass, Capital	Br. 31,100
Total Liabilities & Owner's Equity	Br. 37,700

4. The Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time.

The statement of cash flows reports

(1) The cash effects of a company's operations during a period

(2) Its investing activities

(3) Its financing activities

(4) The net increase or decrease in cash during the period, and

(5) The cash amount at the end of the period. Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. As shown in Admas Company's statement of cash flows, cash increased Br.15, 000 during the period. Net cash provided by operating activities decreased cash Br.4, 000. Cash flow from investing activities decreased cash Br. 16,500, while cash flow from financing activities increased cash Br.35, 500.

Admass Company
Statement of Cash Flows
For the month ended December 31, 2022

Cash flows from operating activities:			
Cash received from customers	Br. 5,700		
Cash payments for wages expense	(2,600)		
Cash payments for rent expense	(400)		
Cash payments for purchase of supplies	(6,000)		
Net cash flows used by operating activities	(3,300)		
Cash flows from investing activities:			
Cash payment for purchase of equipment	(16,500)		
Net cash flows used by investing activities	(16,500)		
Cash flows from financing activities:			
Loan from bank	6000		
Investment by owner		30,000	
Withdrawal of cash by owner	(500)		
Net cash flows provided by financing activities	35,500		
Net cash flows for December Add: Cash,		15,700	
December 1, 2022		- 0 –	
Cash, December 31, 2022	Br.		15,700

1.10. Summary

This chapter accounting summary sums up a company's financial activity for a specific period of time, Summaries can by assemble for a week, month or quarter, or for longer periods, such as a year, three years, five years or 10 years. Summarizing business transactions can help a company make future plans regarding growth, sales and profit by looking back at what was achieved previously. Financial summaries are created as financial statements. The formats for reporting the various statements, along with the way in which the financial data is gathered, follow generally accepted accounting principles, known as GAAP. Financial summaries can reveal the successes and failures of a business. The summaries gather data from accounting records to draw conclusions about profit, loss, and cash flow, and to evaluate a company's overall financial health. There are specifics and standards to creating a financial summary, and there are certain types of summaries that are asked for during audits and company marketing opportunities.

1.11. Exercise

1. Which of the following is a true statement in regards to the international accounting standards board?
   A. The IASB deals with issues caused by the lack of uniform accounting principles.
   B. The IASB has the authority to audit financial statements of all US corporations.
   C. The IASB was created by the American Accounting Association.
   D. The IASB develops all accounting principles to be used in the United States.
2. Which of the following is not a core financial statement?
   A. The Income Statement C. The Trial Balance
   B. Statement of Cash Flows D. The Balance Sheet
3. The income statement, which presents the results of operations, can be prepared in many forms including:
   A. Single Step Income Statement C. Common Sized Income Statement
   B. Condensed Income Statement D. All of the above
4. Which of the following account types increase by debits in double-entry accounting?
   A. Assets, Expenses, Losses C. Expenses, Liabilities, Losses
   B. Assets, Revenue, Gains D. Gains, Expenses, Liabilities
5. Which of the following is true?
   A. Accounts receivable are found in the current asset section of a balance sheet.
   B. Accounts receivable increase by credits.
   C. Accounts receivable are generated when a customer makes payments.
   D. Accounts receivable become more valuable over time.
6. A company that uses the cash basis of accounting will:
   A. Record revenue when it is collected.
   B. Record revenue when it is earned.
   C. Record revenue at the same time as accounts receivable.
   D. Record bad debt expense on the income statement.
7. What are the main sections on a balance sheet?
   A. Assets, liabilities, income C. Assets, liabilities, expenses
   B. Assets, liabilities, equity D. Assets, gains, revenue
8. How are a company's financial statements used?
   A. For internal analysis C. For compliance
   B. For external negotiation D. All of the above
9. Which of the following scenarios increases accounts payable?
   A. A customer fails to pay an invoice. C. Office supplies are purchased with cash.
   B. A supplier delivers raw materials on credit. D. None of the above
10. Which of the following must a certified public accountant (CPA) have in-depth knowledge of to pass the CPA licensing exam? (Check all that apply.)
   A. Accounting software packages C. Derivatives
   B. Auditing D. International banking laws

11. What is the result of the following transaction for Company A? Company A's customer is unable to pay for a previous credit sale in accordance with Company A's 90-day payment terms. The customer makes a promissory note to Company A that extends payment over a 24-month term including 5% interest.
    A. No result because the customer didn't pay.
    B. Accounts receivable increases because of the interest.
    C. A note receivable is recorded in non-current assets.
    D. Company a records the loan as a liability.
12. When are liabilities recorded under the accrual basis of accounting?
    A. When incurred C. At the end of the fiscal year
    B. When paid D. When bank accounts are reconciled
13. Which is true about time in accounting?
    A. Current liabilities are debts payable within 2 years.
    B. Balance sheets reflect a company's financial position at a certain point in time.
    C. The time value of money is a finance concept, not relevant in accounting.
    D. Accounts receivable are more easily collected as time passes.
14. When a company purchases property, plant, and equipment, how is it reflected on the statement of cash flows?
    A. As a source of cash in the "cash from investing activities" section
    B. As a source of cash in the "cash from financing activities" section.
    C. As a use of cash in the "cash from investing activities" section.
    D. As a use of cash in the "cash from operating activities" section.
15. What would the journal entry be for a company that takes out a five-year, $100,000 business loan?
    A. Debit $100,000 non-current asset, Credit $100,000 non-current liabilities
    B. Debit $100,000 current asset, Credit $100,000 non-current liabilities
    C. Debit $100,000 non-current liabilities, Credit $100,000 non-current assets
    D. Debit $100,000 current liabilities, Credit $100,000 current assets
16. Which accounts are associated with cost of goods sold?
    A. Accrued interest B. Depreciation C. Dividends D. Inventory
17. Which organizations are involved in development of US Generally Accepted Accounting Principles (GAAP)? (Check all that apply.)
    A. Financial Accounting Standards Board (FASB)
    B. Government Accounting Standards Board (GASB)
    C. Securities and Exchange Commission (SEC)
    D. Federal Accounting Standards Advisory Board (FASAB)
18. Which inventory valuation method reflects the most current market value for inventory on hand?
    A. Last-in-First-Out (LIFO) C. First-in-First-Out (FIFO)
    B. Average Costs D. Specific Identification

CHAPTER TWO

2. ACCOUNTING CYCLE FOR SERVICE ENTERPRISES

Definition of Accounting cycle

- Refers the series of procedures used to record, classify summarize and business transactions and preparing financial reports
- used when the firms large in volume of transactions and more cost and time effective

Basic procedures: -the accounting cycle /process includes the following basic procedures

1. Collection of data about economic events
2. Analyzing data about economic events
3. Recording economic events in a Journal (the genera journal and special journal)
4. Posting to ledger accounts (general and subsidiary ledgers)
5. Preparing unadjusted trial balance
6. Preparing and posting adjusting entries (this is for deferrals, accruals, depreciation expense, uncollectible accounts expense, inventory adjustment etc)
7. Preparing the adjusted trial balance
8. Completion of the worksheet (optional)
9. Preparation of financial reports
10. Recording and posting closing entries
11. Preparing a post-closing trial balance
12. Recording and posting reversing entries (for prepayments and unearned items).

Steps	Description	Objectives
1	Identify Transaction or Event to be Recorded	To gather information, generally in the form of source documents, about transactions or events
2	Journalize Transaction andEvents	To identify, assess and record the economic impact of transactions on the firm in a chronological record (a journal), in a form that facilitates transfer to theaccounts
3	Posting from Journals to Ledgers	To transfer the information from the journal to the ledger, the device that stores the accounts
4	Prepare Unadjusted TrialBalance	To provide a convenient listing to check for debit-credit equality, and a starting point for adjusting entries
5	Journalize and Post AdjustingJournal Entries	To record accruals, expiration of deferrals, estimations, and other events often not signaled by a new source document
6	Prepare Adjusted Trial Balance	To check for debit-credit equality and to simplify preparation of the financial statements
7	Prepare Financial Statements	To communicate summarized financial information to external decision makers
8	Journalize and Post Closing entries	To close temporary accounts and transfer the net income amount to retained earnings
9	Prepare Post-Closing Trial Balance	To check for debit-credit equality after the closing entries
10	Journalize and Post Reversing entries	To simplify certain subsequent journal entries and reduce accounting costs.

This all steps /procedures will be illustrated and elaborated by giving a brief example

2.1. Characteristics of an Account

Accounting information has the following characteristics

Understandability

This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users - who are generally assumed to have a reasonable knowledge of business and economic activities

Relevance

This implies that, to be useful, accounting information must assist a user to form, confirm or maybe revise a view - usually in the context of making a decision (e.g. should I invest, should I lend money to this business? Should I work for this business?)

Consistency

This implies consistent treatment of similar items and application of accounting policies

Comparability

This implies the ability for users to be able to compare similar companies in the same industry group and to make comparisons of performance over time. Much of the work that goes into setting accounting standards is based around the need for comparability.

Reliability

This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (e.g. by a potential investor).

Objectivity

This implies that accounting information is prepared and reported in a "neutral" way. In other words, it is not biased towards a particular user group or vested interest

2.2. Classification of Accounts

Transactions are the exchange of goods or services between entities, as well as other events that have an economic impact on a business.

Business Documents are records that are evidence of transactions.

Account- is a basic storage unit for accounting data and used to record increases and decreasesfor each individual asset, liability, owner's equity, and revenue and expense items.

Basic accounting records – refers to records organizations use in transforming business transactions into useful accounting information which includes *accounts, ledgers and journals.*

Ledger - is a group of related accounts of a specific business enterprise

The simplest form of an account is called **T account**; and it has three parts

- Title to write the name of the account
- Space for recording increases or decreases in the account (item) interns of money, i.e. (left and right sides). It can be presented as follows:

Title (name)	
Left side	Right side
(Debit)	**(Credit)**
Assets	Liabilities &Owner Equity

Examples

1. Aksum Hotel deposited Br. 150,000 cash in a bank account on September-1 After the deposit, the balance sheet for the business is as follows

Aksum Hotel

Balance sheet

On September 1

Assets		Owners	
Cash	Br. 150,000	Aksum, Capital	Br. 150,000

Since the cash account is increased and cash is an asset, this increase is recorded on the left side (debit side) of the account. And owner's equity or capital is increased and this increase is recorded in the right side (credit) of the account. Hence, using the simplest account the effects are shown as follows:

Cash	
Sep. 1 1150, 000(+)	

Aksum, Capital	
Sep1	150,000 (+)

2. Aksum paid salary Br. 2000 for the month of September on September 30

The effect of the above transaction is decreasing cash (an asset) by Br. 2000 and increasing salary expense account by Br. 2000. Increase an expenses is recorded on the debit side and decrease on assets on the credit side. Using the T accounts the effect is shown as follows:

Cash	
Sep30 150,000(+)	2000 (-) Sep30
148,000	

Salary Expense	
Sep 30 (+) 2000	
2000	

At the end of the month the balance on cash account is Br. 148,000, on salary expense Br. 2000and on the capital account Br. 150,000

Generally accounts are categorized as

1. **Balance sheet accounts and**
2. **Income statement accounts**

1. Balance Sheet Accounts /Real /Permanent Accounts

They include thefollowing groups of accounts.

a) **Assets**: are both physical (tangible/ sensible) or rights (intangible or the right to use something) properties that have monetary values which are owned by the business. They arefurther classified as:

- **Current assets**: - which are expected to be converted to cash or used up within a year or less. Examples: *cash, accounts receivable, prepaid expenses, merchandise inventory*, etc
- **Plant assets /Fixed assets/ long-term assets** are those acquired or constructed internally to be used for relatively long-period of time, usually more than a year. Examples: *land, building, equipments, furniture's and fixtures*, etc

All plant assets except land lose their usefulness with the passage of time. This decline in usefulness is called **depreciation**.

b) **Liabilities: -** are obligations to pay money or to deliver goods to customer/creditors or obligations to perform service.

They are, like assets, grouped as current and long- term liabilities.

- **Current liabilities** are liabilities that must be paid or settled with a period of one year or less. Examples: *accounts payable, salary payable, tax payable, rent payable, unearnedrent,* etc.
- **Long-term liabilities** are Liabilities that they will be paid within more than a year. Example: *notes payable, bonds, long- term payable, mortgage payable/bank loan*, etc.

c) **Owner's equity**: - is the residual claim against the assets of the business after the total liabilities are deducted- (for a corporation, owner's equity is frequently called **stockholders equity's**, **shareholders equity or stockholders' investment**). Capital is the owner's equity in a sole proprietorship and partnership. The owner's equity maybe described as net worth. For a corporation, capital stocks represent the investment of the stockholders, and retained earnings represent the net income retained in the business.

Drawings: represent the amount of withdrawals made by the owner of a sole proprietorship anda partnership. For corporations, **dividends** represent the distribution of earning to stockholders.

2. Income statement /temporary / nominal accounts

They are also called *temporary or nominal accounts*, for they are closed at the end of the accounting year. They include the following:

a) **Revenue accounts**: - are inflows of assets from sale of merchandise (sales), renting / leasing properties (rent income), rendering service (fees earned), etc.

They are the **gross** increase in owner's equity as a result of sale of merchandise, the performance of services for a customer or client, the rental of money, etc.

b) **Expenses accounts**: -are outflows / consumption of assets in the day-to-day activities of a business in order to generate profit/ income to the business. Expenses are **expired Costs** of goods and service consumed in generating revenue.

2.3. Charts of accounts

The number of accounts maintained by a specific enterprise is affected by the nature of its operations, its volume of business and the extent to which details are needed for taxing authorities, managerial decisions, credit purpose, etc.

A chart of accounts lists all accounts used by the company.

Accounting systems are intended to show the increase and decrease in financial statement item in a separate record. This is called an account.

A group or collection of all the accounts of a business entity is called a ledger. (a ledger and its forms will be discussed in detail later on the accounting cycle using examples). A list of all general ledger account titles and their related identification numbers is called chart of accounts. The chart of accounts for Aksum Hotel, for example, is shown below.

Balance Sheet Accounts

Accounts beginning with

1 - Assets, 2- Liabilities, 3 - Capitals Or Owner's Equity, 4 - Revenue And 5 - Expenses.

The other digits indicate the location of the account with in its class. For example; 4001 sales revenue indicates it is revenue with a first class in its category, revenue; and 2008 bank loan payable indicates it is a liability with the either position in its category liabilities. Therefore, digits in an account number may show major divisions (assets, liabilities, owner's equity, revenue and expenses), subdivision or position of the account in the subdivision. Of course, this numbering depends on the size and type of the business. There should be a flexible system.

- **Journal** is the book of original entry and refers to accounting record in which business transactions are entered in chronological order.
- **Journal entries** record transaction information; debits equal credits. General Journal Entry Format

Date /Debit Entry……………….xx

Credit Entry............................ xx

Explanation

Example: Merchandise is sold to a customer on account for $75. The cost of the product to the firm is $60. Make the journal entry

Jan. 1 Accounts Receivable. $75

Sales Revenue......................... 75

Sold merchandise on account.

1 Cost of Goods Sold..................... $60

Inventory................................ 60

To record cost and reduce inventory

Ledger is a book of accounts in which data from transactions recorded in the journals are posted, classified, and summarized. Classified as General Ledger and Subsidiary Ledgers

General Ledger – contains all accounts that appear on the balance sheet and income statements and commonly called **controlling accounts,** like A/R, A/P …

Subsidiary Ledgers - contains all accounts showing *details of controlling accounts*

2.4. Rule of Debits and Credits

The rules to debit or credit accounts or transactions occurred may be summarized in short as follows:

- Increases in asset accounts /expense accounts are recorded in the debit side of the account but decreases on them are recorded in the credit side.
- Increases in liability, capital and revenue accounts are recorded in the credit side of the count but decreases on them are recorded in the debit side.

2.5. Normal Balance of an Account

The difference between the total increases (may be debit or credit depending on the close of the account) and the total decreases (debit or credit side) recorded in an account is called account balance. Normal or the usual balance of an account is positive, i.e., the difference between the sum of the increased side of the account and that of the sum of the decreased side is positive under normal business operations.

The increase, decrease and the normal balance of the five classes of accounts are summarized as follows:

	Normal balance side	**Right hand side**	**Left hand side**
		Increase side	**Decrease side**
1. Assets	**Debit**	**Debit**	**Credit**
1001 Cash	Debit	Debit	Credit
1002 Accounts Receivable	Debit	Debit	Credit
1003 Inventory	Debit	Debit	Credit
1004 Supplies	Debit	Debit	Credit
1005 Prepaid Insurance	Debit	Debit	Credit
1006 Prepaid Rent	Debit	Debit	Credit
1007 Land	Debit	Debit	Credit
1008 Office Equipment’s	Debit	Debit	Credit
1009 Machinery	Debit	Debit	Credit
2. Liabilities	**Credit**	**Credit**	**Debit**
2001 Accounts Payable	Credit	Credit	Debit
2002 Salary Payable	Credit	Credit	Debit
2003 Notes Payable	Credit	Credit	Debit
2004 Unearned Rent 2005 Bank Loan	Credit	Credit	Debit

Payable	Credit	Credit	Debit
3. Owner's Equity	**Credit**	**Credit**	**Debit**
3001 Owner's, Capital 3002 Owner's Drawing	Credit Debit	Credit Debit	Debit Credit
4. Revenue:	**Credit**	**Credit**	**Debit**
4001 Sales Revenue 4002 Rent Revenue 4003 Interest Revenue	Credit Credit Credit	Credit Credit Credit	Debit Debit Debit
5. Expenses:	**Debit**	**Debit**	**Credit**
5001 Salary Expenses 5002 Supplies Expenses 5003 Utilities Expenses 5004 Rent Expenses 5005 Miscellaneous Expense	Debit Debit Debit Debit Debit	Debit Debit Debit Debit Debit	Credit Credit Credit Credit Credit

Note:
The sum of the increases recorded in an account is usually equal to or greater than the sum of the decreases recorded in the account. For this reason, the normal balances of all accounts are positive. For example, in the summary above, the total debits (increases) in an asset account will ordinarily be greater than the total decreases (credits). Thus, the asset accounts normally have debit balance. Remember that a normal balance of an account is its increase side

2.6. Analyzing and Recording Transactions

<u>Illustration</u>

To illustrate the accounting procedures / steps consider the following example

Roble and Rahel, the two outstanding New Life College students and the first batch graduates of the accounting department had operated a super snack in Rahel's parents' home on their extra time. As of January 2002, after graduation, they decided to open a new metal and wood work shop and moved to rented campus and to devote full time to the business, which is to be known as "***2 R Lovers Shop Service"***. Assume a fiscal /accounting year of January to December and entered the following transitions during January

January 1 the following assets were received (transferred) from the super snack to the shop

Cash ....Br. 7500
Accounts receivable................................ 900
Supplies 1,250
Service equipment 11,000

R lovers shop, capital ……………………………….. Br. 20, 650
There were no liabilities received.

The beginning capital of 2 R lovers shop service is Br. 20,650 (7,500 + 900+ 1,250 + 11,000) which is computed using the accounting equation **A = L +C**

C = Asset – Liability

The transactions occurred during the month were summarized as follows:

January

1. Paid three-month's rent in advance Br. 2250 ⟶ Prepaid rent.
2. Paid the premiums on property and casualty insurance policies, Br. 1,740 ⟶ prepaidinsurance.
4. Purchased additional service equipment on a accounts from Omedad Br. 2,500
6. Received cash from customers on account Br. 500
9. Paid cash for a newspaper advertisement, Br. 110
11. Paid Omedad for the part of liability incurred on January 4, Br. 1, 250
12. Record service revenue on account? Br. 1000
13. Paid laborers for two weeks‟ salary Br. 500
17. Recorded cash from cash customers for service revenue earned during the first half of January Br. 1, 100
17. Purchased supplies for cash Br. 950
20. Recorded service revenue on account for the period January 13- 20, Br. 700
24. Recorded cash from customers for service revenue earned for the period January 17-24 Br. 1, 850
27. Received cash from customers on account, Br. 1,200
27. Paid laborers for two weeks‟ salary Br. 500
30. Paid telephone bill for January Br. 75
30. Paid electricity bill for January Br. 140
30. Recorded cash from cash customers for services revenues earned for the periodJanuary 25- 30, Br. 950
30. Recorded sales on account for the remainder of January, Br. 800
30. Rahel and Robel withdrew Br. 1,500 for their personal use

Instructions:

1. Journalize each transaction in a **two-column** journal, referring to the following chart of accounts in selecting the accounts to be debited and credited. (Do not insert the account numbers in the journal at this time.)

Cash, 11; accounts receivable, 12; supplies 14; prepaid rent15; prepaid insurance, 16; service equipment, 18; accumulated depreciation, 19; accounts payable, 21; salaries payable, 22; 2R-lovers, capital, 31; 2R lovers Drawing, 32; income summary, 33, service revenue. 41; salary expense, 51; Rent expense, 52; supplies expense, 53; depreciation expense, 54‟ insurance expense, 55; miscellaneous expense, 59.

2. Post the journal to a ledger of **four-column** accounts.
3. Prepare an unadjusted trial balance.
4. At the end of January, the following adjustment data were assembled. Analyze and use these data to complete parts (5) and (6).
   a. Insurance expired during January ---------------------- Br. 145

   b. Inventory of supplies on January31 ----------------------- 1520
   c. Depreciation of service equipment for January 100
   d. Accrued salary on January 31 -------------------------------- 100
   e. Rent expired during September ------------------------------ 750

5. Enter the unadjusted trial balance on an end-of-period spreadsheet (work sheet) and complete the spreadsheet.
6. Journalize and post the adjusting entries.
7. Prepare an adjusted trial balance.
8. Prepare an income statement, a statement of owner's equity, and a balance sheet.
9. Prepare and post the closing entries. (Income Summary is account #33 in the chart of accounts.) Indicate closed accounts by inserting a line in both the Balance columns opposite the closingentry.
10. Prepare a post-closing trial balance.

<u>Procedure /steps: 1. Collecting data about economic events</u>

Business transactions are economic events that they need recording. Bills, invoices etc could be used as source documents to record the transaction. The transactions involved from **January1 - January 31** in the example, above, are the data for the economic events.

<u>Procedure / step 2 single analyzing the data about economic events</u>

The ability to analyze the effects of transactions on financial statements is an essential skill for a successful career in a business. Double accounting system is very powerful tool in this regard. Analyzing transactions involve the following steps.

a. Determine whether an assets, a liability, owner's equity, revenue of an expense account is affected by the transaction
b. For each account affected by the transaction, determine whether the accounts increases or decreases
c. Determine whether each increase or decrease should be recorded as a debit or a credit

To illustrate this analysis let's consider two transactions from the example given. Transaction(January 2 and January 9) is taken randomly. The others effect is left to you.
January 2: paid the premiums on property and casualty insurance policies, Br. 1, 740

Analysis: advance payments of expenses such as

a. Insurance are prepaid expenses, which are assets. Hence the accounts involved are assets(prepaid insurance) and cash (an asset).
b. The asset cash decreases and another asset prepaid insurance increases
c. Cash is credited and prepaid insurance debited.

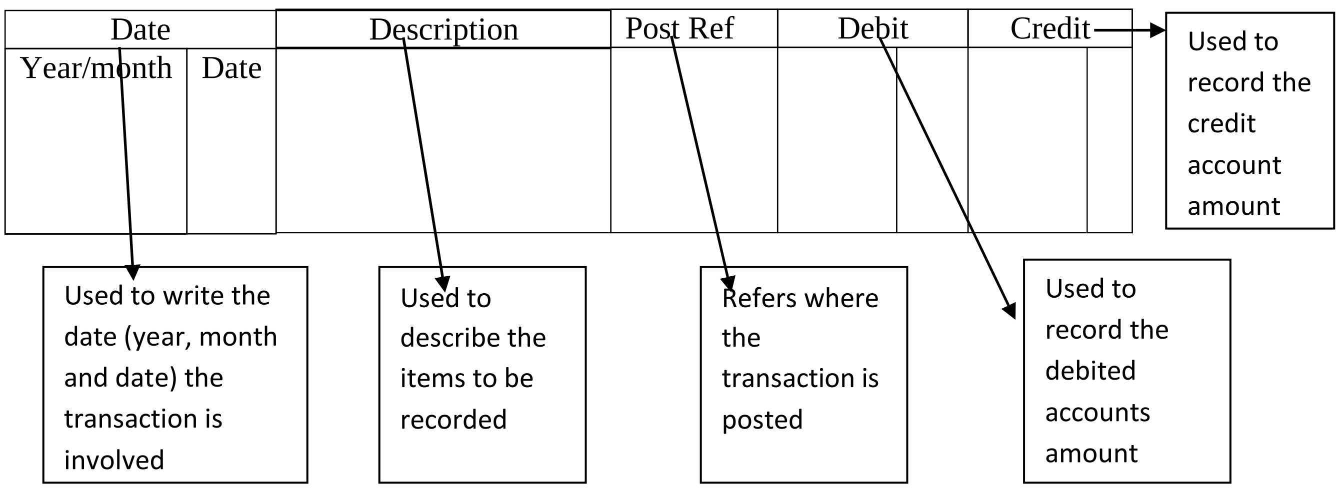
January 9: paid cash for a newspaper advertisement.Br.110

Analysis:

a. The accounts involved are cash (asset) and advertisement expense (could simply becharged to miscellaneous expense)
b. Cash decreases and miscellaneous expense increases
c. Cash is credited and miscellaneous expense debited

Step 3 Journalizing: is the process of recording transactions in a business book called journal. This recording transaction in a chronological order is done, after collecting the source documentsand annualizing the transaction

<u>The following is called a two – column journal used to record transactions</u>



Journal Page 1

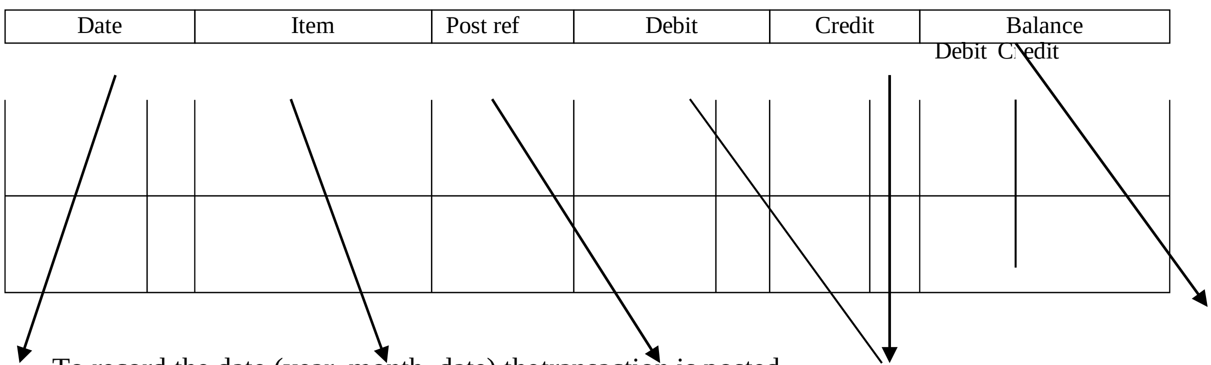
#1. Journalize entry for January, 2R

Date		Description	Post ref.	Debit		Credit	
2002, Jan	1	Cash Accounts receivable Supplies Service equipment2R, capital		Br. 7500 900 1,250 11,000		Br. 20, 650	
	1	Prepaid rent Cash	15 11	2250	00	2250	00
	2	Prepaid insurance Cash	16 11	1740	00	1740	00
	4	Service equipment Accounts payable	18 21	2500	00	2500	00
	6	Cash Accounts receivable	11 12	500	00	500	00
	9	Miscellaneous expe. Cash	59 11	110	00	110	00
	11	Accounts payable Cash	21 11	1250	00	1250	00
	12	Accounts receivable Service revenue	12 41	1000	00	1000	00
	13	Salary expense Cash	51 11	500	00	500	00
	17	Cash Service revenue	11 41	1100	00	1100	00
	17	Supplies Cash	14 11	950	00	950	00
	20	Accounts receivable Service revenue	12 41	700	00	700	00
	24	Cash Service revenue	11 41	1850	00	1850	00
	27	Cash Accounts receivable	11 12	1200	00	1200	
	27	Salary expense Cash	51 11	500	00	500	
	30	Miscellaneous expense Cash	59 11	75		75	
	30	Miscellaneous expense Cash	59 11	140		140	
	30	Cash Service revenue	11 41	950		950	
	30	Account receivable Service revenue	12 41	800		800	
	30	2R- Drawing Cash	32 11	1500		1500	
			Balance	**Br. 40265**		**Br. 40265**	

A Four-Column Account Form Is Depicted Below

Used to write theaccount ID

Account title   Account No



To record the date (year, month, date) thetransaction is posted

Description about the item

Refers from which pageof the journal the transaction comes

Used to record the increase/decrease onthe account due to atransaction

Used to show thedebit or credit balance of the account

#2. Posting the Journal Entries to a ledger four column account

Cash **Account No: 11**

Date		Items	PR	Debit	credit	Balance	
						Debit	credit
2002, Jan	1	Beg. balance	J			Br. 7500	
	1		J		2250	5250	
	2		J		1740	3510	
	6		J	500		4010	
	9		J		110	3900	
	11		J		1250	2650	
	13		J		500	2150	
	17		J	1100		3250	
	17		J		950	2300	
	24		J	1850		4150	
	27		J	1200		5350	
	27		J		500	4850	
	30		J		75	4775	
	30		J		140	4635	
	30		J	950		5585	
	30		J		1500	4085	
End balance						**Br. 4, 085**	

Account receivable **Account No: 12**

Date		Items	PR	Debit	credit	Balance	
						Debit	credit
2002, Jan	1	Beg. balance	J			Br. 900	
	6		J		500	400	
	12		J	1000		1400	
	20		J	700		2100	
	27		J		1200	900	
	30		J	800		**Br. 1, 700**	

Supplies **Account No: 14**

Date		Items	PR	Debit	credit	Balance	
						Debit	credit
2002, Jan	1	Beg. balance	J			Br. 1250	
	17		J		950	**Br. 2200**	

Prepaid Rent **Account No: 15**

Date		Items	PR	Debit		credit		Balance			
								Debit		credit	
2002, Jan	1		J					**Br. 2250**			

Prepaid Insurance **Account No: 16**

Date		Items	PR	Debit		credit		Balance			
								Debit		credit	
2002, Jan	2		J					**Br. 1, 740**			

Service equipment **Account No: 18**

Date		Items	PR	Debit		credit		Balance			
								Debit		credit	
2002, Jan	1	Beg. balance						Br. 11, 000			
	4		J	2500				**Br. 13, 500**			

Accounts payable **Account No: 21**

Date		Items	PR	Debit		credit		Balance			
								Debit		credit	
2002, Jan	4					Br. 2, 500				Br. 2, 500	
	11		J	1250						**Br. 1, 250**	

2R – Capital **Account No: 31**

Date		Items	PR	Debit		credit		Balance			
								Debit		credit	
2002, Jan	1	Beg. balance								**Br. 20650**	

2R – Drawing **Account No: 32**

Date		Items	PR	Debit		credit		Balance			
								Debit		credit	
	30	Drawing	J	**Br. 1, 500**							

Service Revenue **Account No: 41**

Date		Items	PR	Debit	credit	Balance Debit	Balance credit
2002, Jan	12				1000		1000
	17				1100		2100
	20				700		2800
	24				1850		4650
	30				950		5600
	30				800		**Br. 6400**

Salary expense **Account No: 51**

Date		Items	PR	Debit	credit	Balance Debit	Balance credit
2002, Jan	13			500		500	
	27			500		**Br. 1000**	

Miscellaneous expense **Account No: 59**

Date		Items	PR	Debit	credit	Balance Debit	Balance credit
2002, Jan	9			110		110	
	30			75		185	
	30			140		**Br. 250**	

2.7. Preparing Trial Balance

3. Prepare An Unadjusted Trial Balance.

2R Shopping Service

Unadjusted Trial Balance

For The Month Ended January 31, 2002

Account Title	Debit (Dr)	Credit (Cr)
Cash	Br. 4085	
Account receivable	1700	
Supplies	2200	
Prepaid rent	2250	
Prepaid insurance	1740	
Service equipment	13500	
Account payable		Br. 1250
Service revenue		6400
2R, capital		20650
2R, drawing	1500	
Salary expense	1000	
Miscellaneous expense	250	
Balance	**Br. 28300**	**Br. 28300**

2.8. Adjusting Process – Accrual vs. Cash Basis of Accounting

Procedure / Step 4: Adjusting Process

Before directly involving in to the adjusting procedure and the adjusting entries it is important to introduce some basic concepts such as the following:

i. **Accounting period concept**: according to this concept reports should be prepared at periodic intervals such as monthly, quarterly or yearly called **accounting periods**. The annual accounting period adopted by a business enterprise is called fiscal/ **accounting year**. Financial statements prepared for less than one-year period are called **interim financial statements**

ii. **Accrual concept**: there are two revenue and expense recording methods

Cash basis: under this method revenues are recorded and reported in which cash is collected;and expenses are recorded and reported in the period in which cash is paid

Accrual basis: under this method of accounting revenues are recorded and reported in the periodin which they are earned (goods are sold or services are performed regardless of collection of cash). Expenses are recorded and reported in the period in which they are incurred (assets are consumed or expired; services are received regardless of payment of cash).

Activity: an enterprise has provided services to a customer in March and the customer paid for the service in April. When should the revenue be recorded and reported using cash basis, or Accrual basis?

iii. **Matching principle**: this principle states that in determining net income / net loss for a given period, all expenses incurred in that period should be deducted from the revenues earned in that period, i.e. the income statement should match the revenues earned and the expenses incurred in a certain period to determine net income/ net loss of that period.

At the end of an accounting period, many of the balances of accounts in the ledger can be reported, without change, in the financial statements. Some accounts in the ledger, however, require updating. The process of updating the balances of accounts by recording unrecorded transactions at the end of the accounting period is called an **adjusting process**; and the journal entries needed are called **adjusting entries**. By their nature, all adjusting entries affect at least one income statement and one balance sheet account. Thus, an adjusting entry will always involve revenue or an expense account and an asset or a liability account.

Some items that require adjusting entries include the following

Prepaid expenses (deferred expenses):- initially recorded as assets but are expected to become expenses over time in the business. Examples include prepaid rent, prepaid insurance, supplies etc

Accruals: are created by failure to record an expense that has been incurred or revenue that has been earned. Examples include unrecorded wage (accrued expense/ accrued liabilities) and unrecorded fees earned (accrued revenue often called accrued assets)

Plant assets: the expired cost of plant assets due to usage and passage of time is called depreciation.

Accumulated depreciation" is a contra plant asset account whose balance must be deducted from the original cost of a plant asset.

Unearned revenues: are liabilities created by receiving cash in advance for provision of goods or services

Note: deferrals are cash received or paid in the current period but revenues or expanse recorded in the future period

-Accruals are revenues or expenses recorded in the current period but cash received or paid is the future period.

- Journalizing and posting adjusting entries is used to bring the balance of accounts in the general ledger in to agreement with the balances shown on the financial statements, i.e. to update balances. The entries should be recorded on the Journal and posted to the respective ledgers.

For the example given above, 2R- shopping service the adjustment data is given. From the adjustment data adjusting entries are recorded on the journal at the end of the month (January 31) and posted to the respected ledgers on that time. Let's see the effect, of the adjusting entries using a worksheet

<u>Adjusting Entries</u>

a. Insurance expense................. Br. 145
   Prepaid insurance.................... 145
b. Supply expense...................... 680
   Supply (2200-1520)............... 680
c. Depr. Expense.......................... 100
   Accum. Depreciation................ 100
d. Salary expense.......................... 100
   Salary payable......................... 100
e. Rent expense.......................... 750
   Prepaid rent............................ 750

<u>Explanation for the adjustment column:</u>

Cross-referencing the debit and credit of each adjustment by letters is useful in reviewing the worksheet.

If the tittles of some of the accounts to be adjusted do not appear in the trial balance, they should be inserted in the account title column, below the trial balance totals, as needed. On the adjustment column let's see the adjustment given by letter

a) **Prepaid insurance**:

The prepaid insurance as of January the beginning of the month has a balance of Br. 1,740, which represents advance payment for the year. For the month of January out of the total balance

Br. 145 was expired. Therefore as January 31 of the total balance 145 was expensed but the remaining 1595 (1740-145) is entered by writing (a) insurance expenses in the account title column and (a) in the adjustments debit column

b) **Supplies**:

The supplies account including the purchase has a balance of Br. 2200. But after physical inventory or count the supplies on hand was found Br. 1520, therefore, Br. 680 (2200- 1520) i.e. the expired or consumed amount which is supplies expense. The adjustment is entered by writing (b) Br. 680 in the adjustments debit column on the same line as supplies expense ad
(b) Br. 680 in the line as supplies

c) **Depreciation expense**:

Depreciation for the equipment for the month is Br. 100. The adjustment is entered by writing(c) depreciation expense in the account title column Br. 100 adjustment debit column the same line as depreciation expense but accumulated depreciation in the account title column Br. 100 in the adjustment credit column on the same line as accumulated depreciation

d) **Accrued salary**:

The amount Br. 100 for January is an increase in expense and increase in liabilities. The adjustment is entered by writing (d) Br. 100 in the adjustments debit column on the same line as salary expenses (d) salary payable in the account title column, and (d) Br. 100 in the adjustment credit column on the same line as salary payable.

e) **Prepaid rent**:

Of the total amount paid in advance for three months Br. 750 (2250/3) is expired, rent expense. The adjustment is entered as rent expense Br. 750 in the same line in the debit side of the adjustment column and (e) Br. 750 in the credit side of the adjustment column the same line as the prepaid rent line moth adjustment column

The adjustment columns are totaled to verify the mathematical accuracy of the adjustment data. The total of the debit column must equal the total of the credit column

Note: The adjusted trial balance amounts are determined by extending the trial balance amounts plus or minus the adjustments. For example, supplies account debit balance Br. 1520 on the adjusted trial balance is the trial balance amount of Br. 2200 minus the Br.680 of the adjustment credit. Accordingly, the worksheet is completed as shown in the worksheet. (Procedure 7 is completed)

2.9. Preparing a Worksheet

Procedure/ Step 5: Worksheet Completion:

It is a working paper used by an accountant. It is a multicolumn sheet of paper used to collect andsummarize data needed for preparation of financial statements, adjusting and closing entries

The worksheet of 2R –shopping service is presented as follows using the given data. The beginning data on the worksheet is the trial balance prepared above, then the adjusting entries recorded (from the given data) helps for the adjustment column. In the adjustment column similar items (debits or credits) are added and different items are deducted. To begin the completion of the column worksheet for 2R- shopping service, let we inset the figures on a ten-column worksheet as follows complete it

2R shopping service

Worksheet

For the month ended January 31, 2002

Account title	Unadjusted Trial balance		Adjustments		Adjusted trial balance		Income statement		Balance sheet	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
cash	4085				4085				4085	
Acc/Receivable	1700				1700				1700	
Supplies	2200			b) 680	1520				1520	
Prepaid Rent	2250			e) 750	1500				1500	
Prepaid insurance	1740			a) 145	1595				1595	
Service. Equip.	13500				13500				13500	
Acc. Payable		1250				1250				1250
2R-capital		20,650				20,650				20650
2R,drawing	1500				1500				1500	
Service Revenue		6400				6400		6400		
Salary expense	1000		d) 100		1100		1100			
Misce. Expense	325				325		325			
Insurance Expe.			a) 145		145		145			
Supplies. Exp.			b) 680		680		680			
Deprecation Exp.			c) 100		100		100			
Accumulated dep.				c) 100		100				100
Salary payable				d) 100		100				100
Rent expense			e) 750		750		750			
	28300	**28300**	**1775**	**1775**	**28500**	**28500**	**3100**	**6400**	**25400**	**22100**
							3300	=	=	**3300**
							6400	**6400**	**25400**	**25400**

Procedure/ Step 6: Preparation Of A Trial Balance

The equality of debits and credits in a ledger must be proved at the end of each accounting period. This is made by preparing **a trial balance**. Trial balance is a list of tittles and related balances of the accounts in the ledger.

After posting all the entries, including adjusting and closing, the end balances and tittles of 2R- shopping service using the trial balance is shown as below.

2R Shopping Service
Adjusted Trial Balance
For The Month Ended January 31, 2002

Account Title	Dr	Cr
Cash	4085	
Account receivable	1700	
Supplies	2200	
Prepaid rent	2250	
Prepaid insurance	1740	
Service equipment	13500	
Account payable		1250
Service revenue		6400
2R- lovers capital		20650
2R- drawing	1500	
Salary expense	1000	
Miscellaneous expense	325	
	Br. 28300	**Br. 28300**

The trial balance does not provide the complete proof of accuracy of the ledger. It indicates onlythat debits and credits are equal.

If the two totals of the trial balance are not equal it is probably due to the following errors.

- Errors in preparing the trial balance was incorrectly added: it may be due to one of the following activates
  - One of the columns of the trial balance may be incorrectly determined
  - Omitting balance of an account
  - Incorrect listing of an account
- Error in computing account balance such as:
  - Omitting to add/deduct a given figure
  - Entering account balance to wrong column
- Error in posting such as
  - Posting wrong debit or credit
  - Posting debit as credit or vice versa
  - Omitting debit /credit entry
- Error in Journalizing such as
  - Journalize wrong debit /credit figure
  - Journalizing a debit as a credit or vice versa
  - Omitting debit/credit entry

The following errors cannot be detected by the trial balance

- Failure to record or post a transaction
- Journalizing or posting erroneous but equal amounts of debit and credit
- Recording the same transaction more than one
- Posting a part of a transaction correctly as a debit or credit but to the wrong accounts

Note: two other common types of errors are known as **transpositions** and **slides**. Transportation is the erroneous rearrangement of digits, such as writing Br. 625 as Br. 265 or Br. 652. In a slid error type the entire number is erroneously moved one or more spaces to the right or the left, such as writing Br. 625 as Br. 62.50 or 6.25

Detecting errors: There are no standard rules for searching errors. Errors can be detected by trial and error, by auditing, by chance, etc.

Some of the procedures used to locate an error include the following

- Recalculate the debit and credit totals of the trial balance
- Compare amounts in the trial balance with the balance of accounts in the general ledger
- Recalculate the balance of accounts
- Check postings from the journal
- Check the equality of debit and credit entries in the journal

Correction of errors: For incorrect journal entry but not yet posted or for incorrect amounts posted draw a single line through the error and write the correct title or amount

-For incorrect Journal entry which is posted or for posting to the wrong account journalizing and posting a correcting entry.

2.10. Preparation of Financial Statements

Procedures /Step 7: Preparation of Financial Statements.

The financial statements are directly derived from the work sheet. The statements are, therefore,prepared as follows

2R- shopping service

Income statement

For the month ended January 31, 2002

Service revenue... Br. 6400Less: Expenses

Salary expenses…................1100

Insurance expense…............. 145

Supplies expense...................680

Rent expense........................ 750

Depreciation expense........... 100

Miscellanies expense ……….325.................(3100)

Net income ………………………………………… **Br. 3300**

2R shopping service
Statement of owner's equity
For month ended January 31, 2002

2R- capital, January 2002 -------------------Br. 20650
Add: Net income for the month…................. 3300
Less: with drawl… .... (1500)
Increase in capital 1700
2R –capital, January 31, 2002 …………………….. Br. **24,150**

2R- shopping service
Balance sheet
On January 31, 2002

Assets: Current assets:

Cash Br.4085
Account Receivable............ 1700
Supplies… 1520
Prepaid rent.......................... 1500
Prepaid insurance................. 1595
Total current assets… **10400**

Plane assets:

Service equipment… 13500
Less accumulate. Depreciation…….. (200) **13300**
Total assets ……………………………………………… **Br. 23,700**

Liabilities and capital:

Account payable… 1250
Salary payable…......................100
Total liability 1350
2R- lovers, capital................................... 22,350
Total liab& capital………………………………… **Br. 23,700**

2.11. Adjusting and Closing Entries

Procedure /Step 9: Closing Entries

Revenues, expenses and drawing /dividend account are temporary accounts used to accumulated effects of some transaction on owner's equity account for a specific period. At the end of the accounting period the balances of revenue and expense accounts are summarized in one another temporary account called the **income summary**. The balance in the income summary is transferred/closed to the capital (owner's equity) account. The balance on the drawing /divided account is directly closed to the capital (retained earnings account).

The process of transferring balances of temporary accounts to the capital account is called closing entry; and these entries should be posted to the respective ledgers after journalization.

This closing of accounts is used to transfer net income or net loss and drawing /dividend to capital/retained earnings, account. Moreover; it is used to reduce the balance of temporary accounts to zero so that they will be ready for the next accounting period.

For our example, 2R-shopping service, the closing entries are journalized on the journal and posted to the respective ledgers. See them on the journal and on their respective ledgers.

<u>Procedure /Step 10: Prepare and the Closing Entries.</u>

(Income Summary is account #33 in the chart of accounts.)

Date		**Closing entry**	**PR**	**Debit**	**Credit**
2002 Jan	31	Income Summary Salary expense Rent expense Supplies expense Dep. Exp. Store eqInsurance expense Miscene. Expense	33 51 52 53 54 55 59	3100	 1100 750 680 100 145 325
		To close expenses			
		Service Revenue Income summary	41 33	6400	 6400
		To close revenue			
		2R, Capital 2R, Drawing		1500	 1500
		To close Drawing			
		Income Summary 2R, Capital		1500	 1500
		To close income summary (Net income of the period)			
		Net income Income summary		3300	 3300

There are two types of ledgers-general and subsidiary. A general ledger is the principal ledger when used in conjunction with the subsidiary ledgers that contains all accounts. It is containing account. Subsidiary ledger is a ledger containing individual accounts with common characteristic

In the accounting procedures the journalizing and posting processes are actions taken simultaneously. Therefore, these procedure are presented together using a journal form and a ledger (an account) form

2.12. Prepare Post-Closing Trial Balance

Procedure / Step 11: Post-Closing Trial Balance:

It is a trial balance prepared after all adjusting and closing entries is posted. It is prepared to check the equality of the total debit and the total credit of the balance of the real accounts. It is the last step on the accounting cycle/ process the post-closing trial balance for the 2R-shopping service is prepared and presented as follows.

2R- Shopping Service
Post-Closing Trial Balance
For The Month Ended On January 31, 2002

	Debit	Credit
Cash	Br 4085	
Accounts Receivable	1700	
Supplies	1520	
Prepaid Rent	1500	
Prepaid Insurance	1595	
Service Equipment	13500	
Accumulated Depreciation		Br 200
Accounts Payable		1250
Salaries Payable		100
2R -Lovers, Capital		22350
	Br. 23, 800	**Br 23, 800**

2.13. Summary

This chapter shows revenues, expenses and drawing /dividend account are temporary accounts used to accumulated effects of some transaction on owner's equity account for a specific period. At the end of the accounting period the balances of revenue and expense accounts are summarized in one another temporary account called the income summary. The balance in the income summary is transferred/closed to the capital (owner's equity) account. The balance on the drawing /divided account is directly closed to the capital (retained earnings account).

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This closing of accounts is used to transfer net income or net loss and drawing /dividend to capital/retained earnings, account. Moreover; it is used to reduce the balance of temporary accounts to zero so that they will be ready for the next accounting period. For our example, 2R-shopping service, the closing entries are journalized on the journal and posted to the respective ledgers. See them on the journal and on their respective ledgers.

2.14. Exercise

1. If the supplies account, before adjustment on May 31, indicated a balance of Br. 2,250 and an inventory of supplies on hand at May 31, totaled Br. 950, the adjusting entry would be:
   A. debit supplies, Br. 950; credit supplies Expense, Br. 950.
   B. debit supplies, Br. 1,300; credit supplies Expense, Br. 1,300.
   C. debit supplies, Expense, Br. 950; credit supplies, Br. 950.
   D. debit supplies, Expense, Br. 1,300; credit supplies, Br. 1,300.
2. If the estimated amount of depreciation on equipment for a period is Br. 2,000 the adjusting entry to record depreciation would be:
   A. debit depreciation Expense, Br. 2,000; credit Equipment, Br. 2,000
   B. debit Equipment, Br. 2,000; credit depreciation Expense, Br. 2,000
   C. debit depreciation Expense, Br. 2,000; credit Accumulated Depreciation, Br. 2,000
   D. debit Accumulated Depreciation, Br. 2,000; credit depreciation Expense, Br. 2,000
3. If the equipment account has a balance of Br. 22,500 and its accumulated depreciation account has a balance of Br. 14,000, the book value of the equipment is:
   A. Br. 36, 500 C. Br. 14, 000
   B. Br. 22,500 D. Br. 8,500
4. Which of the following accounts would be closed to the income summary account at the end of a period?
   A. sales C. both sales and salary expense
   B. salary Expense D. Neither sales nor salary expense
5. The post-closing trial balance would include which of the following accounts?
   A. cash C. salary expense
   B. sales D. all of the above
6. Which of the following accounts in the ledger of a corporation will ordinarily appear in the post-closing trial balance?
   a) Accounts Receivable g) equipment
   b) Accumulated depreciation h) Retained earnings
   c) Cash i) Dividends
   d) Supplies j) Capital stock
   e) Depreciation expense k) wages expense
   f) Wages payable l) Sales

Workout

7. The trial balance of west side Laundromat at July 31, 2022, the end of the fiscal year, and the data needed to determine year-end adjustments are as follows.

Westside Laundromat **Trial balance** July 31, 2022		
Account Title	**Debit**	**Credit**
Cash	Br. 7,790	
Laundry supplies	4,750	
Prepaid insurance	2,825	
Laundry equipment	85,600	
Accumulated depreciation		Br. 55,700
Accounts payable		4,950
Ana Perez, capital		30,900
Ana Perez, Drawing	18,000	
Laundry Revenue		76,900
Wages expense	24,500	
Rent expense	15,575	
Utilities expense	8,500	
Miscellaneous expense	910	
Total	**Br. 168,450**	**Br. 168,450**

Adjustment data:

(a) Inventory of Laundry supplies at July 31 ....Br. 1,840

(b) Insurance premiums expired during the year 1,500

(c) Depreciation on equipment during the year 5,720

(d) Wages accrued but not paid at July 31 850

Instructions:

1. Record the trial balance on a ten-column worksheet and complete the worksheet.
2. Prepare an income statement, a statement of owner's equity and a balance sheet. (No additional investments were made during the year).
3. On the basis of the adjustment data in the worksheet, journalize the adjusting & closing entries.

CHAPTER THREE

3. MERCHANDISING ENTERPRISE

3.1. Characteristics of Merchandising Business

Merchandising businesses sell products. A **merchandising business** buys finished and packaged manufactured products, marks them up, and sells them to customers. A **merchandiser**, therefore, may be either the buyer or the seller in a given transaction, depending upon whether product is being purchased (and added to the stock of inventory), or sold (and removed from the stock of inventory.)

A **vendor** is a company or individual that a merchandiser purchases goods from. A **customer** is a company or individual that a merchandiser sells goods to. **Inventory** consists of items that are purchased for resale. Note that inventory is different from supplies. **Supplies** are items that are purchased to be used in the operation of the business, not to be sold to customers. For example, a merchandiser may have Windex glass cleaner on hand. It is considered inventory if it will be resold to customers and is considered a supply if it is used in running the business to keep the check-out counters clean. Similarly, inventory is also different from fixed assets such as **equipment**. For example, a merchandiser may have desktop computers on hand. They are considered inventory if they are to be resold to customers, such as in the case of *Best Buy*, *Dell*, or *Apple*. They would be classified as equipment if the merchandiser is using the computers to run its own business operations.

A sale is the new revenue account used to record income from selling products. This account replaces **Fees Earned**, the revenue account used for a service business. The following are common sequences of events for merchandising businesses. When you are the **buyer**, you will (1) purchase product on account; (2) return product; and (3) pay for the product. When you are the **seller**, you will (1) sell product on account **and** reduce the inventory balance; (2) accept returns **and** increase the inventory balance; and (3) receive payment for sales.

Most merchandising businesses use a **perpetual inventory system**. It is the process of keeping a current running total of inventory, both in number of units on hand and its dollar value, at all times. When product is purchased for resale, inventory immediately increases. When product is sold, the total value of the inventory on hand is immediately reduced.

A merchandising company is an enterprise that buys and sells goods to earn a profit/ revenue.

1. **Wholesalers** sell to **retailers**.
2. **Retailers** sell to **consumers**.

A merchandiser's primary source of revenue is sales, whereas a service company's primary source of revenue is service revenue. Example:

<u>In Service co</u>

Giving service and collect…. **Revenue**

Revenue – Expenses = Net Income / Loss**<u>In Merchandising co</u>**

Sales of goods and collect…. **Revenue**

Manufacturer Wholesaler Retailer Consumers

Sales Revenue – CGS = Gross Profit – Expense = Net Income / Loss

The primary source of revenues is referred to as sales revenue or sales. Whether a merchandiser is a wholesaler or a retailer, it uses the same basic accounting methods as a service company. However, the buying and selling of goods adds to the complexity of the business and of the accounting process.

Income Measurement

The activities of a service business differ from those of a merchandising business. These differences are illustrated in the following condensed income statements: The revenue activities of a service business involve providing services to customers. On the income statement for a service business, the revenues from services are reported as fees earned and the operating expenses incurred in providing the services are subtracted from the fees earned to arrive at net income. In contrast, the revenue activities of a merchandising business involve the buying and selling of merchandise.

3.2. Accounting for purchases of merchandises

Accounting for purchases

Purchases of merchandise are usually identified in the ledger as purchases. This is the most commonly used account. "Purchase of merchandise" which is a more exact account could be used. But the briefer and most commonly used is the "purchase" account

If purchases are made on cash or on accounts the transaction could be recorded as follows.

Purchases	**xxx**	
Cash (or Accounts payable)		**xxx**

This is the entry to record purchase from a supplier firm

3.2.1 Purchase Discounts

A deduction from the invoice price granted to convince early payment of the amount due.

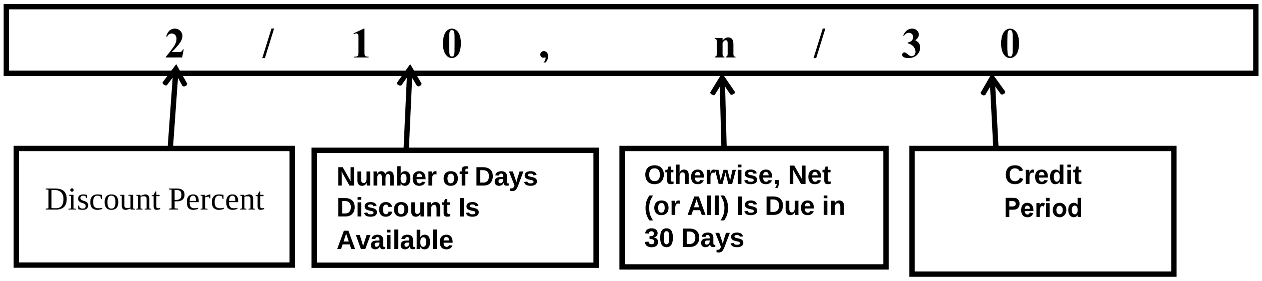
The buyer and the seller may reach an agreement for some arrangements as to when payments for merchandise are to be effected. If the purchases or the merchandise are on accounts such arrangements are called credit terms. If payment is required immediately upon delivery, the terms are said to be "cash" or "net cash". Otherwise, the buyer is allowed a certain amount of time, known as the credit period, in which to pay the amount.

Example:

45 days, the terms are said to be "net 45 days," which may be written as "n/45." If a payment is due by the end of the moth (eom) in which the sale was made, it may be expressed as "n/eom)"

To encourage early payments before the credit period the seller may offer a discount called purchase discount by the buyer. They are recorded by crediting purchase discount account and considered as a control account to purchases.

For example in the expression 2/10, n/45, 2/10, n/30…



Examples;

ABC trading purchased merchandise, from XYZ on 1 January 2021 organization amount Br. 1800 terms 2/10, n/30. On 9 January 2021 the total amount was settled. Required record the transaction.

January 1: purchases ……………….. 1800

Accounts payable…………………...1800

January 9: accounts payable ………………1800

Cash (1800-36)…………..1764

Purchase discount (2%x1800)……….36

This is the entry to record the initial purchase and the payment with in the due date.

3.2.2 Purchases returns and allowances Purchase Return

Merchandise returned by the purchaser to the supplier when the items to be defective or wrong specification.

Purchase Allowance –

A reduction in the cost of defective or unacceptable merchandise received by purchaser from a supplier or price adjustment

Example:

ABC trading purchased merchandises from BCD manufacturing company amounted Br. 2,000 terms, 2/10, n/30 on March 1, 2021. On March 5 when the merchandise were delivered some items costing Br.200 were found defective and returned to the seller by writing debit memorandum # 21.

Required record the transactions.

March 1, 2004/ purchases …………… 2000

Accounts payable ………….……2000

March 5, 2004/ Accounts payable ………200

Purchase returns and allowance…. 200

Debit memo # 21

Assume further that the amount was paid within the discount period (March 10, 2021). Record the transaction.

Accounts payable (2000 - 200)………1800

Cash (1800- 36)……………………..1764

Purchase discount (2%x1800) ………...36

3.3. Accounting for Sales of Merchandises

In merchandising businesses merchandise sales are usually identified in the ledger as sales. A business enterprise may sell merchandises on cash in which case a cash register may be used and the total will be summed up at the end of the day. If merchandise is sold on cash on a certain time on a day the entry to record the transaction will be

Cash……………………xxx

Sales ……………..………xxx

To record cash sales

A business may also sell merchandise on account. In such sells the entry is

Accounts receivable………….xxx

Sales ……………………….xxx

To record sales on account

3.3.1 Sales Retunes and Allowances

In merchandising businesses if some items of the merchandise sold are found defective or wrong specification the buyer may return (sales return) or may be allowed a reduction from the original price at which the goods were sold (sales allowance). If the return or allowance is for a sale on account, the seller usually gives the buyer a credit memorandum which shows the amount for which the buyer is to be credited and there reason therefore.

Sales returns and allowances - usually involve dissatisfied customers and the possibility of lost future sales.

Sales returns - refer to merchandise that customers return to the seller after a sale.

Sales allowances - refer to reductions in the selling price of merchandise sold to customers.

Sales Discounts

Sales discounts on credit sales can benefit a seller by decreasing the delay in receiving cash and reducing future collection efforts.

Sales discounts are considered and viewed as a contra (or offsetting) accounts to sales.

Example;

ABC merchandising business sold merchandises to XYZ organization costing Br. 50,000 on January 5, 2021, terms 2/10, n/30. On January 10 when the goods were delivered some items costing Br. 5000 were found defective and returned to the seller with acceptable reasons stated. The seller collects half of the credit sales on January 14, 2021

Required: Record the necessary Journal entry for the transactions involved.

January 5 accounts receivable……. 50,000

Sales ……………………….………. 50,000

10. Sales returns and allowance …………….. 5.000

Account receivable ……………..… 5,000

14 cash (22,500-450) ………………………..22,050

Sales discount (2%x 22,500)…………………...450

Account receivable ………22,500

3.3.2 Transportation costs

The sales agreement should indicate whether the seller or the buyer is to pay the cost of transporting the goods to the buyer's place of business.

FOB (Free On Board) Shipping Point

- Goods delivered to shipping point by buyers
- Buyer pays freight costs from shipping point to destination
- Ownership transfer immediately after selling – goods

Example; if you buy computer from Merkato, ownership transfer immediately after buying Goods and cost of transport is cover by buyers

FOB (Free On Board) Destination

- Goods delivered to destination by sellers
- Seller pays freight costs
- Ownership transfer after destination of goods

Example; if you buy computer from Merkato, Goods are arrived by covering cost of transportation by sellers then ownership transferred after destination

Illustration: - Assume that on June 10, 2004, ABC Company purchased merchandises from XYZ Corporation on account, Br. 900, terms FOB shipping point, 2/10, n/30, with prepaid transportation costs of Br. 50 added to the invoice. Assume, further that ABC paid the amount within 10 days.

Required: record the entries by both companies

On the book of ABC Company (buyer)	On the book of XYZ company (seller)
June 10. Purchases……..…900 Transportation in……..50 Accounts payable ……..950 June 20. Account payable ……950 Cash ……………….932 Purchase discounts….18	June 10. Accents receivable …..950 Cash…………………50 Sales ……………… 900 June 20. Cash ………………..932 Sales discount ……….18 Account receivable ……..950

Note: in merchandising businesses if the sales are cash sales the seller will collect the sales tax but when sales is made on account, the buyer is charged for the tax. The seller credits the sales account for only the amount of sale, and credits the tax to sales tax payable which will be paid periodically to the taxing unit, and the sales tax payable is debited.

3.4. Merchandise Transactions Using Perpetual and Periodic Inventory Systems

Like any business organizations for any merchandising enterprises at yearly intervals financial statements such as an income statement, a balance sheet and others prepared

The sequence of year-end procedures may be changed slightly

1. Prepare a trial balance of the ledger on a worksheet form
2. Review the accounts and gather the data required for the adjustments.
3. Insert the adjustments and complete the worksheet.
4. Prepare financial statements from the data in the worksheet.

5. Journalize the adjusting entries and post to the ledgers
6. Journalize the closing entries and post to the ledgers
7. Prepare a post-closing trial balance of the ledger.

3.4.1 Merchandise Inventory Systems

There are two main systems for accounting for merchandise held for sale:

1. **Perpetual –**Where detailed records of each inventory purchase and sale are maintained. Cost of goods sold is calculated at the time of each sale. Simply recording continuously
2. **Periodic** – Detailed records are not maintained. Cost of goods sold is calculated only at the end of the accounting period. Simply recording at the end of the accounting period

3.4.2 Cost of merchandise sold

In merchandising enterprise's that use periodic inventory system income statement the cost of merchandise sold is reported in a separate section.

Examples

ABC Trading, assumes, began its business operation on January 1, 2023 and purchased Br. 500,000 of merchandise during the year. Assume, the ending inventory on hand using physical count was found costing Br. 100,000 on Dec 31, 2023 (year-end). The cost of merchandise sold during the year (1992) would be reported in the income statement of the organization as follows:

Cost of merchandise sold:

Purchases	Br. 500,000
Less: merchandise Inventory, December 31, 1992	(100,000)
Cost of merchandise sold	**Br. 400,000**

To continue the illustration assumes that during 1993 the company purchased additional merchandise of Br. 600,000 received credit memo for purchase returns & Allowances of Br. 10,000 took purchase discounts of Br. 5000 and paid transportation costs of Br. 5000. Assume ending inventory of 90,000 for the report 1993 would be reported, in the income statement would be prepared as follows (only the cost of goods sold section).

Cost of merchandise sold:

Merchandise Inventory (beginning), January 1, 1993		Br. 100,000		
Purchases (in 1993)		Br. 600,000		
Less: Purchase returns & Allowances	10,000			
Purchase discounts	5,000	(15,000)		
Net purchases			**685,000**	
Add: Transportation in			5,000	
Cost of merchandise purchased			690,000	
Merchandise available for sale			**690,000**	
Less: merchandise Inventory (ending) December 1993			(90,000)	
Cost of merchandise sold				**600,000**

<u>Note that</u> in the cost of merchandise sold section the beginning inventory is added to the cost of merchandise purchased, which is the sum of net purchases (purchases – purchase returns & allowances – purchase discounts) and transportation in, if any. The sum of the beginning inventory and the cost of merchandise purchased give the total merchandise available for sale during a period. When the ending inventory determined by physical count at the end of a period is deducted from the merchandises available for sale the cost of merchandise sold is computed.

To illustrate these adjusting entries consider the balances on the merchandise inventory of ABC trading stated above. The adjusting entries for the enterprise for the year ended on December 31, 2022 would be:

Dec 31	Income summary	100,000	
	Merchandise Inventory		100,000

It is entry to transfer the amount to income summary as a part of the cost of merchandise available for sale it is replaced by a debit of Br. 90,000 the merchandise inventory at the end of the year as follow.

Dec 31	Merchandise Inventory	90,000	
	Income summary		90,000

3.5. Chart of accounts for a merchandising business

The chart of accounts for a merchandising business should reflect the elements of the financial statements.

For example Merchandising Business chart of accounts consists of three-digit account numbers. The first digit indicates the major financial statement classification (1 for assets, 2 for liabilities, and so on). The second digit indicates the sub-classification (e.g., 11 for current assets, 12 for noncurrent assets). The third digit identifies the specific account (e.g., 110 for Cash, 123 for Store Equipment). Using a

Three-digit numbering system makes it easier to add new accounts as they are needed.

3.5.1 Completing the worksheet for a merchandising company

The use of a worksheet, as you remember, assists in preparing adjusting and closing entries.

In addition it contains all of the information needed for the preparation of the financial statements.

Except for the merchandise-related accounts, the work sheet for a merchandising Co. is the same as for a service company.

The following illustration, therefore, assumes that all selling and administrative expenses have been adjusted. That accomplished, the only account, which remains to be adjusted, is the Merchandise Inventory account.

Illustration: The following is the trial balance of Hard Works, a merchandising business owned by Yibeltal. All accounts have been adjusted except the Merchandise Inventory account.

The chart of accounts for a merchandising business should reflect the elements of the financial statements. For example Merchandising Business chart of accounts consists of three-digit account numbers. The first digit indicates the major financial statement classification (1 for assets, 2 for liabilities, and so on). The second digit indicates the sub-classification (e.g., 11 for current assets, 12 for noncurrent assets). The third digit identifies the specific account (e.g., 110 for Cash, 123 for Store Equipment). Using a three-digit numbering system makes it easier to add new accounts as they are needed.

3.5.2 Completing the worksheet for a merchandising company

The use of a worksheet, as you remember, assists in preparing adjusting and closing entries. In addition it contains all of the information needed for the preparation of the financial statements. Except for the merchandise-related accounts, the work sheet for a merchandising Co. is the same as for a service company. The following illustration, therefore, assumes that all selling and administrative expenses have been adjusted. That accomplished, the only account, which remains to be adjusted, is the Merchandise Inventory account..

3.5.3 Recording Purchases

Under the periodic inventory system a merchandising company uses the Purchases account to record the cost of goods bought for resale to customers.

Example: IKA Company bought goods worth Birr 43,000 from Saba Co., which is based in Addis Ababa, on account on January 4, 2023, terms 2/10, n/30.

Record the transaction. Solution:

January 4 – Purchases …………………..43,000

Accounts payable………………………..43,000

3.5.4 Under perpetual inventory system

January 4: Merchandise inventory -----------------------------43,000

Accounts payable ---------------------------------------43,000

Deductions from Purchases

a) Purchase Discounts

A merchandising company can buy goods under credit terms that permit it to get a discount if it pays within a specified period of time. The deduction from the original purchase price is recorded in a separate contra Purchase account called Purchase Discounts.

Example: IKA Company bought goods worth Birr 50,000 from Gibir Company on account on January 14, 2023, terms 1/10, n/60. Ika Company paid on January 24, 2023.

Record the transactions on both dates.

Solution:

Jan.14/Purchases………………....50,000

A/P………………………50,000

Jan. 24. A/P…………………… …50,000

Purchase Discounts ……..........500

Cash……………………… 49,500

b) Purchase Returns and allowances: A purchase return occurs when a buyer returns merchandise to a seller. A purchase allowance is a reduction on the price of goods bought for dissatisfaction on the side of the buyer.

3.6. Financial statements for a merchandising business

In journalizing, the company credits all temporary accounts with debit balances, and debits all temporary accounts with credit balances, as shown below for Hard Works. Note that Hard Works closes Cost of Goods Sold to Income Summary.

A. To close all income statement items having Credit balances to income summary account
   Sales……………………………..14,600
   Income summary……………………..14,600
   Purchase Discounts………………………82
   Purchase Ret. &All………………..........100
   Income Summary………………………..182
B. To close all income statement items having Debit balances to income summary account
   Incomesummary………………………………6,075
   Purchases………………………………………….6,000
   Transportation-In……………………………………..75
   Income summary…………………………………66
   Sales discount……………………………………….44
   Sales Returns and Allowances………………………20
   Income summary……………………………..3,800
   Selling Expenses…………………………………2,650
   Administrative expense…………………………..1,150
C. To close income summary account
   Income summary…………………………………7,843
   Yibeltal Capital…………………………………7,843
   Note that this entry will be made if there is net income and it will be vice versa if there is net loss
D. To close drawings Yibeltal Capital……………………………………..2,000
   Yibeltal Drawings…………………………………2,000

3.6.1 Recording Sales

When a merchandising company transfers goods to the buyer, in exchange for cash or a promise to pay at a later date, revenue is produced to the company. This revenue is recorded in a Sales account. However, the sales revenue, which is reported on the Income Statement, is Net Sales. That is,

Net Sales = Gross Sales – Sales Discounts - Sales Returns and Allowances
Adjusting entries at the end of the accounting period are used to match properly the revenues and expenses for the period.
Deferrals & accruals need adjusting entries at the end of a period.
Deferral is a delay of the recognition of an expense already paid or of revenue already received.
Accrual is an expense that has not been paid or revenue that has not been received.

Deferred expenses expected to benefit a short period of time are reported in the balance sheet among the current assets, where they are called prepaid expenses. They are costs of goods and services that have been purchased but not used.
An adjustment is necessary at the end of the period so that the portion of the asset that has been used during the period becomes an expense; the remainder is an asset. Long-term prepayments that can be charged to the operations of several years are presented on the balance sheet in a section called deferred charges.
Deferred revenues may be listed on the balance sheet as current liabilities, where they are called unearned revenues or revenues received in advance (deferred credits if a long period of time is involved).
Any unrecorded accruals must be recorded before financial statements are prepared. Accrued expenses may be described on the balance sheet as accrued liabilities, or reference to the accrual may be omitted from the title, as in "Wages payable".
Accrued revenues may be described on the balance sheet as accrued assets, or reference to the accrual may be omitted from the title, as in "Interest receivable" and "Fees receivable".

Illustration
Adjusting entries for Accrual and deferrals prepaid expenses (Deferrals):
Assume that the office supplies account of ABC trading has a balance of Br. 500 on December 31, 2021, the end of the year. It includes the cost of supplies on hand at the beginning of the year and the cost of supplies purchased during the year. Assume the cost of supplies on hand using physical inventory at the end of the year total Br. 500. Hence, the cost of supplies used during the year is Br. 1000 (1500-500). The adjusting entry to record the Br. 1000 decrease of the asset and the corresponding increase in expense is as follows.

Dec 31	Supplies expense	1000	
	Supplies		1000

The supplies expense will be reported on the income statement with other expenses and the remaining balance on the supplies account (1500-1000 = 500) will be reported in the balance sheet as an asset in the current assets section.

Illustration

Adjusting entries for unearned revenues (Deferrals):

By accepting advance payment of a good or a service, a business commits itself to furnish the good or the service at some future time. At the end of the accounting period, if some portion of the good or the service has been furnished, part of the revenue has been earned. The earned portion appears on the on the income statement and the unearned portion represents a liability of the business to furnish the good or service in a future period and it reported in the balance sheet as a liability. When revenue is received in advance, it may be credited to a liability account.

To illustrate assume the following transactions: On March1, 2023, ABC trading rents a portion of its building for a period of one year receiving Br. 24,000 in payment for the entire year's rental. Assume also at the end of the year (Dec 31, 2022) adjusting entries are recorded. Hence, the entry to record the initial entry & the revenue and reduce the liability appears as follows.

March 1 Cash 24,000

Unearned Revenue.......................... 24,000

Entry to record the advance receipt of cash for rent

Dec 31 Unearned Rent (24,000/12 = 2000, 2000 x 9 months) 18,000

Rent Income.. 18,000

Adjusting entry to record the revenue earned

After this entry has been posted, the unearned rent account will have a balance of Br. 6000 (24,000-18,000), which will be reported as a liability on the balance sheet and the rent income will have a balance of Br.18,000, which will be reported on the income statement.

Illustration

Adjusting entries for Accrued liabilities (Accrued expenses):

Some expenses accrue from day to day but are usually recorded only when they are paid. The amounts of such accrued but unpaid items at the end of the fiscal period are both an expense and a liability. It is for this reason that such accruals are called accrued liabilities or accrued expenses.

Illustration

Assume that on December 31, 2022, the end of the fiscal year, the sales salaries expense account and the office salaries expense account have a debit balance of Br.65, 000 and Br.30, 000 respectively. During the year salaries have been paid every two weeks. For this particular fiscal year, the records of the business show that the accruals for sales salaries and office salaries are Br. 750 and Br. 450, respectively, at the end of the year. The entry to record the additional expenses and liability is as follows.

Dec 31 Sales Salary expense................. 750

Office Salary expense................. 450

Salary payable....................... 1200

After the adjusting entry has been posted to the accounts, the sales salaries expense totals Br.65,750 (Br.65,000+Br.750), and the office salaries expense totals Br.30,450 (Br.30,000+Br.450). These amounts will appear as expense on the income statement. The balance on the salary payable account totals Br. 1200 and that amount will be reported as liability on the balance sheet.

Illustration

Adjusting entries for Accrued Assets (Accrued Revenues):

In merchandising enterprises and other business organizations all assets and all revenues belonging to the business should be recorded. Sometimes it is common to record some types of revenues only as the cash is received; consequently, at the end of the period there may be items of revenue that have not been recorded. In such cases, debiting an asset account and crediting a revenue account must record the amount of the accrued revenue. Because of the dual nature of such accruals, they are called accrued assets or accrued revenues.

Illustration:

On December 31, 2022, the end of the fiscal year, ABC trading has an interest bearing note receivable. All interest income will be collected in the next year (2023), when payment is due on the note. Assume further that the interest earned but not collected on December 31, 2023 amounted Br. 3000. The entry to record this increase in the amount of interest due/ receivable on the note and the revenue earned is as follows:

Dec 31. Interest Receivable 3000

Interest income 3000

After posting, the balance on the interest receivable (3000) will reported on the balance sheet and the interest income on the income statement.

Work sheet:

The work sheet for a merchandising enterprise is completed in a similar fashion to that of a service enterprise. The primary difference is that the beginning and ending merchandise inventories, which are shown in the income summary account, appear in both the debit and credit income statement columns of the work sheet. The completion of the work sheet for merchandising business will be illustrated using examples at the end.

3.7. Adjusting and closing entries for a merchandising business

The basic financial statements for a merchandising enterprise are the income statement, statement of owner's equity or retained earnings, statement, and balance sheet.

There are two widely used forms for the income statement: multiple step and single step. The multiple-step income statement is so called because of its many sections, subsections, and intermediate balances. The single step income statement derives its name from the fact that the

total of its expenses is deducted from the total of all revenues.
The various sections of the multiple-step income statement include the following.
Revenue from sales: the total of all charges to customers for merchandise sold, both for cash and on account, is reported in this section. Sales discounts, sales returns & allowances are deducted from the gross amount of sales revenue to yield net sales.
Cost of merchandise sold: It is also termed as cost of goods sold or cost of sales and explained its sections in the above discussions.

Gross profit:

- is the excess of the net sales over the cost of sales. It is called gross because operating expenses must be deducted from it. i.e ***Gross Profit = Net Sales – Cost of Sales***

Operating expenses:

Depending on the nature of the nature of the business operating expenses may be grouped under any desired number of headings & subheadings. For example in retailing businesses operating expenses may be classified into two categories: Selling expenses (that are incurred directly and entirely in connection with the sale of merchandise such as salaries of the sales force, store supplies used, deprecation of store equipment, and advertising) and administrative expenses or general expenses (which are incurred directly and entirely in the general operation or administration of the business such as expenses for office salary depreciation of office equipment, office supplies used, etc.)

Expenses that are partly connected with selling and partly connected with administrative operations of the business may be divided between the two categories. Miscellaneous marketing (selling expenses & miscellaneous administrative expenses accounts may be used for relatively small amounts, which cannot be identified with principal accounts.

Income from operations/operating income:

Is the excess of gross profit over total operating expenses. It operating expenses are greater than the gross profit; the excess is called loss from operating operations. These are important factors in judging the efficiency of management and the degree of profitability of an enterprise.

Other Income/non-operating income:

- Income other than from the operating activities. For merchandising businesses income from interest, rent, dividends and gains resulting from the sale of plant assets are considered as non-operating incomes to the business.

Other Expenses/non-operating expenses: -

- Expenses that cannot be associated definitely with operations of the business. Such expenses, for merchandising businesses, include interest expenses that results from financing activities and losses incurred in the disposal of plant assets etc.

The two categories of non-operating items are offset against each other on the income statement. The net obtained by deducting the operating income over the operating expense is added to or deducted from the operating income.

Net Income/net loss:

- is the final figure on the income statement. It is the net increase or net decrease (if net loss) in owner’s equity as a result of profit making activities

The retained earnings statement summarizes the changes that have occurred in retained earnings account during a fiscal period. It is not unusual to add the analysis of retained earnings at the bottom of the income statement to form a combined income and retained earnings, statement.
The balance sheet may be prepared using the account form or the report form. The account form lists assets on the left-hand side of the statement, with liabilities and owners‟ equity on the right-hand side. The report form lists assets, liabilities and owner’s equity in a downward sequence.

3.7.1 Adjusting, closing & Reversing entries

The adjusting entries are prepared for a merchandising enterprise from the work sheet adjustments column. After the adjusting entries have been posted, the balance of all assets, liability & revenue and expense accounts correspond exactly to the amounts reported in the financial statements.
The closing entries are recorded in the Journal immediately following the adjusting entries. All the temporary accounts (Revenues & Expenses should close to income-summary, a temporary account that is opened & closed at the end of the accounting period, and the income summary to the owner’s equity/capital account. The withdrawal or dividend account should also closed to capital account) and cleared off their balances, reducing them to zero.
The final effect of closing out such balances is a net increase or decrease in the retained earnings (owner’s equity/capital) account. After the adjusting & closing entries have been posted, it is advisable to take another trial balance to verify the debit-credit equality of the ledger as of the beginning of the following year. It is called the post-closing trial balance.
A reversing entry is the exact reverse of the adjusting entry to which it relates. Some of the adjusting entries recorded at the end of the fiscal year have an important effect on otherwise routine transactions that occur in the following year. To simplify the recording of transactions in the following year, to reduce the time required to record such transactions, to avoid errors, and to promote efficiency, reversing entries may be prepared.

Illustrative problem

On preparation of multiple steps, single step and combined & retained earnings statement. The following selected accounts and their normal balances appear in the income statement and balance sheet columns of the worksheet of ABC-company for the fiscal year ended December31, 2022.

Cash…………………………………………………..	Br.87, 750.00
Notes Receivable…………………………………..	50,000.00
Accounts Receivable…………………………………	97,000.00
Merchandise Inventory, Jan1, 2023 …………………..	75,000.00
Merchandise Inventory, Dec 31, 2022 ………………...	85,000.00
Office Supplies……………………………………..	2,600.00
Prepaid insurance…………………………………..	9,800.00
Office equipment…………………………………..	27,750.00
Accumulated depreciation-office equipment…………	10,800.00
Store equipment…………………………………….	50,000.00
Accumulated depreciation-store equipment…………..	18,900.00
Accounts payable…………………………………...	35,000.00
Salaries payable…………………………………….	2,500.00
Note payable (final payment, 2022)…………………..	25,000.00
Capital stock………………………………………..	150,000.00
Retained Earnings…………………………………..	140,210.00
Dividends…………………………………………...	25,000.00
Sales………………………………………………...	975,000.00
Sales Returns & Allowance……………………………	9,000.00
Sales Discounts……………………………………..	8,500.00
Purchases………………………………………………	775,000.00
Purchase Returns & Allowances………………………	16,200.00
Purchase Discounts……………………………………	3,800.00
Transportation – in…………………………………….	10,300.00
Sales salaries expense………………………………….	83,000.00
Advertising Expense………………………………….	16,300.00
Depreciation Expense-store equipment………………	4,800.00
Miscellaneous selling expense……………………….	1,000.00
Office salaries expense……………………………....	25,900.00
Rent expense………………………………………….	12,150.00
Depreciation expense-office equipment………………	3,500.00
Insurance expense…………………………………….	2,750.00
Office supplies expense……………………………….	900.00
Miscellaneous Administrative expense………………..	1,150.00
Interest income…………………………………………	5,000.00
Interest expense………………………………………..	3,260.00

Instructions:-

1. Prepare a multiple-step income statement
2. Prepare a retained earnings statement
3. Prepare a report form of a balance sheet, assuming that the current portion of the note Payable is Br. 2,500.
4. Prepare a single-step income statement
5. Prepare a combined income & retained earnings statement, using the single-step form for theincome statement portion.

#1. Multiple-step income statement

ABC-Company

Income statement

For the Year ended Dec 31, 2022

Revenue from sales:				
Sales…...		Br.975, 000		
Less: sales Returns & Allowance………	9000			
Sales Discounts…………………	8500	(17,500)		
Net sales……………………………………………….....................			**957, 500**	
Cost of merchandise sold:				
Merchandise Inventory, Jan, 1991………………………………			**75,000**	
Purchases………………………………		775,000		
Less: Purchase Returns & Allowance…	16, 200			
Purchase Discount………………..	3,800	(20.000)		
Net Purchases…………………………………..		***755,000***		
Add: transportation in……………………………		10,300		
Cost of merchandise purchased……………			**765,300**	
Merchandise available for sale…………….			***840,300***	
Less: merchandise Inventory, December 31, 2022.			(85,000)	
Cost of merchandise sold………………….			**(755,300)**	
Gross profit………………………………………. 202,200				
Operating expenses:				
Selling expenses:				
Sales salaries expense….............................		83,000		
Advertising expense…		16,300		
Depreciation expense-store equipment…......		4,800		
Miscellaneous, selling expense….................		1,000		
Total selling expense………………			105,100	
Administrative expenses:				
Office salaries Expense…................................		25,900		
Rent expense…..		12,150		
Insurance expense...		2,750		
Depreciation expense-office equipment…		3,500		
Office supplies expense……………………		900		
Miscellaneous Administrative expenses….........		1,150		
Total Administrative Expenses…………..			46,350	
Total operating expenses…………………				(151,450)
Operating income………………………………**50,750**				
Other Income:				
Interest income		5,000		
Other expense				
Interest expense		(3,260)		
Net other income …………………………………………			1,740	
Net income……………………………………………………….…………				**Br. 52,490**

#2. Single- step income statement

ABC- Company

Income statement (Single step)

For the year ended December 31, 2022

Revenues:			
Net sales…………………………..		Br.957, 5000	
Interest income……………………		5, 000	
Total Revenue…………………..			962,500
Expenses:			
Cost of merchandise sold……….	755,300		
Selling expense………………….	105,100		
Administrative expense………….	46,350		
Interest expense……………….....	3,260		
			(910,010)
Net income………………………			**Br. 52,490.00**

#3. Retained Earnings statement:

ABC Company

Retained Earnings Statement

For the year ended December 31, 2022

Retained Earnings Jan 1,2023………..		Br.140, 210
Net income for theyear……………....	52,490	
Less: Dividends…………………….…...	(25,000)	
Increase in retained earnings…………		27,490
Retained Earnings December 31, 2022…..		**Br.167, 700**

 # 4: Income & Retained Earnings statement

ABC-Company

Income & Retained earnings statement

For the year ended December 31, 2023

Revenues:				
Net sales…………………………………	Br.957, 500			
Interest income………………………..	5,000			
Total Revenue………………………		962,500		
Expenses:				
Cost of merchandise sold……………..	755, 300			
Selling expense………………………..	105,100			
Administrative expense……………….	46,350			
Interest expense……………………….	3,260			
Total expenses……………………..		(910,010)		
Net income……………………………			52,490	
Retained earnings, January 1, 2023……			140,210	
				192, 700
Less: Dividends………………………..				(25,000)
Retained Earnings, December 31, 2022...				**Br.167, 700**

#5. Report form of the balance sheet For ABC- Company

Assets:

Current Assets:

ABC- Company Balance Sheet

On December 31, 2022

Cash …………………………………………..	Br.87, 750			
Accounts Receivable………………………….	97,000			
Notes Receivable……………………………..	50,000			
Office Supplies……………………………….	2,600			
Merchandise Inventory……………………….	85,000			
Prepaid Insurance…………………………….	9,800			
Total Current Assets………………………….			332, 150	
Plant Assets:				
Office equipment …………………………..	27, 750			
Less: Acc. dep-office equip………………….	(10,800)	16,950		
Store equipment……………………………..	50,000			
Acc. dep-Store equip…………………………	(18,900)	31,100		
Total plant assets…………………………….			48,050	
Total assets…………………………………				**Br. 380, 200**

Liabilities

Current Liabilities:

Accounts payable..............................35,000

Salaries payable 2,500

Notes payable… 2,500

Total current liabilities………………… 40,000

Long-term liabilities:

Notes payable (final payment, 2023)………. 22,500

Total liabilities…………………………… 62,500

Stockholders' equity

Capital stock 150,000

Retained Earnings.............................167,700

Total stockholder's equity……………… 317,700

Total liabilities & stockholders' equity… Br. 380,200

3.8. Summary

In this chapter merchandising businesses sell products. A **merchandising business** buys finished and packaged manufactured products, marks them up, and sells them to customers. A **merchandiser**, therefore, may be either the buyer or the seller in a given transaction, depending upon whether product is being purchased (and added to the stock of inventory), or sold (and removed from the stock of inventory.) A **vendor** is a company or individual that a merchandiser purchases goods from. A **customer** is a company or individual that a merchandiser sells goods to. **Inventory** consists of items that are purchased for resale. Note that inventory is different from supplies. **Supplies** are items that are purchased to be used in the operation of the business, not to be sold to customers. For example, a merchandiser may have Windex glass cleaner on hand. It is considered inventory if it will be resold to customers and is considered a supply if it is used in running the business to keep the check-out counters clean. Similarly, inventory is also different from fixed assets such as **equipment**

3.9. Exercise

1. At the beginning of the year, Paradise Co. Had an inventory of $200,000. During the year, the company purchased goods costing $900,000. Paradise Co reported ending inventory of $300,000 at the end of the year. Their **cost of goods sold** is
   a. $1,000,000 b. $800,000 c. $1,400,000 d. $400,000
2. Under the perpetual inventory system, in addition to making the entry to record a sale, a company would
   a. Debit Inventory and credit Cost of Goods Sold.
   b. Debit Cost of Goods Sold and credit Purchases.
   C. Debit Cost of Goods sold and credit Inventory.
   D. Make no additional entry until the end of the period.

3. Gross profit equals the difference between net sales and
   a. Operating expenses.
   b. Cost of goods sold.
   C. Net income.
   D. Cost of goods sold plus operating expenses.
4. Income from operations appears on
   a. Both a multiple-step and a single-step income statement.
   b. Neither a multiple-step nor a single-step income statement.
   c. A single-step income statement.
   d. A multiple-step income statement.
5. The entry for a buyer to record the return of goods under a perpetual inventory system assuming the purchase was made on account would include a
   a. Debit to inventory
   b. Debit to purchase returns and allowances
   c. Credit to accounts payable
   d. Debit to accounts payable
6. Under the perpetual system, cash freight costs incurred by the buyer for the transporting of goods are recorded in which account?
   a. Freight Expense b. Freight-In c. Inventory d. Freight-Out
7. Cost of goods sold can be calculating by which of the following formulas?
   a. Beginning Inventory + Net Purchases – Ending Inventory
   b. Ending Inventory + Net Purchases – Beginning Inventory
   c. Beginning Inventory + Sales – Ending Inventory
   d. Ending Inventory + Sales – Beginning Inventory
8. The entry to record a sale of $1,800 with terms of 2/10, n/30 will include a
   a. Debit to Sales Discounts for $36.
   b. Debit to Sales Revenue for $1,764.
   c. Credit to Accounts Receivable for $1,800.
   d. Credit to Sales Revenue for $1,800.
9. The entry to record the receipt of payment within the discount period on a sale of $10,000 with terms of 3/15, n/60 will include a
   a. Credit to Sales Discounts for $300.
   b. Debit to Cash for $9,700.
   C. Credit to Accounts Receivable for $9,700.
   D. Credit to Sales Revenue for $10,000.
10. Under a perpetual inventory system
   a. Accounting records continuously disclose the amount of inventory.
   b. Increases in inventory resulting from purchases are debited to purchases.
   c. There is no need for a year-end physical count.
   d. The account purchase returns and allowances is credited when goods are returned to vendors.
11. A company using a perpetual inventory system that returns goods previously purchased on credit would
   a. Debit Accounts Payable and credit Inventory.
   b. Debit Sales and credit Accounts Payable.
   c. Debit Cash and credit Accounts Payable.
   d. Debit Accounts Payable and credit Purchases.
12. In the credit terms of 3/15, n/60, the “15” represents the
   a. Number of days in the discount period.
   b. Full amount of the invoice.
   c. Number of days when the entire amount is due.
   d. Percent of the cash discount.
13. Under the perpetual system, cash freight costs incurred by the seller for the transporting of goods are recorded in which account?
   a. Freight Expense b. Freight-In c. Inventory d. Freight-Out

CHAPTER FOUR
4. ACCOUNTING FOR MANUFACTURING ENTERPRISES

Overview

The accounting cycle is the same in a manufacturing company, merchandising company, and a service company. Journal entries are used to record transactions, adjusting journal entries are used to recognize costs and revenues in the appropriate period, financial statements are prepared, and closing entries are recorded. Raw material purchases are recorded in the raw material inventory account if the perpetual inventory method is used, or the raw materials purchases account if the periodic inventory method is used. For example, using the periodic inventory method, the purchase of $750 of raw materials on account is recorded as an increase (debit) to raw materials purchases and an increase (credit) to accounts payable.

4.1 Characteristics of manufacturing business

This is how to distinguish manufacturing businesses from other businesses. These are the characteristic of manufacturing business:

Production Process -Since the distribution of work is distributed throughout several sectors, this procedure is known to be extremely complicated. The administrator, for example, would handle the company's administrative duties, the operator will operate the current equipment, and the quality control department will ensure that the items produced meet the feasibility criteria.

Production Cost- The manufacturing production costs are high due to the vast quantity of items produced. The expenses are often used to assist the manufacturing –raw resources, equipment maintenance, personnel expenditures, and so on.

Product Processing - is defined as transforming raw resources into finished items to be sold to the customers. This method is not as simple as it seems since it needs a substantial amount of time and work.

The Availability of Heavy Machinery

The availability of high machinery is a well-known characteristic of manufacturing enterprises. Of course, this equipment is utilized to manufacture a specific amount and quality of items. Aside from big machines, industrial production processes still need the employment of human labor to operate and monitor the hardware.

Sales and Marketing -The operations of production, marketing, and sales are strongly intertwined. When the sales revenue grows, the manufacturing process should be prepared to deliver the product in large quantities to make the products available to the public. Product marketing performed by the sales and marketing department is essential because through the marketing process, the company will make its own product to be publicly known and attract customers to buy the products.

Examples of Manufacturing Business - Every industry has a manufacturing company that is well known to the public. The following are examples of the most popular manufacturing companies.

4.2 Classification of manufacturing costs

Manufacturing costs are constantly under change, getting impacted by its various determining factors. But considering that the success of the business depends on its productivity as well as profitability, having an accurate prediction of its manufacturing costs will help it in reaching its targets. Manufacturing cost is the sum of the costs of all resources consumed in the process of making a product. It is classified into three main categories: direct materials cost, direct labor cost, and manufacturing overhead. Determining your manufacturing costs will help you correctly price your products and therefore ensure high net profits for your company. In fact, by using the insights provided by the manufacturing costs, you will be able to find out whether you are meeting your goals and whether your production process is conducive to your desired level of productivity.

Management accounting, as previously explained, consists primarily of planning, performance evaluation, and decision-making models useful to management in making better decisions. In every case, these tools require cost and revenue information. A basic assumption of management accounting is that it is the responsibility of the management accountant to provide the needed cost and revenue information.

Consequently, the management accountant needs a complete understanding of the different types of costs required by the various models. In management accounting, as in financial accounting, it may be said that a major building block in the conceptual foundation is cost. Both the financial and management accountant must have a sound understanding of the varied and complex rami-fictions of cost. From a financial accounting viewpoint, a faulty understanding of cost may cause financial statements to be incorrectly prepared. From a management accounting viewpoint, an inadequate understanding or use of costs will result in poor decisions.

There are two broad aspect of the term cost that needs to be understood: cost classification and cost behavior. Cost classification refers to the separation of costs into categories for proper preparation of financial statements or for use in decision-making models.

Direct material

Direct material costs are the costs of raw materials or parts that go directly into producing products. For example, if Company A is a toy manufacturer, an example of a direct material cost would be the plastic used to make the toys.

2. Direct labor

Direct labor costs are the wages, benefits, and insurance that are paid to employees who are directly involved in manufacturing and producing the goods – for example, workers on the assembly line or those who use the machinery to make the products.

3. Manufacturing overhead

Manufacturing overhead costs include direct factory-related costs that are incurred when producing a product, such as the cost of machinery and the cost to operate the machinery.

Manufacturing overhead costs also include some indirect costs, such as the following:
Indirect materials: Indirect materials are materials that are used in the production process but that are not directly traceable to the product. For example, glue, oil, tape, cleaning supplies, etc. are classified as indirect materials.
Indirect labor: Indirect labor is the labor of those who are not directly involved in the production of the products. An example would be security guards, supervisors, and quality assurance workers in the factory. Their wages and benefits would be classified as indirect labor costs.
Example of Product Costs
Company A is a manufacturer of tables. Its product costs may include:

- **Direct material:** The cost of wood used to create the tables.
- **Direct labor:** The cost of wages and benefits for the carpenters to create the tables.
- **Manufacturing overhead (indirect material):** The cost of nails used to hold the tables together.
- **Manufacturing overhead (indirect labor):** The cost of wages and benefits for the security guards to overlook the manufacturing facility
- **Manufacturing overhead (other):** The cost of factory utilities.

Company a produced 1,000 tables. To produce 1,000 tables, the company incurred costs of:
$12,000 on wood

- $2,000 on wages for carpenters and $500 on wages for security guards to overlook the manufacturing facility
- $100 for a bag of nails to hold the tables together
- $500 for factory rent and utilities

Total product costs: $12,000 (direct material) + $2,000 (direct labor) + $100 (indirect material) + $500 (indirect labor) + $500 (other costs) = $15,100. As this is the cost to produce 1,000 tables, the company has a per unit cost of $15.10 ($15,100 / 1,000 = $15.10).
Period Costs
Product costs are costs necessary to manufacture a product, while period costs are non-manufacturing costs that are expensed within an accounting period.

	Product Costs	**Period Costs**
Definition	Costs incurred to manufacture a product	Costs that are not incurred to manufacture a product and, therefore, cannot be assigned to the product
Comprises of	Manufacturing and production costs	Non-manufacturing costs
Examples	Raw material, wages on labor, production overheads, rent on the factory, etc.	Marketing costs, sales costs, audit fees, rent on the office building, etc.

4.3 Product Costing Systems- An Overview

What is Product Costing?

Product costing is the process of calculating the costs incurred with manufacturing a single product. This total cost includes the consumption of raw materials and components, labor, and overhead allocated to sole unit. For accountants, product costing is essential for inventory valuation and for calculating the cost of goods sold. Managers, however, use product costing as a jumping-off point for deciding which products to manufacture as well as for pricing the manufactured products. After calculating the cost per unit, you can use various pricing methods to determine an optimal selling price for the product. The cost per unit also serves as a manufacturing performance metric to help keep tabs on production costs.

Although there are several different ways to approach product costing, you can follow these seven basic steps in any situation.

1. **Identify the cost object.** If your company manufactures standard products, you can take a single product as the cost object. If you build custom products, then you can also use job costing to determine the costs related to a full order.
2. **Track the direct costs of individual items.** Simply add together all direct material and direct labor costs that go into making a particular product.
3. **Pool together the overhead costs.** These include indirect materials (lubricants, fasteners, and other goods used for manufacturing that are not tracked), indirect labor (production planning, maintenance, quality assurance and control, supervisors, shop floor janitors, etc.), and manufacturing overhead (rent, utilities, insurance, depreciation, etc.).
4. **Pick the overhead cost allocation base.** You may just pool together the indirect costs and apply it evenly over all your products. But for better accuracy and decision-making, you should allocate the overhead according to how resource-heavy a product is. In this case, more overhead is allocated to those items that take more time or materials to make, and less overhead is allocated to those products that consume less. Generally, either machine hours or labor hours are used as the overhead cost allocation base.
5. **Calculate the overhead allocation rate.** If you apply the same amount of overhead to each product, you can skip this step. However, if you use machine or labor hours, then use the following formula:

   Overhead allocation rate = Total overhead / Total hours

For example, if the total overhead incurred over a month is estimated at $24,000 and production workers put in a total of 800 hours of work, the overhead allocation rate would be:

24,000 / 800 = $30/hour

6. **Allocate the overhead costs.** If you apply the same amount of overhead to each product, and you produced 600 products during the period, the formula would be:

Overhead cost per product = Total overhead / Total products With the numbers from the previous example, the overhead per product would be:
24,000 / 600 = $40
If you use the overhead allocation rate, however, you would also need to know how much time was spent on making different products. Let's say you make three distinct products: tables, chairs, and coffee tables. Producing a table takes 1.25 hours, a chair takes 0.75 hours, and a coffee table takes 1 hour to finish.
Therefore, the overhead allocated to each product would be:
Table: 1.25 x 30 = $37.50
Chair: 0.75 x 30 = $22.50
Coffee table: 1 x 30 = $30

3. **Calculate the total cost.** To do this, just take the direct costs of a product and add them to the overhead allocated to the product. Let's say the table consists of a tabletop that costs $30 and four table legs that cost $20 per set. The direct material costs are therefore $50. Furthermore, the labor cost of the workers assembling and finishing the table is $30/hour, with one person working on the table at a time. As a table takes 1.25 hours to finish, the labor cost per table is: $30 x 1.25 = $37.50 Now, adding together the direct costs and the applied overhead per table, we will get the cost per unit. CPU = Direct labor + Direct materials + Overhead $37.50 + $50 + $37.50 = $125

The production costs incurred with the manufacture of one table total $125

4.4 Chart of Accounts for a Manufacturing Business

The chart of accounts is a record of the valid accounts you assign to the business units within your company's reporting structure. When you set up your chart of accounts, you define the location of the accounts using automatic accounting instructions (AAIs) that indicate which number ranges represent assets, liabilities, and so on.

The chart of accounts begins with the major headings of your transactions and continues with detailed transaction descriptions:

Transaction	**Description**
Assets	(Balance Sheet)
Liabilities	(Balance Sheet)
Owners' Equity	(Balance Sheet)
Revenues	(Income Statement)
Expenses	(Income Statement)

The chart of accounts displays the following elements:

- The account number
- The posting edit codes
- The level of detail assigned to the account
- Which accounts are assigned to which business units

Example: Chart of Accounts

Acct	Description	Post Edit	LOD	B/S BU100	DEN BU210
1000	Assets	N	3	X	
1001	Current Assets	N	4	X	
1100	Cash	N	5	X	
1110	Cash in Bank	N	6	X	
1130	Short-Term Investments	N	7	X	
1200	Accounts Receivable	M	5	X	
1210	Trade Accounts Receivable	M	6	6	
1215	Allow for Doubtful Accounts	N	5	X	
1400	Inventory	N	5	X	
1800	Prepaid Expenses		6	X	
1810	Prepaid insurance		6	X	
1890	Other Prepaid Expenses		6	X	
2000	Fixed Assets	N	4	X	
2001	Property and Equipment	N	5	X	
2020	Buildings	N	6	X	
2060	Furniture & Office Equipment	N	6	X	
2100	Accumulated Depreciation		6	X	
2160	Accum Depr - Buildings		5	X	
2170	Accum Depr -		6	X	
3900	Office Furniture/Equipment		6	X	
	Accum Depr - Computer		6	X	
	Other Assets		5	X	

For example, you can categorize the "Cash in Banks" object (account 1110) into the following subsidiary accounts:

Account	Description
1110.BEAR	Bear Creek National Bank
1110.FIB	First Interstate Bank
1110.FRANCE	First Bank of France

4.5 Recording the flow of costs through production process

As products physically move through the production process, the product costs associated with these products move through several important accounts as shown back in Figure 4.5 "A Comparison of Cost Flows for Job Costing and Process Costing". In this section, we present a detailed look at how product costs flow through accounts using a process costing system. Later in the chapter, we explain how dollar amounts are established for product costs that flow through the accounts. As you review each of the following cost flows for a process costing system, remember that product costs are now tracked by department rather than by job.

Direct Materials

Question: In a process costing setting, direct materials are often used by several production departments. How do we record direct materials costs for each production department?

Answer: When direct materials are requisitioned from the raw materials storeroom, a journal entry is made to reduce the raw materials inventory account and increase the appropriate work-in-process inventory account. For example, assume the Assembly department of Desk Products, Inc., requisitions direct materials to be used in production. The journal entry to reflect this is as follows:

1.a.	WIP inventory—*assembly*	XXX	
	Raw materials inventory		XXX

The use of direct materials is not limited to one production department. Suppose the Finishing department requisitions direct materials for production. The journal entry to reflect this is as follows:

1.b.	WIP inventory—*finishing*	XXX	
	Raw materials inventory		XXX

Notice that two different work-in-process inventory accounts are used to track production costs—one for each department.

Direct Labor

Question: Each production department typically has a direct labor work force. How do we record direct labor costs for each production department? Answer: Direct labor costs are recorded directly in the production department's work-in-process inventory account. Assume direct labor costs are incurred by the Assembly department. The journal entry to reflect this is as follows:

2.a.	WIP inventory—*assembly*	XXX	
	Wages payable		XXX

As with direct materials, the use of direct labor is not limited to one production department. Suppose direct labor costs are incurred by the Finishing department. The journal entry to reflect this is as follows:

2.b.	WIP inventory—*finishing*	XXX	
	Wages payable		XXX

Manufacturing Overhead

Question: Manufacturing overhead costs are typically assigned to products using a predetermined overhead rate using a normal costing system as discussed in Chapter 2 "How Is Job Costing Used to Track Production Costs?" (Job costing) and Chapter 3 "How Does an

Organization Use Activity-Based Costing to Allocate Overhead Costs?" (Activity-based costing). How do we record manufacturing overhead costs for each department?

Answer: Assume manufacturing overhead costs (often simply called overhead costs) are being applied to products going through the Assembly department. The journal entry to reflect this is as follows:

3.a.	WIP inventory—*assembly*	XXX	
	Manufacturing overhead		XXX

The journal entry to reflect manufacturing overhead costs being applied to products going through the Finishing department is as follows:

3.b.	WIP inventory—*finishing*	XXX	
	Manufacturing overhead		XXX

Transferred-In Costs

Question: At this point, we have discussed how to record product costs (direct materials, direct labor, and manufacturing overhead) related to each production department. As you review Figure 4.1 "A Comparison of Cost Flows for Job Costing and Process Costing", notice that products often flow from one production department to the next. Transferred-in costs are the costs associated with products moving from one department to another. How do we record transferred-in costs for each department?

Answer: Assume the Assembly department at Desk Products, Inc., completes a batch of desks and moves the desks to the Finishing department. The costs associated with these desks must be transferred from the work-in-process inventory account for the Assembly department to the work-in-process inventory account for the Finishing department. Thus these costs are being transferred in to the Finishing department. The journal entry to reflect this is as follows:

4.	WIP inventory—*finishing*	XXX	
	WIP inventory—*assembly*		XXX

Finished Goods

Question: Goods are completed and ready to sell once they have gone through the final production department. The final production department at Desk Products, Inc., is the Finishing department. How do we record production costs for products moved from the final production department to the finished goods warehouse? Answer: When goods go through the final production department and are completed, the related costs are moved to the finished goods inventory account. The journal entry to reflect this is as follows:

5.	Finished goods inventory	XXX	
	WIP inventory—*finishing*		XXX

Cost of Goods Sold

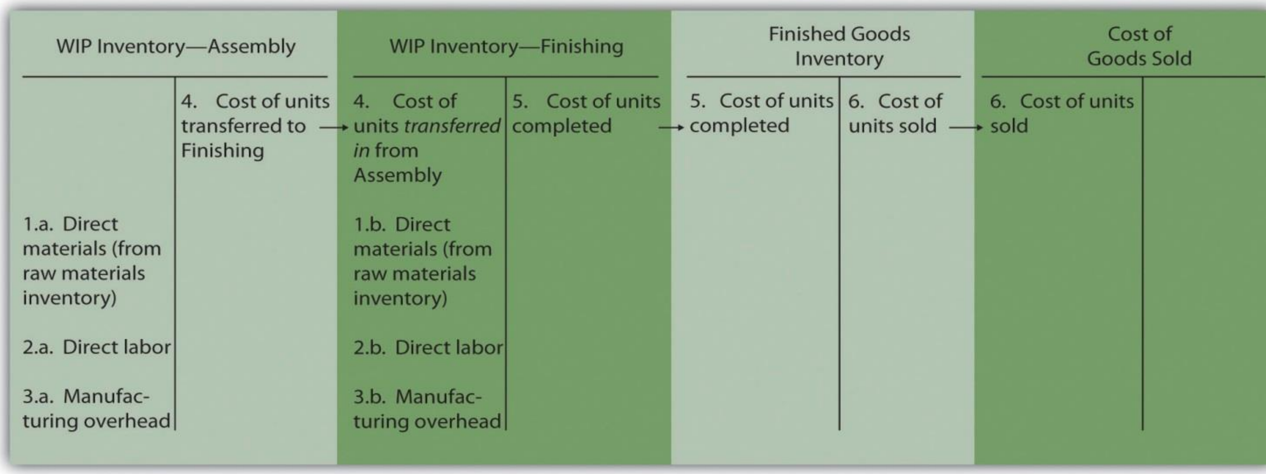
Question: How do we record production costs for goods that have been sold?

Answer: Once the completed goods are sold, the related costs are moved out of the finished goods inventory account and into the cost of goods sold account. The journal entry to reflect this is as follows:

6. Cost of goods sold	XXX	
Finished goods inventory		XXX

"Flow of Product Costs in a Process Costing System" summarizes the flow of product costs through T-accounts for each of the journal entries presented in this section. Note that when goods are sold and production costs are moved from finished goods inventory to cost of goods sold, an additional entry is made to record the revenue associated with this transaction. We do not show this entry because the focus of this section is on the flow of production costs rather than revenues.

Flows of Product Costs in a Process Costing System



Job is to understand how we use the inventory cost flow equation to calculate raw materials placed in production, cost of goods manufactured and cost of goods sold. (Note: Companies using a perpetual inventory system do not necessarily prepare these formal schedules because perpetual systems update records immediately when inventory is transferred from one inventory account to another. However, these companies take a physical count periodically to ensure the accuracy of inventory accounts and use the cost flow equation and similar schedules to ensure their perpetual system balances are accurate. "Business in Action 2.8" shows how the cost flow equation can be used to analyze the effects of fraud that was allegedly committed at Rite Aid.)

4.6 Financial Statements for a Manufacturing Business

Custom Furniture Company
Schedule of Raw Materials Placed in Production
Month Ended May 31

Raw materials inventory, beginning balance *(BB)*	$ 25,000[a]
Add current period raw materials purchases *(TI)*	15,000
Raw materials available for production	$ 40,000
Less raw materials inventory, ending balance *(EB)*	19,000[b]
Raw materials placed in production *(TO)*	$ 21,000
Less indirect materials included in manufacturing overhead	3,000
Direct materials placed in production	**$ 18,000**

Custom Furniture Company
Schedule of Cost of Goods Sold
Month Ended May 31

Finished goods inventory, beginning balance *(BB)*	$ 90,000[a]
Add cost of goods manufactured *(TI)*	161,000
Cost of goods available for sale	$ 251,000
Less finished goods inventory, ending balance *(EB)*	116,000[b]
Cost of goods sold *(TO)*	**$ 135,000**

a. From the company's balance sheet at April 30 (April 30 ending balance is the same as May 1 beginning balance).

b. From the company's balance sheet at May 31.

c. This is actual manufacturing overhead for the period and includes indirect materials, indirect labor, factory rent, factory utilities, and other factory-related expenses for the month.

Figure: Income Statement for Custom Furniture Company

Custom Furniture Company Income Statement Month Ended May 31	
Sales	$ 190,000
Cost of goods sold	135,000*
Gross profit	$ 55,000
Less operating (nonmanufacturing) expenses:	
Selling	18,000
General and administrative	26,000
Operating profit	$ 11,000

4.7 Adjusting and closing entries for a merchandising business

Journalizing Closing Entries for a Merchandising Enterprise

At this point in the accounting cycle, we have prepared the financial statements. Now we do the last part, the closing entries. The videos in the adjusting entry section gave you a preview into this process but we will discuss it in more detail.

Accounting Cycle		
1. Analyze Transactions	5. Prepare Adjusting Journal Entries	**9. Prepare Closing Entries**
2. Prepare Journal Entries	6. Post Adjusting Journal Entries	**10. Post Closing Entries**
3. Post journal Entries	7. Prepare Adjusted Trial Balance	**11. Prepare Post-Closing Trial Balance**
4. Prepare Unadjusted Trial Balance	8. Prepare Financial Statements	

The closing entries will be a review as the process for closing does not change for a merchandising company. Do you remember why we do closing entries? They are the journal entry version of the statement of retained earnings to ensure the balance we report on the statement of retained earnings and the balance sheet matches the ending balance of retained earnings in our general ledger. Closing entries also set the balances of all temporary accounts (revenues, expenses, dividends) to zero for the next period.

If the process is the same, why do we need to review it? We have many new accounts learned for a merchandiser and we want to see how they fit into the closing process. The new accounts remaining for a merchandiser after adjusting entries are:

Account	Account Type
Sales Revenue	Revenue
Sales Discount*	Revenue
Sales Returns and Allowances*	Revenue
Cost of Goods Sold	Expense
Delivery Expense	Expense

Revenue accounts typically have normal credit balances (credit to increase, debit to decrease) but Sales Discounts and Sales Returns and Allowances are contra-accounts because they are revenue accounts but have normal debit balances (debit to increase, credit to decrease). Expenses have normal debit balances.

The four basic steps in the closing process are modified slightly:

- **Closing the revenue accounts with credit balances**—transferring the credit balances in the revenue accounts to a clearing account called Income Summary.
- Closing the expense accounts and contra-revenue accounts**—transferring the debit balances in the expense accounts and contra-revenue accounts to a clearing account called Income Summary.**
- Closing the Income Summary account**—transferring the balance of the Income Summary account to the Retained Earnings account (this should always equal net income or loss from the income statement).**
- Closing the Dividends account**—transferring the debit balance of the Dividends account to the Retained Earnings account.**

To illustrate, let's look at the adjusted trial balance from Hanlon from the previous section:

Adjusted Trial Balance	Debit	Credit
Retained Earnings	25,000	
Dividends*	8,000	
Sales Revenue		275,000
Sales discounts*	2,000	
Sales returns and allowances*	1,000	
Interest revenue		150
Cost of goods sold	159,000	
Commissions expense	10,000	
Advertising expense	7,000	
Sales Salaries expense	20,000	
Rent expense – sales	12,000	
Rent expense – office	12,000	
Office Salaries expense	40,000	
Utilities expense	5,000	
Interest expense	50	

*Contra-accounts

We will prepare the closing entries for Hanlon. Remember to close means to make the balance zero. To do this, we will do the opposite of the balance in the adjusted trial balance in a journal entry and use Income Summary to balance the entry.

1. **Close the revenue accounts with credit balances.** We have 2 revenue accounts with a credit balance, Sales Revenue (or Sales) and Interest Revenue.

Account	Debit	Credit
Sales Revenue	275,000	
Interest Revenue	150	
Income Summary		275,150
To close revenue accounts with credit balances.		

2. **Close contra-revenue accounts and expense accounts with debit balances**. We will close sales discounts, sales returns and allowances, cost of goods sold, and all other operating and no operating expenses.

Account	Debit	Credit
Income Summary	268,050	
Sales Discounts		2,000
Sales Returns and Allowances		1,000
Cost of Goods Sold		159,000
Commissions Expense		10,000
Advertising Expense		7,000
Sales Salaries Expense		20,000
Rent Expense – Sales		12,000
Rent Expense – Office		12,000
Office Salaries Expense		40,000
Utilities Expense		5,000
Interest Expense		50
To close contra-revenue and expense accounts.		

4. **Close income summary into retained earnings.** We will take the difference between income summary in step 1 $275,150 and subtract the income summary balance in step 2 $268,050 to get the adjustment amount of $7,100. *This should always match net income calculated on the income statement.*

Account	Debit	Credit
Income Summary (275,150 – 268,050)	7,100	
Retained Earnings		7,100
To close net income into retained earnings.		

4. Close the debit balance of dividends into retained earnings. Remember, dividends are earnings of the company given back to the owner and will reduce retained earnings. Retained earnings is an equity account and is decreased with a debit. Dividends is a contra-account because it is an equity account but has a normal debit balance. Do not use the retained earnings balance in this entry!

Account	Debit	Credit
Retained Earnings	8,000	
Dividends		8,000
To close dividends into retained earnings.		

To check our work, the Statement of Retained Earnings would look like this:

Hanlon Food Store	
Statement of Retained Earnings	
For Year Ended December 31	
Retained Earnings, January 1	25,000
Add: Net Income	7,100
Less: Dividends	(8,000)
Retained Earnings, December 31	**24,100**

When we post the closing entries to the general ledger, the revenues, expenses and dividends accounts are all zero. The retained earnings ledger card would look like:

Account: Retained Earnings	Debit	Credit	Balance
Beginning Balance			25,000
(3) Close income summary		7,100	32,100
(4) Close dividends	8,000		**24,100**

The final step in the merchandising accounting cycle would be to prepare a post-closing trial balance. The post-closing trial balance will contain assets, liabilities, common stock and the new ending balance calculated for retained earnings.

4.8 Summary

Merchandising enterprises purchase goods and service and sell it to customers without changing its basic form. In the purchase and sale of inventory they use two basic accounting systems: Periodic and perpetual inventory system. In Periodic inventory system the cost of all merchandise purchased is accumulated in a Purchase account; whereas in Perpetual Inventory system purchase of inventory is directly accumulated in the Inventory account. A deduction made on the purchase of inventory is considered as purchase discount. There are two basic methods to record purchase discount: gross method and the net method. Under gross method, the purchase is recorded at the invoice amount before deduction of any related cash discount is made. In the case of Net method purchase is recorded at the invoice amount less any related cash discount.

If merchandise received from suppliers is defective or not accepted, buyer may return it (purchase return) or the buyer may negotiate on price adjustment (purchase Allowance). This process is known as purchase return and allowances. Purchase returns and Allowance, is a contra purchase account, same with purchase discount account.

Revenues from merchandise sales are usually identified in the ledger as sales. Sell of merchandise can be made on cash or on credit (Account).

In the delivery of goods purchased always, there is an agreement or terms of sale between buyers and sellers .For example on the payment of transportation cost. These terms are: FOB Destination and FOB shipping point. If agreements are made on FOB destination, seller pays transportation costs and debits transportation (Freight) out or Delivery Expense account. On the other hand if an agreement is made on FOB shipping point buyer pays transportation cost and debits merchandise inventory (Purchase) account.

4.9 Exercise

Part one: Multiple Choices

1.If merchandise purchased on account is returned, the buyer may inform the seller of the details by issuing a(n):

A. Debit memo. C. Invoice.
B. Credit memo. D. Bill.

2. If merchandise is sold on account to a customer for birr 1,000, terms FOB shipping point, 1/10, n/30, and the seller prepays birr $50 in freight, the amount of the discount for early payment would be:

A. birr $0 B. birr $5.00 C. birr 10.00 D. birr $10.50.

3. Merchandise is sold on account to a customers for birr 1,000, terms of FOB destination.1/10, n/30. If seller pays birr 50 in transportation costs and the customer return birr 100 of the merchandise inventory prior to payment, what is the amount of the discount for early payment?

A. birr 0.00 B. birr 9.00 C. birr 10.00 D. birr 10.50

4. For an enterprise using the periodic inventory system, which of the following is added to merchandise inventory at the be3fginning of the period in computing the cost of merchandise sold?

A. Purchases discounts C. Merchandise inventory at the end of the period
B. Purchases Returns and allowances D. None of the above

5. The balance in unearned rent at the end of a period represents.

A. An assets B. liability C. a revenue D. an expense.

Part Two: Work out

Each merchandising transaction affects a buyer and a seller. This exercise shows how the same transactions would be recorded by both the seller and the buyer. Assume the seller is Fraol Company and the buyer is Roza Company. Record the following transactions on both the seller (Fraol) and buyer (Roza) Company. Use perpetual Inventory system.

July1. Fraol Company sold merchandise on account to Roza Company for 7500birr, terms FOB shipping point, n145. The cost of merchandise sold was birr 4500.

July 2. Roza Company paid transportation costs of birr 150 on July1. Purchase from Fraol Company.

July 5. Fraol Company sold merchandise on account to Roza Company for 5000 birr, terms FOB destination, and n130. The cost of merchandise sold was 3500birr.

July 7. Fraol Company paid transportation of 250birr for delivery of merchandise sold to Roza Company on July 5.

July 13. Fraol Company issued Roza Company a credit memorandum for merchandise returned having a price of 1000 birr. The merchandise had been purchased by Roza Company on account on July5. The cost of merchandise returned was 7000birr.

July 15. Fraol Company received payment from Roza Company for purchase of July5.

July 18. Fraol Company sold merchandise on Account to Roza Company for birr 12,000, terms FOB shipping point 2110, nleom. Fraol Company prepaid transportation cost of 500birr, which were added to the invoice. The cost of the merchandise sold was 7200.

July 23. Fraol Company received payment from Roza Company for purchase of July 18.

CHAPTER FIVE

5. ACCOUNTING SYSTEMS

An accounting system is a set of accounting processes with integrated procedures and controls. The intent of an accounting system is to record business transactions, summarize those transactions into an aggregated form, and create reports that can be used by decision makers to monitor, analyze, and improve operations. Though an accounting system can be entirely paper-based, this situation is usually only found in quite small businesses. In most cases, accounting systems are largely based upon off-the-shelf accounting software, supplemented by any procedures needed to input information into the software.

An accounting system typically includes coverage of the major functional areas of an organization, including the purchase of goods and services, sales of goods of services, payments to employees for wages earned, and financing activities, such as obtaining debt, selling shares, and paying interest to lenders. The specific components of an accounting system include accounts payable, billings and accounts receivable, fixed assets, inventory, and payroll. Depending on the volume of transactions being processed, there may be specialized accounting staff assigned to each of the preceding modules.

5.1 Manual and Computerized Accounting Systems and Enterprise Resource Planning

Comparison between Manual and Computerized Accounting, by definition, is the process of identifying, recording, classifying and summarizing financial transactions to produce the financial reports for their ultimate analysis. Let us understand these activities in the context of manual and computerized accounting system.

- Identifying: The identification of transactions, based on application of accounting principles is, common to both manual and computerized accounting system.
- Recording: The recording of financial transactions, in manual accounting system is through books of original entries while the data content of such transactions is stored in a well-designed accounting database in computerized accounting system.
- Classification: In a manual accounting system, transactions recorded in the books of original entry are further classified by posting into ledger accounts. This results in transaction data duplicity. In computerized accounting, no such data duplication is made to cause classification of transactions. In order to produce ledger accounts, the stored transaction data is processed to appear as classified so that the same is presented in the form of a report. Different forms of the same transaction data are made available for being presented in various reports.
- Summarizing: The transactions are summarized to produce trial balance in manual accounting system by ascertaining the balances of various accounts. As a result, preparation of ledger accounts becomes a prerequisite for preparing the trial balance. However, in

computerized accounting, the originally stored transactions data are processed to churn out the list of balances of various accounts to be finally shown in the trial balance report. The generation of ledger accounts is not a necessary condition for producing trial balance in a computerized accounting system.

- Adjusting Entries: In a manual accounting system, these entries are made to adhere to the principle of cost matching revenue. These entries are recorded to match the expenses of the accounting period with the revenues generated by them. Some other adjusting entries may be made as part of errors and rectification. However, in computerized accounting, Journal vouchers are prepared and stored to follow the principle of cost matching revenue, but there is nothing like passing adjusting entries for errors and rectification, except for rectifying an error of principle by having recorded a wrong voucher such as using payment voucher for a receipt transaction.

5.2 Subsidiary Ledgers and Control Accounts

A subsidiary ledger is a detailed list to support a control account. A control account appears on the balance sheet in summary or total, and is accounts like accounts receivable, accounts payable, and inventory. This video explains the theory (the video refers to a Debtor account which is Accounts Receivable and a Creditor account which is Accounts Payable. A Debtor is a customer and a Creditor is a vendor)

5.2.1 Accounts Receivable Subsidiary Ledger

The accounts receivable subsidiary ledger will contain an account for each individual customer. The sales, payments, and returns and allowances are recorded into the individual customer accounts as well as the bigger picture (control account) accounts receivable account. For Fooz Ball Town, the sales entries were:

- July 5 Sold $5,000 of merchandise inventory, terms 1/15, n 30, FOB Destination with a cost of goods sold of $3,000 to Robby Red.
- July 10 Sold $1,500 of merchandise inventory for cash, FOB Shipping Point, with a cost of goods sold of $1,000.
- July 15 Received payment from Robby Red from July 5 sale less the discount.
- July 30 Sold $7,000 of merchandise inventory, terms 1/15, n 30, FOB Shipping point with cost of goods sold $5,000 to Bobby Blue.

These entries were recorded in the sales journal and cash receipts journal as follows:

Sales Journal			
Date	**Customer**	**Dr Accounts Receivable**	**Dr Cost Of Goods Sold**
		Cr Sales	**Cr Inventory**
July 5	Robby red	$5,000	$3,000
July 30	Bobby blue	7,000	5,000
Totals		**$12,000**	**$8,000**

Cash Receipts Journal						
Date	**Customer**	**Dr Cash**	**Dr Sales Discounts**	**Cr Accounts Receivable**	**Cr Sales**	**Dr Cost Of Goods Sold / Cr Inventory**
July 10	Cash Sale	1,500			1,500	1,000
July 15	Robby Red	4,950	50	5,000		
Totals		**6,450**	**50**	**5,000**	**1,500**	**1,000**

These journals would be posted to the Accounts Receivable control account like this:

Account: Accounts Receivable				
Date	**Description**	**Debit**	**Credit**	**Balance**
July 31	from Sales Journal	12,000		12,000
July 31	from Cash Receipts Journal		5,000	**7,000**

The customer (subsidiary) ledger would be updated for Robby Red and Bobby Blue as:

Customer Account: Robby Red				
Date	**Description**	**Debit**	**Credit**	**Balance**
July 5	Sale	5,000		5,000
July 15	Payment		5,000	**-0-**
Customer Account: Bobby Blue				
Date	**Description**	**Debit**	**Credit**	**Balance**
July 15	Sale	7,000		

At the end of the period, a schedule is prepared to verify (or prove) the Accounts Receivable (control account) balance reported on the balance sheet. This schedule is a listing of all customers with the ending amounts owed and should always match the ending balance in Accounts Receivable. The schedule of accounts receivable for Fooz Ball Town would be:

7,000	
Fooz Ball Town	
Schedule of Accounts Receivable	
July 31	
Robby Red	$0
Bobby Blue	7,000
Total Accounts Receivable	**$ 7,000**

Note: It would not be necessary to include customers with zero balances but it is included here just so you can see how the subsidiary ledger works. Notice how the schedule of accounts receivable balance equals the ending accounts receivable balance (control account).

Accounts Payable Subsidiary Ledger

The accounts payable subsidiary ledgers works the same way as accounts receivable with the control account of accounts payable and the subsidiary ledger a vendor ledger to provide a listing of everyone we owe. The purchases, payments, returns and allowances are recorded in the individual vendor accounts as well as in the accounts payable account. The purchase transactions for Fooz Ball Town are:

- July 12 purchased $10,000 of merchandise inventory, terms 2/15, n 45, FOB Destination from Gus Grass.
- July 16 returned $2,500 of merchandise damaged in shipment from July 12 purchase.
- July 25 Paid for the July 15 purchase from Gus Grass less the return and discount.

These transactions were recorded, under the perpetual inventory method, in the following journals:

Purchases Journal		
Date	**Vendor**	**Dr Merchandise Inventory**
		Cr Accounts Payable
July 12	Gus Grass	10,000
Totals		**10,000**

Cash Disbursement Journal				
Date	**Account**	**Dr Accts Payable**	**Cr Mdse Inventory**	**Cr Cash**
July 25	Gus Grass	7,500	150	7,350

General Journal			
Date	**Account**	**Debit**	**Credit**
July 16	Accounts Payable	2,500	
	Merchandise Inventory		2,500

These journals would be posted to the Accounts Payable control account like this:

Account: Accounts Payable				
Date	**Description**	**Debit**	**Credit**	**Balance**
July 16	Gus Grass Return	2,500		-2,500
July 31	from Purchases Journal		10,000	7,500
July 31	from Cash Disbursements Journal		7,500	**-0-**

The vendor (subsidiary) ledger would be updated for Gus Grass:

Vendor Account: Gus Grass				
Date	**Description**	**Debit**	**Credit**	**Balance**
July 12	Purchase		10,000	10,000
July 16	Return	2,500		7,500
July 25	Payment		7,500	**-0-**

The vendor balance for Gus Grass is $0 and the accounts payable balance is $0. Since both are zero and match, it would not be necessary to prepare a schedule of accounts payable. If there is a balance, a schedule of accounts payable would be prepared in the same manner as accounts receivable.

5.3 Special Journals and Vouchers

5.3.1 Special Journals

Instead of having just one general journal, companies group transactions of the same kind together and record them in special journals rather than in the general journal. This makes it easier and more efficient to find a specific type of transaction and speeds up the process of posting these transactions. In each special journal, all transactions are totaled at the end of the month, and these totals are posted to the general ledger. In addition, instead of one person entering all of the transactions in all of the journals, companies often assign a given special journal's entries to one person. The relationship between the special journals, the general journal, and the general ledger can be seen in Figure.

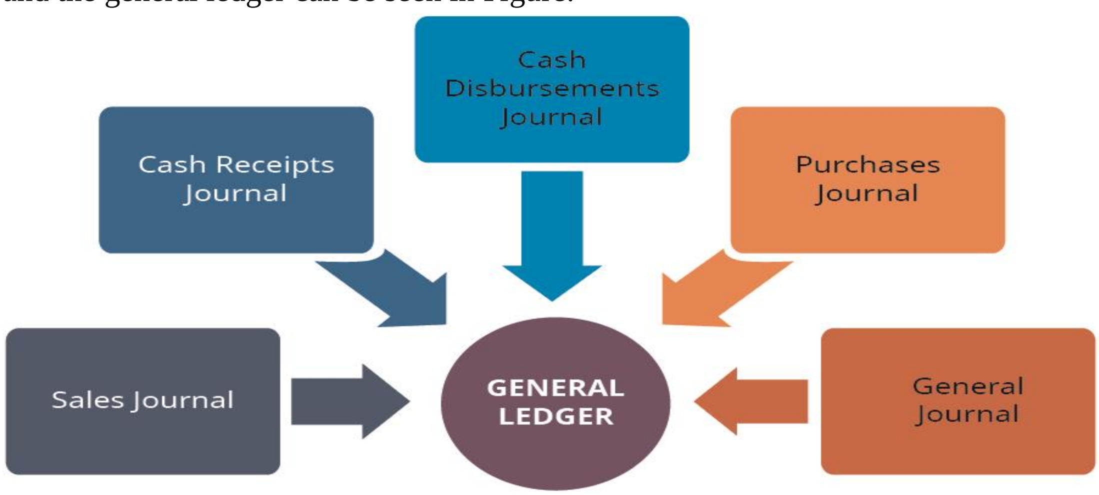


Figure Special and General. Transaction summaries form the special journals, and all transactions in the general journal are posted to the general ledger. (attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Most companies have four special journals, but there can be more depending on the business needs. The four main special journals are the sales journal, purchases journal, cash disbursements journal, and cash receipts journal. These special journals were designed because some journal entries occur repeatedly. For example, selling goods for cash is always a debit to Cash and a credit to Sales recorded in the cash receipts journal. Likewise, we would record a sale of goods on credit in the sales journal, as a debit to accounts receivable and a credit to sales. Companies using a perpetual inventory system also record a second entry for a sale with a debit to cost of goods sold and a credit to inventory. You can see sample entries in

SALES JOURNAL					Page 10
Date	Account	Invoice No.	Ref.	DR Accts. Receivable CR Sales	DR COGS CR Merchandise Inventory
2019					
Feb. 21	Jack Customer	715		$ 5,200	$3,800
Feb. 23	Susan Carol	716		$10,600	$8,400

Figure Sales Journal. (Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Note there is a column to enter the date the transaction took place; a column to indicate the customer to whom the `1transaction pertains; an invoice number that should match the number on the invoice given (in paper or electronically) to the customer; a reference box that indicates the transaction has been posted to the customer's account and can include something as simple as a check mark or a code that links the transaction to other journals and ledgers; and the last two columns that indicate the accounts and amounts debited and credited.

Purchases of inventory on credit would be recorded in the purchases journal with a debit to Merchandise Inventory and a credit to Accounts Payable.

PURCHASES JOURNAL					Page 36
Date	Account	Invoice No.	Ref.	Merchandise Inventory DR	Accounts Payable CR
2019					
Feb. 14	Irving's Inventory	1542		$35,000	$35,000
Feb. 27	Greta's Goods	612		$14,700	$14,700

Figure Purchases Journal. (Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license)

Paying bills is recorded in the cash disbursements journal and is always a debit to Accounts Payable (or another payable or expense) and a credit to Cash.

CASH DISBURSEMENTS JOURNAL					Page 100
Date	Account	Invoice No.	Ref.	Accounts Payable (or other account) DR	Cash CR
2019					
Feb. 7	Mumford, Inc.	1,100		$15,000	$15,000
Feb. 18	Ballyho, Co.	716		$21,200	$21,200

Figure: Cash Disbursements Journal. (Attribution: Copyright Rice University, Opens tax, under CC BY-NC-SA 4.0 license)

The receipt of cash from the sale of goods, as payment on accounts receivable or from other transactions, is recorded in a cash receipts journal (Figure 7.12) with a debit to cash and a credit to the source of the cash, whether that is from sales revenue, payment on an account receivable, or some other account.

CASH RECEIPTS JOURNAL					
Date	Account	Invoice No.	Ref.	Cash DR	Accounts Receivable, Sales, or other accounts CR
2019					
Feb. 8	Connie Customer	450		$ 300	$ 300
Feb. 27	Billy May	602		$1,000	$1,000

Figure Cash Receipts Journal. (Attribution: Copyright Rice University, OpenS tax, under CC BY-NC-SA 4.0 license)

Table: summarizes the typical transactions in the special journals previously illustrated.

Types and Purposes of Special Journals

Journal Name	Journal Purpose	Account(s) Debited	Account(s) Credited
Sales Journal	Sales on credit	Accounts Receivable, Cost of Goods Sold	Sales, Inventory
Purchases Journal	Purchases on credit	Inventory	Accounts Payable
Cash Disbursements Journal	Paying cash	*Could be:* Accounts Payable, or other accounts	Cash
Cash Receipts Journal	Receiving cash	Cash	*Could be:* Sales, Accounts Receivable, or other accounts
General Journal	Any transaction not covered previously; adjusting and closing entries	*Could be:* Depreciation Expense	*Could be:* Accumulated Depreciation

5.4 Exercise

(1) **Which of the following is the accounting equation**

A. Assets + Liabilities + Capital = Drawings + Profit
B. Assets = Liabilities â+ Capital + Profit + Drawings
C. Assets + Liabilities â€" Capital = Profit+ Drawings
D. Assets + Liabilities = Capital + Profit + Drawings

(2) **Which of the following statements is true?**

A. The income statement illustrates a business financial position.
B. The income statement includes dividends paid
C. The income statement illustrates the business financial performance
D. The income statement has to show the results for one year

(3) **What is included in the statement of financial position of a business?**

A. Capital, drawings, assets and liabilities
B. Capital, dividends paid, sales and assets
C. Assets, liabilities, profit on disposals of non-current assets and introduced capital
D. Dividends paid, assets, discounts and liabilities

(4) **Which of the following is incorrect?**

A. The statement of financial position and income statement form part of the financial statements of a business
B. The statement of financial position illustrates the accounting equation
C. The income statement illustrates the accounting equation
D. The statement of financial position and income statement illustrate the financial position and performance of the business

(5) **Which statement is not true?**

A. Inventory is shown on the income statement and in the statement of financial position
B. Expenses should be included on the income statement
C. Inventory should be included on the statement of financial position only
D. Receivables are included in current assets on the statement of financial position

CHAPTER SIX

6. CASH AND RECEIVABLES

6.1 Nature of cash

Cash is one of the most liquid assets reported on balance sheet as current asset. Most companies include cash equivalents, which are similar to cash, as part of cash. Cash can be easily hidden and moved. Therefore, it is important to apply principles of a good internal control to cash and cash equivalent. Good system of internal control provides adequate procedures for protecting both cash and cash equivalents.

6.2 Internal Control over Cash

Assets are the lifeblood of a company and must be protected. This duty falls to managers of a company. The policies and procedures implemented by management to protect as- sets are collectively referred to as internal controls. An effective internal control program not only protects assets, but also aids in accurate record-keeping, produces financial statement information in a timely manner, ensures compliance with laws and regulations, and promotes efficient operations. Effective internal control procedures ensure that adequate records are maintained, transactions are authorized, duties among employees are divided between record-keeping functions and control of assets, and employees' work is checked by others. The use of electronic record-keeping systems does not decrease the need for good internal controls.

The effectiveness of internal controls is limited by human error and fraud. Human error can occur because of negligence or mistakes. Fraud is the intentional decision to circumvent internal control systems for personal gain. Sometimes, employees cooperate with each other to avoid internal controls. This collusion is often difficult to detect, but fortunately, it is not a common occurrence when adequate controls are in place.

Internal controls take many forms. Some are broadly based, like mandatory employee drug testing, video surveillance, and scrutiny of company email systems. Others are specific to an asset type or process. For instance, internal controls need to be applied to a company's accounting system to ensure that transactions are processed efficiently and correctly to produce reliable records in a timely manner. Procedures should be documented to promote good recordkeeping, and employees need to be trained in the application of internal control procedures.

Financial statements prepared according to generally accepted accounting principles are useful not only to external users in evaluating the financial performance and financial position of the company, but also for internal decision making. There are various internal control mechanisms that aid in the production of timely and useful financial information. For instance, using a chart of accounts is necessary to ensure transactions are recorded in the appropriate account. As an example, expenses are classified and recorded in applicable expense accounts, then summarized and evaluated against those of a prior year.

The design of accounting records and documents is another important means to provide financial information. Financial data is entered and summarized in records and transmitted by documents. A good system of internal control requires that these records and documents be prepared at the time a transaction takes place or as soon as possible afterwards, since they become less credible and the possibility of error increases with the passage of time. The documents should also be consecutively pre-numbered, to indicate whether there may be missing documents.

Internal control also promotes the protection of assets. Cash is particularly vulnerable to misuse. A good system of internal control for cash should provide adequate procedures for protecting cash receipts and cash payments (commonly referred to as cash disbursements). Procedures to achieve control over cash vary from company to company and depend upon such variables as company size, number of employees, and cash sources. However, effective cash control generally requires the following:

- Separation of duties: People responsible for handling cash should not be responsible for maintaining cash records. By separating the custodial and record-keeping duties, theft of cash is less likely.
- Same-day deposits: All cash receipts should be deposited daily in the company's bank account. This prevents theft and personal use of the money before deposit.
- Payments made using non-cash means: Cheques or electronic funds transfer (EFT) provide a separate external record to verify cash disbursements. For example, many businesses pay their employees using electronic funds transfer because it is more secure and efficient than using cash or even cheques.

Two forms of internal control over cash will be discussed in this chapter: the use of a petty cash **account and the preparation of bank reconciliations.**

Petty Cash The payment of small amounts by cheque may be inconvenient and costly. For example, using cash to pay for postage on an incoming package might be less than the total processing cost of a cheque. A small amount of cash kept on hand to pay for small, infrequent expenses is referred to as a petty cash fund.

6.3 Bank Reconciliation

The bank reconciliation is a report prepared by a company at a point in time. It identifies discrepancies between the cash balance reported on the bank statement and the cash balance reported in a business's Cash account in the general ledger, more commonly referred to as the books. These discrepancies are known as reconciling items and are added or subtracted to either the book balance or bank balance of cash. Each of the reconciling items is added or subtracted to the business's cash balance. The business's cash balance will change as a result of the reconciling items. The cash balance prior to reconciliation is called the unreconciled cash balance. The balance after adding and subtracting the reconciling items is called the reconciled cash balance. The following is a list of potential reconciling items and their impact on the bank reconciliation.

Book reconciling items	Bank reconciling items
Collection of notes receivable (added)	Outstanding deposits (added)
NSF cheques (subtracted)	Outstanding cheques (subtracted)
Bank charges (subtracted)	Bank errors (added or subtracted, depending on the nature of the error)
Book errors (added or subtracted, depending on the nature of the error)	

6.3.1 Book Reconciling Items

The collection of notes receivable may be made by a bank on behalf of the company. These collections are often unknown to the company until they appear as an addition on the bank statement, and so cause the general ledger cash account to be understated. As a result, the collection of a notes receivable is added to the unreconciled book balance of cash on the bank reconciliation.

Cheques returned to the bank because there were not sufficient funds (NSF) to cover them appear on the bank statement as a reduction of cash. The company must then request that the customer pay the amount again. As a result, the general ledger cash account is overstated by the amount of the NSF cheque. NSF cheques must therefore be subtracted from the unreconciled book balance of cash on the bank reconciliation to reconcile cash.

Cheques received by a company and deposited into its bank account may be returned by the customer's bank for many reasons (e.g., the cheque was issued too long ago, known as a stale-dated cheque, an unsigned or illegible cheque, or the cheque shows the wrong account number). Returned cheques cause the general ledger cash account to be overstated. These cheques are therefore subtracted on the bank statement, and must be deducted from the unreconciled book balance of cash on the bank reconciliation.

Bank service charges are deducted from the customer's bank account. Since the service charges have not yet been recorded by the company, the general ledger cash account is overstated. Therefore, service charges are subtracted from the unreconciled book balance of cash on the bank reconciliation.

A business may incorrectly record journal entries involving cash. For instance, a deposit or cheque may be recorded for the wrong amount in the company records. These errors are often detected when amounts recorded by the company are compared to the bank statement. Depending on the nature of the error, it will be either added to or subtracted from the unreconciled book balance of cash on the bank reconciliation. For example, if the company recorded a cheque as $520 when the correct amount of the cheque was $250, the $270 difference would be added to the unreconciled book balance of cash on the bank reconciliation. Why? Because the cash balance reported on the books is understated by $270 because of the error. As another example, if the company recorded a deposit as $520 when the correct amount of the deposit was $250, the $270 difference would be subtracted from the unreconciled book balance of cash on the bank reconciliation. Why? Because the cash balance reported on the books is overstated by $270 because of the error. Each error requires careful analysis to determine whether it will be added or subtracted in the unreconciled book balance of cash on the bank reconciliation.

6.3.2 Bank Reconciling Items

Cash receipts are recorded as an increase of cash in the company's accounting records when they are received. These cash receipts are deposited by the company into its bank. The bank records an increase in cash only when these amounts are actually deposited with the bank. Since not all cash receipts recorded by the company will have been recorded by the bank when the bank statement is prepared, there will be outstanding deposits, also known as deposits in transit. Outstanding deposits cause the bank statement cash balance to be understated. Therefore, outstanding deposits are a reconciling item that must be added to the unreconciled bank balance of cash on the bank reconciliation.

On the date that a cheque is prepared by a company, it is recorded as a reduction of cash in a company's books. A bank statement will not record a cash reduction until a cheque is presented and accepted for payment (or clears the bank). Cheques that are recorded in the company's books but are not paid out of its bank account when the bank statement is prepared are referred to as outstanding cheques. Outstanding cheques mean that the bank statement cash balance is overstated. Therefore, outstanding cheques are a reconciling item that must be subtracted from the unreconciled bank balance of cash on the bank reconciliation.

Bank errors sometimes occur and are not revealed until the transactions on the bank statement are compared to the company's accounting records. When an error is identified, the company notifies the bank to have it corrected. Depending on the nature of the error, it is either added to or subtracted from the unreconciled bank balance of cash on the bank reconciliation. For example, if the bank cleared a cheque as $520 that was correctly written for $250, the $270 difference would be added to the unreconciled bank balance of cash on the bank reconciliation. Why? Because the cash balance reported on the bank statement is understated by $270 as a result of this error. As another example, if the bank recorded a deposit as $520 when the correct amount was $250, the $270 difference would be subtracted from the unreconciled bank balance of cash on the bank reconciliation. Why? Because the cash balance reported on the bank statement is overstated by $270 because of this specific error. Each error must be carefully analyzed to determine how it will be treated on the bank reconciliation.

Illustrative Problem: Bank Reconciliation

Assume that bank reconciliation is prepared by Big Dog Carworks Corp. (BDCC) at April 30. At this date, the Cash account in the general ledger shows a balance of $21,929 and includes the cash receipts and payments shown in Figure 6.1.

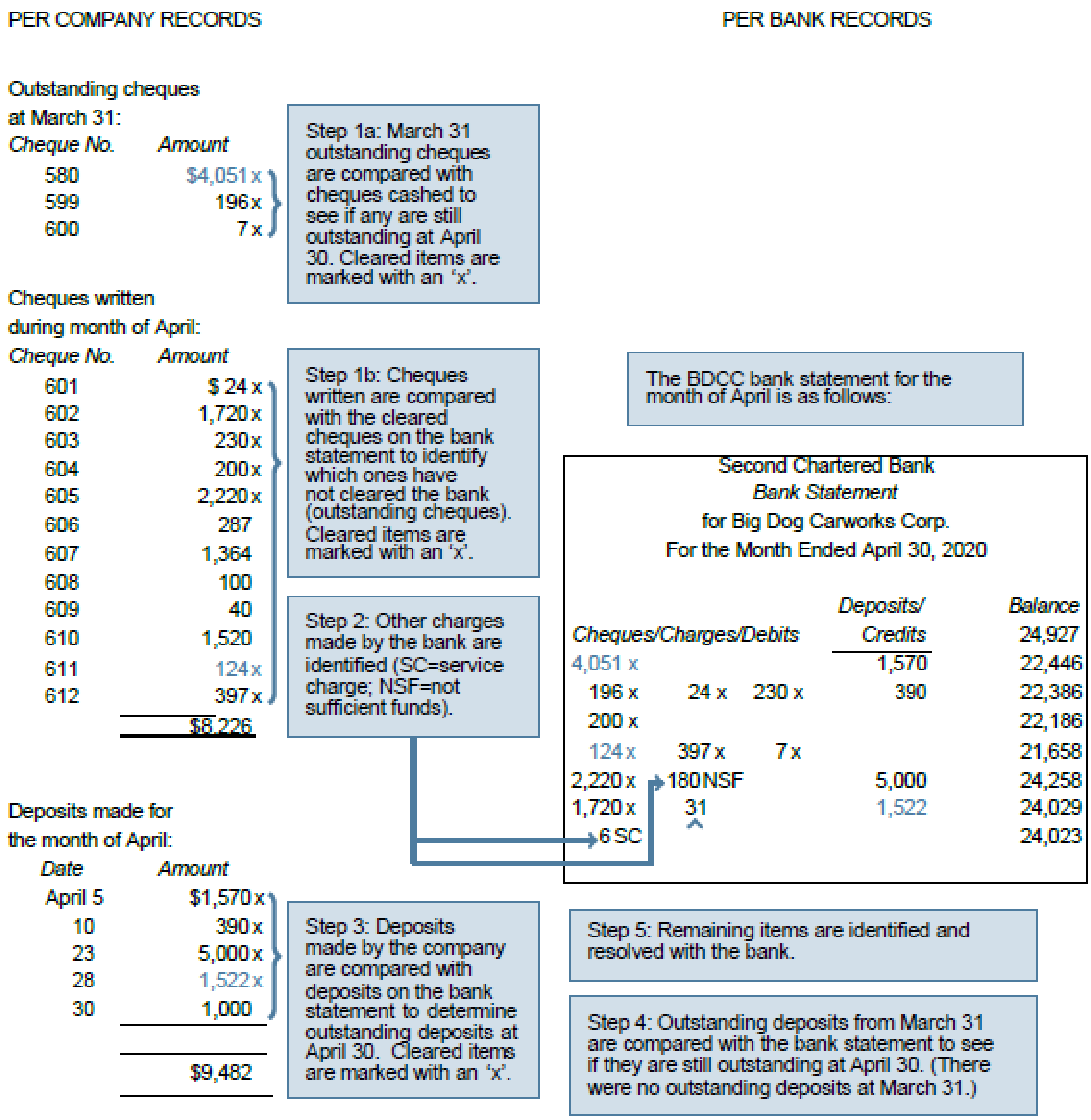
Cash — Acct. No. 101

Date		Description	Debit	Credit	DR/CR	Balance
2020						
Mar.	31	Balance			DR	20673 -
Apr.	30	April cash receipts	9482 -		DR	30155 -
	30	April cash payments		8226 -	DR	21929 -

Remember, 'DR' (debit) denotes a positive cash balance in the far right-hand column of the general ledger.

Figure: Big Dog's General Ledger 'Cash' Account at April 30

Extracts from BDCC's accounting records are reproduced with the bank statement for April in Figure 6.2.



6.3.3 The Bank Reconciliation Process

For each entry in BDCC's general ledger Cash account, there should be a matching entry on its bank statement. Items in the general ledger Cash account but not on the bank statement must be reported as a reconciling item on the bank reconciliation. For each entry on the bank statement, there should be a matching entry in BDCC's general ledger Cash account. Items on the bank statement but not in the general ledger Cash account must be reported as a reconciling item on the bank reconciliation.

There are nine steps to follow in preparing a bank reconciliation for BDCC at April 30, 2020:

Step 1 Identify the ending general ledger cash balance ($21,929 from Figure 6.1) and list it on the bank reconciliation as the book balance on April 30 as shown in Figure 6.3. This represents the unreconciled book balance.

Step 2 Identify the ending cash balance on the bank statement ($24,023 from Figure 6.2) and list it on the bank reconciliation as the bank statement balance on April 30 as shown in Figure 6.3. This represents the unreconciled bank balance.

Step 3 Cheques written that have cleared the bank are returned with the bank statement. These cheques are said to be cancelled because, once cleared, the bank marks them to prevent them from being used again. Cancelled cheques are compared to the company's list of cash payments. Outstanding cheques are identified using two steps:

a. Any outstanding cheques listed on the BDCC's March 31 bank reconciliation are compared to the cheques listed on the April 30 bank statement.For BDCC, all of the March outstanding cheques (nos. 580, 599, and 600) were paid by the bank in April. Therefore, there are no reconciling items to include in the April 30 bank reconciliation. If one of the March outstanding cheques had not been paid by the bank in April, it would be subtracted as an outstanding cheque from the unreconciled bank balance on the bank reconciliation.
b. The cash payments listed in BDCC's accounting records are compared to the cheques on the bank statement. This comparison indicates that the following cheques are outstanding.

Cheque No.	***Amount***
606	$287
607	1,364
608	100
609	40
610	1,520

c. Outstanding cheques must be deducted from the bank statement's unreconciled ending cash balance of $24,023 as shown in Figure 6.3.

Step 4 Other payments made by the bank are identified on the bank statement and subtracted from the unreconciled book balance on the bank reconciliation.

a. An examination of the April bank statement shows that the bank had deducted the NSF cheque of John Donne for $180. This is deducted from the unreconciled book balance on the bank reconciliation as shown in Figure 6.3.
b. An examination of the April 30 bank statement shows that the bank had also deducted a service charge of $6 during April. This amount is deducted from the unreconciled book balance on the bank reconciliation as shown in Figure 6.3.

Step 5 Last month's bank reconciliation is reviewed for outstanding deposits at March 31. There were no outstanding deposits at March 31. If there had been, the amount would have been added to the unreconciled bank balance on the bank reconciliation.

Step 6 The deposits shown on the bank statement are compared with the amounts recorded in the company records. This comparison indicates that the April 30 cash receipt amounting to $1,000 was deposited but it is not included in the bank statement. The outstanding deposit is added to the unreconciled bank balance on the bank reconciliation as shown in Figure 6.3.

Step 7 Any errors in the company's records or in the bank statement must be identified and reported on the bank reconciliation.

An examination of the April bank statement shows that the bank deducted a cheque issued by another company for $31 from the BDCC bank account in error. Assume that when notified, the bank indicated it would make a correction in May's bank statement.

The cheque deducted in error must be added to the bank statement balance on the bank reconciliation as shown in Figure 6.3.

Step 8 Total both sides of the bank reconciliation. The result must be that the book balance and the bank statement balance are equal or reconciled. These balances represent the adjusted balance.

The bank reconciliation in Figure below is the result of completing the preceding eight steps.

Big Dog Carworks Corp.
Bank Reconciliation
At April 30, 2020

Book balance at Apr. 30		$21,929	Bank statement balance at Apr. 30		$24,023
			Add: Outstanding deposit		1,000
			Cheque deducted in error		31
					25,054
Less: Bank charges	$6		Less: Outstanding cheques		
NSF Cheque – J. Donne	180	186	*Cheque No.*	*Amount*	
			606	$287	
			607	1,364	
			608	100	
			609	40	
			610	1,520	3,311
Adjusted book balance at Apr. 30		$21,743	Adjusted bank balance at Apr. 30		$21,743

These balances must agree.

Reconciling items in this section require journal entries to be made in the general journal to correct the unreconciled Cash balance of $21,929 in the general ledger to the reconciled balance of $21,743.

Reconciling items in this section do not require journal entries because the outstanding deposits and cheques should clear the bank next month, in May. Additionally, the other reconciling items (e.g., the $31 cheque deducted in error) must be reported to the bank so it can make the necessary corrections to Big Dog's account in the next month.

Figure: BDCC's April Bank Reconciliation

Step 9 For the adjusted balance calculated in the bank reconciliation to appear in the accounting records, an adjusting entry (or entries) must be prepared.

The adjusting entry (or entries) is based on the reconciling item(s) used to calculate the adjusted book balance. The book balance side of BDCC's April 30 bank reconciliation is copied to the left below to clarify the source of the following April 30 adjustments.

Book balance at Apr. 30		$21,929
Less: Bank charges	$ 6	
NSF Cheque – J. Donne	180	186
Adjusted book balance at Apr. 30		$21,743

Bank Service Charges Expense	6	
Cash		6
To record service charges from April 30 bank reconciliation.		

Accounts Receivable – J. Donne	180	
Cash		180
To record NSF cheque from April 30 bank reconciliation.		

It is common practice to use one compound entry to record the adjustments resulting from a bank reconciliation as shown below for BDCC.

Once the adjustment is posted, the Cash general ledger account is up to date, as illustrated in Figure

Bank Service Charges Expense	6	
Accounts Receivable – J. Donne	180	
Cash		186
To record reconciling items from April 30 bank reconciliation.		

Cash — Acct. No. 101

Date		Description	Debit	Credit	DR/CR	Balance
2020						
Mar.	31	Balance			DR	20673 -
Apr.	30	April cash receipts	9482 -		DR	30155 -
	30	April cash payments		8226 -	DR	21929 -
	30	Bank charge expense		6 -	DR	21923 -
	30	NSF cheque		180 -	DR	21743 -

This adjusted cash balance now agrees with the bank reconciliation.

Figure : Updated Cash Account in the General Ledger

Note that the balance of $21,743 in the general ledger Cash account is the same as the adjusted book balance of $21,743 on the bank reconciliation. Big Dog does not make any adjusting entries for the reconciling items on the bank side of the bank reconciliation since these will eventually clear the bank and appear on a later bank statement. Bank errors will be corrected by the bank.

6.4 Petty Cash and Change Fund

To set up the petty cash fund, a cheque is issued for the amount needed. The custodian of the fund cashes the cheque and places the coins and currency in a locked box. Responsibility for the petty cash fund should be delegated to only one person, who should be held accountable for its contents. Cash payments are made by this petty cash custodian out of the fund as required when supported by receipts. When the amount of cash has been reduced to a pre-determined level, the receipts are compiled and submitted for entry into the accounting system. A cheque is issued to reimburse the petty cash fund. At any given time, the petty cash amount should consist of cash and supporting receipts, that total to the petty cash fund amount. To demonstrate the management of a petty cash fund, assume that a $200 cheque is issued to establish a petty cash fund.

The journal entry is:

General Journal				
Date	Account/Explanation	PR	Debit	Credit
	Petty Cash		200	
	Cash			200
	To establish the $200 petty cash fund.			

Petty Cash is a current asset account and is reported with Cash as one amount.

Assume the petty cash custodian has receipts totalling $190 and $10 in coin and currency remaining in the petty cash box. The receipts consist of the following: delivery charges $100, $35 for postage, and office supplies of $55. The petty cash custodian submits the receipts to the accountant who records the following entry and issues a cheque for $190.

General Journal				
Date	Account/Explanation	PR	Debit	Credit
	Delivery Expense		100	
	Postage Expense		35	
	Office Supplies Expense[3]		55	
	Cash			190
	To reimburse the petty cash fund.			

3. An expense is debited instead of Office Supplies, an asset, because the need to purchase supplies through petty cash assumes the immediate use of the items.

The petty cash receipts should be cancelled at the time of reimbursement to prevent their reuse for duplicate reimbursements. The petty cash custodian cashes the $190 cheque. The $190 plus the $10 of coin and currency in the locked box immediately prior to reimbursement equals the $200 total required in the petty cash fund.

Sometimes, the receipts plus the coin and currency in the petty cash locked box do not equal the required petty cash balance. To demonstrate, assume the same information above except that the coin and currency remaining in the petty cash locked box was $8. This amount plus the receipts for $190 equals $198 and not $200, indicating a shortage in the petty cash box. The entry at the time of reimbursement reflects the shortage and is recorded as:

General Journal				
Date	Account/Explanation	PR	Debit	Credit
	Delivery Expense		100	
	Postage Expense		35	
	Office Supplies Expense		55	
	Cash Over/Short Expense		2	
	Cash			192
	To reimburse the petty cash fund and account for the $2.00 shortage.			

The $192 credit to Cash plus the $8 of coin and currency remaining in the petty cash box immediately prior to reimbursement equals the $200 required total in the petty cash fund.

Assume, instead, that the coin and currency in the petty cash locked box was $14. This amount plus the receipts for $190 equals $204 and not $200, indicating an overage in the petty cash box. The entry at the time of reimbursement reflects the overage and is recorded as:

General Journal				
Date	Account/Explanation	PR	Debit	Credit
	Delivery Expense		100	
	Postage Expense		35	
	Office Supplies Expense		55	
	Cash Over/Short Expense			4
	Cash			186
	To reimburse the petty cash fund and account for the $4.00 overage.			

The $186 credit to Cash plus the $14 of coin and currency remaining in the petty cash box immediately prior to reimbursement equals the $200 required total in the petty cash fund.

What happens if the petty cash custodian finds that the fund is rarely used? In such a case, the size of the fund should be decreased to reduce the risk of theft. To demonstrate, assume the petty cash custodian has receipts totalling $110 and $90 in coin and currency remaining in the petty cash box. The receipts consist of the following: delivery charges $80 and postage $30. The petty cash custodian submits the receipts to the accountant and requests that the petty cash fund be reduced by $75. The following entry is recorded and a cheque for $35 is issued.

General Journal				
Date	Account/Explanation	PR	Debit	Credit
	Delivery Expense		80	
	Postage Expense		30	
	Petty Cash			75
	Cash			35
	To reimburse the petty cash fund and reduce it by $75.			

The $35 credit to Cash plus the $90 of coin and currency remaining in the petty cash box immediately prior to reimbursement equals the $125 new balance in the petty cash fund ($200 original balance less the $75 reduction).

In cases when the size of the petty cash fund is too small, the petty cash custodian could request an increase in the size of the petty cash fund at the time of reimbursement. Care should be taken to ensure that the size of the petty cash fund is not so large as to become a potential theft issue. Additionally, if a petty cash fund is too large, it may be an indicator that transactions that should be paid by cheque are not being processed in accordance with company policy. Remember that the purpose of the petty cash fund is to pay for infrequent expenses; day-to-day items should not go through petty cash.

The widespread use of banks facilitates cash transactions between entities and provides a safeguard for the cash assets being exchanged. This involvement of banks as intermediaries between entities has accounting implications. At any point in time, the cash balance in the accounting records of a company usually differs from the bank cash balance. The difference is usually because some cash transactions recorded in the accounting records have not yet been recorded by the bank and, conversely, some cash transactions recorded by the bank have not yet been recorded in the company's accounting records.

The use of bank reconciliation is one method of internal control over cash. The reconciliation process brings into agreement the company's accounting records for cash and the bank statement issued by the company's bank. Bank reconciliation explains the difference between the balances reported by the company and by the bank on a given date.

A bank reconciliation proves the accuracy of both the company's and the bank's records, and reveals any errors made by either party. The bank reconciliation is a tool that can help detect attempts at theft and manipulation of records. The preparation of bank reconciliation is discussed in the following section.

6.5 Internal Control of Receivables

The nature of business and the level of development in the market that is partly catalyzed by the advent of financial engineering mean that selling goods without collecting money has become normal way of doing business

A lot of buy now and pay later scheme keep springing up every day as organizations jostle to get the nod of buying customers. Many households will simply not be able to afford some luxuries that they enjoy if not for the availability of buy now pay later scheme.

In this article on what is accounts receivable, we will be providing simple non-technical definition of accounts receivable, explore some nitty gritty of accounts receivable and then show you the accounting treatment of accounts receivables. So, let's start by gaining understanding of what an account receivable really is.

Meaning of receivables

Receivables in simple language are those monies that organizations are yet to collect from customers who are yet to pay for goods and services that they have received from the business.

This used to be called debtors in old accounting terminologies. In summary, a receivable from a company perspective is any sum of money that is due to a company from any source for any legitimate reason. Notice that our efforts so far have been towards gaining understanding of what a receivable is. Now let's quickly have a look at 'accounts receivable'.

6.6 Classification of Receivables

There are different types of receivables

We have two types of receivables namely;

1. Accounts receivable, and
2. Notes receivables

Accounts receivables are short term privileges that companies offer their customers in the normal course of doing business with no interest charged. While notes receivables has to do with medium to longer term credits with an interest charged a typical example is the hire purchase scheme where an item that ordinarily would sell for say N20,000.00 is sold to a customer for N25,000.00 for the fact that the customer would be allowed to spread the payment over one year.

6.7 Accounting for Uncollectible Accounts

Cash may be incurred or disbursed for a variety of reasons, such as to pay expense and liabilities, or to purchase assets. Generally, internal control over cash disbursements is more effective when payments are made by check, rather than by cash except for incidental amounts that are paid out of petty cash.

Payment by check generally occurs only after specified control procedures have been followed. In addition, the "paid" check provides proof of payment. Effective internal controls of cash disbursements are achieved through a voucher system, through the operation of petty cash, and can be controlled through bank account.

6.8 Accounting for Notes Receivable

Receivable is an amount due from another party. Receivables are usually one of the largest current assets on a company's books. The control and analysis of this asset is very important, because receivables are usually the biggest source of a company's cash flow.

Accounts Receivable is the most common kind of receivable. Accounts Receivable are amounts due from customers from the sale of services or merchandise on credit. They are usually due in 30 – 60 days. They are classified on the Balance Sheet as current assets.
Notes Receivable.

Notes Receivable can arise when the seller asks for a promissory note to replace an Accounts Receivable when the customer requests additional time to pay a past-due account. A promissory note is a written promise to pay a specific amount of money, usually including interest, at a future date. If the note is due within a year it is classified as a current asset. If the note is due after one year, it is classified as a long-term asset.

Other Receivables

Examples of other receivables are income tax refunds, interest receivable, or receivables from employees. These are not covered in this chapter.

Uncollectible Accounts Receivable

In order to help minimize credit losses, a company needs to be very careful and prudent in extending credit. References and credit scores should be checked and credit worthiness needs to be established before credit is granted. Once a receivable becomes past due, companies need to put forth great efforts to collect it. The older a receivable gets, the less likely the chance of collection. A business will usually have some customers that will not pay their debts. GAAP requires that a company estimate the amount of uncollectable receivables at the end of the accounting period and record that amount as Bad Debt Expense. The Bad Debt Expense is recorded in the same year as the sale, complying with the matching principle.

6.9 Presentation of cash and receivables on the statement of financial position

These illustrative financial statements are not a substitute for professional judgment as to fairness of presentation. They do not cover all possible disclosures that IPSAS requires. For instance certain types of transaction and disclosure requirements may have been excluded, as they may not be relevant to the UN Volume I's operations.

A complete set of financial statements should include:

- Statement of Financial Position;
- Statement of Financial Performance;
- Statement of Changes in Net Assets;
- Statement of Cash Flows;
- Statement of Comparison of Budget and Actual Amounts, on the basis of the budget; and
- Notes to the financial statements comprising a summary of significant accounting policies and other explanatory notes.

6.9.1 Preparation and Presentation of General Purpose Financial Reports

The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the Conceptual Framework) establishes and makes explicit the concepts that are to be applied in developing International Public Sector Accounting Standards (IPSASs) and Recommended Practice Guidelines (RPGs) applicable to the preparation and presentation of general purpose financial reports (GPFRs) of public sector entities. While the Conceptual Framework reflects a scope of financial reporting that is more comprehensive than that encompassed by financial statements, information presented in financial statements remains at the core of financial reporting.

The Conceptual Framework states that the objectives of financial reporting are to provide information about the entity that is useful to users of GPFRs for accountability purposes and for decision-making purposes. For the purposes of the Conceptual Framework, the primary users of GPFRs are service recipients and their representatives and resource providers and their representatives. While other parties may find the information provided by GPFRs useful, they are not the primary users of GPFRs. Therefore, GPFRs are not developed to specifically respond to their particular information needs of parties other than service recipients and resource providers.

The qualitative characteristics of information included in GPFRs are relevance, faithful representation, understandability, timeliness, comparability, and verifiability. Pervasive constraints on information included in GPFRs are materiality, cost-benefit, and achieving an appropriate balance between the qualitative characteristics. Each of the qualitative characteristics is integral to, and works with, the other characteristics to provide in GPFRs information useful for achieving the objectives of financial reporting. However, in practice, all qualitative characteristics may not be fully achieved, and a balance or trade-off between certain of them may be necessary.

6.9.2 Financial Statements

1. Statement I: Statement of Financial Position

(Thousands of United States dollars)			
	Note	*31 December 20X2*	*31 December 20X1*
Assets			
Current assets			
Cash and cash equivalents	7		
Investments	8		
Assessed contributions receivable	9		
Voluntary contributions receivable	10		
Other receivables	11		
Inventories	12		
Other assets	13		
Total current assets			
Non-current assets			
Investments	8		
Voluntary contributions receivable	10		
Property, plant and equipment	15		
Intangible assets	16		

Share of joint ventures accounted for using the equity method	24		
Other assets	13		
Total non-current assets			
Total Assets			
Liabilities			
Current liabilities			
Accounts payable and accrued liabilities	17		
Advance receipts	18		
Employee benefit liabilities	19		
Provisions	20		
Tax equalization liability	21		
Other liabilities	22		
Total current liabilities			
Non-current liabilities			
Advance receipts	18		
Employee benefit liabilities	19		
Provisions	20		
Share of joint ventures accounted for using the equity method	24		
Other liabilities	22		
Total non-current liabilities			
Total liabilities			
Net of total assets and total liabilities			
Net assets			
Accumulated surplus/(deficit)	25		
Reserves	25		
Total net assets			

The accompanying notes to the financial statements are an integral part of these financial statements.

2. **Statement II: Statement of Financial Performance**

(Thousands of United States dollars)

	Note	20X2	20X1
Revenue			
Assessed contributions	26		

Voluntary contributions	26
Other transfers and allocations	26
Investment revenue	30
Contributions for self-insurance funds	28
Other revenue	27
Total revenue	
Expenses	
Employee salaries, allowances and benefits	29
Non-employee compensation and allowances	
Grants and other transfers	29
Supplies and consumables	
Depreciation and amortization	15, 16
Impairment	15
Travel	
Other operating expenses	29
Self-insurance claims and expenses	28
Finance costs	33
Contributions to and share of deficit of joint ventures accounted for on an equity basis	24
Other expenses	
[Add material items as separate line item]	
Total expenses	
Surplus / (deficit) for the year	

The accompanying notes to the financial statements are an integral part of these financial statements.

3. Statement III: Statement of Changes in Net Assets

(Thousands of United States dollars)

	Net assets
Net assets as at 31 December 20X0	
Changes in net assets	
Actuarial gains / (losses) on employee benefit liabilities (note 19)	
Transfers of funds to / from other organizations/entities	
Share of changes recognized by joint ventures directly in net assets (note 24)	
Other adjustments to net assets	
Surplus / (deficit) for the year	
[Add additional items recognized in net assets]	
Total changes in net assets	
Net assets as at 31 December 20X1 (note 25)	
Prior-period adjustments (note 4)	

Restated net assets as at 31 December 20X1 (note 25)
Changes in net assets
Actuarial gains / (losses) on employee benefit liabilities (note 19)
Transfers of funds to / from other organizations/entities
Share of changes recognized by joint ventures directly in net assets (note 24)
Other adjustments to net assets
Surplus / (deficit) for the year
[Add additional items recognized in Net assets]
Total changes in net assets
Net assets as at 31 December 20X2 (note 25)

The accompanying notes to the financial statements are an integral part of these financial statements.

4. **Statement IV: Statement of Cash Flows**

(Thousands of United States dollars)			
	Note	20X2	20X1
Cash flows from operating activities			
Surplus / (deficit) for the year			
Non-cash movements			
Depreciation and amortization	15, 16		
Impairment of property, plant and equipment and intangible assets	15, 16		
Impairment of inventory	12		
Increase / (decrease) in allowance for doubtful receivables	9, 10, 11		
Net loss /(gain) on disposal of property, plant and equipment and inventory			
Investment revenue presented in net receipts from cash pool investments	30		
Current service cost and interest cost of employee benefit liabilities	19		
Donation of assets	26		
Net deficit / (surplus) on joint ventures	24		
[Additional non-cash items to be added]			
Changes in assets			
(Increase) / decrease in assessed contributions receivable	9		
(Increase) / decrease in voluntary contributions receivable	10		
(Increase) / decrease in other receivables	11		
(Increase) / decrease in inventories	12		
(Increase) / decrease in other assets	13		

(Increase) / decrease in share of joint venture asset/liability accounted for using the equity method	24		
Changes in liabilities			
Increase / (decrease) in accounts payable and accrued liabilities	17		
Increase / (decrease) in advance receipts	18		
Increase / (decrease) in employee benefit liabilities	19		
Increase / (decrease) in provisions	20		
Increase / (decrease) in tax equalization fund liability	21		
Increase / (decrease) in other liabilities	22		
Increase / (decrease) in share of joint venture asset/liability accounted for using the equity method	24		
Net cash flows from operating activities			
Cash flows from investing activities			
Net changes in cash pool investments	30		
Acquisitions of property, plant and equipment	15, 26		
Proceeds from disposal of property, plant and equipment	15		
Acquisitions of intangible assets	16, 26		
Donation of intangible assets			
Issuance of loans receivable			
Proceeds from repayment of loans receivable			
[Additional investing activities to be added]			
Net cash flows from investing activities			
Cash flows from financing activities			
Proceeds from borrowings			
Repayment of borrowings			
[Additional financing activities to be added]			
Net cash flows from financing activities			
Net increase /(decrease) in cash and cash equivalents			
Cash and cash equivalents - beginning of year			
Exchange gains /(losses) on cash and cash equivalents			
Cash and cash equivalents - end of year			

Note:

- Investing and financing non-cash transactions should be disclosed by way of note to cash flow statement.
- Interest received and paid shall each be disclosed separately.

The accompanying notes to the financial statements are an integral part of these financial statements

5. **Statement V: Statement of Comparison of Budget and Actual Amounts**

(Thousands of United States dollars)						
	Publicly available budget				*Actual annual expenditure (budget basis)*	*Difference (percentage)*
	Original biennial	*Final biennial*	*Original annual*	*Final annual*		
Regular budget						
Overall policymaking, direction and coordination						
Political affairs						
International justice and law						
International cooperation for development						
Regional cooperation for development						
Human rights and humanitarian affairs						
Public information						
Common support services						
Internal oversight						
Jointly financed administrative activities and special expenses						
Capital expenditures						
Security and safety						
Development account						
Staff assessment						
Subtotal, regular budget						
Other publicly available budgets						
Capital master plan						
[Add other available budgets]						
Total						

The accompanying notes to the financial statements are an integral part of these financial statements.

6.10 Summary

Cash is one of the most liquid assets reported on balance sheet as current asset. It consists of coins, currency, checks, money orders, and money on hand or on deposits in a bank or similar depository. Most companies also include cash equivalents, which are similar to cash, as part of cash. Cash is the one asset that is readily convertible in to any other type of asset; it is easily concealed and transported; and it is highly desire. Because of these characteristics, cash is the assets most susceptible to improper diversion and use.

To control cash and to assure the accuracy of the accounting recorded for cash, effective internal control cover cash is imperative. The internal control principles apply to cash receipts and cash disbursements.

The internal control over receipts contains over the- counter and mail receipts. Effective internal controls of cash disbursements are achieved through a voucher system. General, internal control over cash disbursements is more effective when payments are made by check, rather than by cash, except for incidental amounts that are paid out of a petty cash.

A company can safeguard its cash using a bank as a depository and clearing house for checks received and checks written. The use of a bank facilitates the control of cash because double recorded is maintained of all bank transactions. It should be possible to reconcile these accounts at any time.

6.11 Exercise

Part One: Multiple Choice

1. In preparing bank reconciliation, the amount of checks outstanding would be:
   A. Added to the cash balance according to the bank statement.
   B. Deducted from the cash balance according to the bank statement.
   C. Added to the cash balance according to the company's records.
   D. Deducted from the cash balance according to the company's records.
2. Journal entries based on the bank reconciliation are required for:
   A. Additions to the cash balance according to the company's records.
   B. Deductions from the cash balance according to the company's records.
   C. Both A and B D. Neither A nor B.
3. A petty cash fund is:
   A. Used to pay relatively small amounts.

B. Established by estimating the amount of cash needed for disbursements of relatively small amounts during a specified period

C. Reimbursed when the amount of money in the fund is reduced to a predetermined minimum amount.

D. All of the above.

4. The bank erroneously charged Tropical Services' account for birr 450.50 for a check that was correctly written and recorded by Tropical Services as birr.540.50. To reconcile the bank account of Tropical Services at the end of the month, you would:

A. Add birr.90 to the cash balance according to the bank statement.

B. Add birr.90 to the cash balance according to Tropical Services' records.

C. Deduct birr.90 from the cash balance according to the bank statement.

D. Deduct birr.90 from the cash balance according to Tropical Services' records.

5. One of the following leads to unbalance of bank account and depositors (book account).

A. Time lag B. Error C. Both a & b

Part Two: Work out

The following information is available to you to reconcile Tadios Company's' book balance with its bank statement balance as for November 30, 2012.

1. The bank service charge for November was br.25
2. The bank collected a note receivable of Br. 1,200 for Tadios Company on Nov.15 plus Br.48 of interest. The bank made a Br.10 charge for the collection.
3. The Nov. 30 receipts of Br. 1,819.60 were not included in the bank deposits for November. These receipts were deposited by the company in a night deposit on November 30.
4. Company check No. 2480 issued to DEK Company, a creditor, for Br. 492 that cleared the bank in November was incorrectly entered in the cash payments journals on November 10 for Br. 429.
5. Checks written prior to November 30 that had not cleared by bank on November 30 totaled Br. 1,480.10
6. On November 30, the bank statement showed an NSF charge of Br. 550 for a check received by the company from Ato Yilma, a customer on account
7. The cash balance per books of the company was Br. 6,815.30
8. The cash balance per bank statement was Br. 7,075.80.

Required:

i. Prepare the bank reconciliation as of November 30.

ii. Prepare the necessary adjusting entries at November July 30.

Reference

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