INTRODUCTION TO ACCOUNTING

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Course Name – Introduction to Accounting
Course Author - Jacqueline Peters-Richardson, Ministry of Education, Trinidad and Tobago
Commonwealth of Learning
Edition 1.0

Commonwealth of Learning
4710 Kingsway, Suite 2500
Burnaby, British Columbia
Canada V5H 4M2
Telephone: +1 604 775 8200
Fax: +1 604 775 8210
Web: www.col.org
E-mail: info@col.org

ACKNOWLEDGEMENTS

The Commonwealth of Learning wishes to acknowledge the contributions of the course authors and the support of the University of Lesotho in the creation of this course.

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COURSE OVERVIEW

INTRODUCTION

This course is designed to teach you the "language of business" to create a better understand of the terms and concepts used in business decisions. The course Introduction to Accounting prepares entrepreneurs to manage the financial aspects of their businesses. In order for any entrepreneurship business to be successful there should be proper financial recording and management of the business finances. During this course you will be exposed to financial terms and concepts to proper financial control of your business. The Introduction to Business Accounting course will provide future entrepreneurs with basic skills and knowledge required to establish and maintain business accounts, read and interprets financial reports and returns. You will explore the process and procedures of business accounting and its role in establishing and managing a successful business venture. You will also analyse and interpret final accounts of different forms of business.

COURSE GOALS

Upon completion of the Introduction to Business Accounting you should be able to:

1. Define accounting and accounting terms
2. Appreciate the differences between bookkeeping and accounting
3. State and illustrate the accounting cycle
4. Describe the different types of accounts
5. Examine the concepts and best practices of business accounting
6. Record and interpret entries in the books of original entry
7. Transfer information from the books of original entry to the ledgers
8. Generate trial balance from the balances in the ledgers
9. Analyse financial reports and returns
10. Calculate equity rations
11. Explain cash flow
12. Prepare bank reconciliation statements
13. Calculate payroll documents
14. Prepare cash flow, financial statements, income statements and balance sheets
15. Prepare final accounts for other forms of businesses
16. State the basic accounting equation
17. Describe the relationship between the accounting equation and the balance sheet

COURSE STRUCTURE

This course is divided into five units:

Unit One – Introduction to Accounting

Topic 1	Definition of Accounting and key accounting terms.
Topic 2	The Accounting Cycle.
Topic 3	Business accounting process and procedures.
Topic 4	The Accounting Equation and the Balance Sheet.

Unit Two – Double Entry System of Accounting

Topic 1	Source Documents and the Books of original entry
Topic 2	Recording Business Financial Transactions
Topic 3	Balancing Off of Accounts
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Topic 1	Assets Disposal and Depreciation
Topic 2	Adjustments for financial Reporting
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Topic 4	Inventory Accounting
Topic 5	Prepare Cash Flow, Financial Statements, Income Statements and Balance Sheets for Sole Trader

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Topic 5	Petty Cash Book and Imprest System
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Unit Five - Financial Statements of other organizations

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Topic 2	Receipts and Payments Accounts
Topic 3	Partnership Accounts
Topic 4	Company Accounts

REQUIRED READINGS

The institution and instructor delivering the course will identify specific readings to support the course. Below is a list of online ebooks that could be used to support this course.

Taylor, P. (2008). Book-Keeping and Accounting for the Small Business. How to Books. (E-Book). Available at: http://www.e-booksdirectory.com/details.php?ebook=2188

Wlather, L.M. (2001). Principles of Accounting. Principlesofaccounting.com. (E-Book). Available at: http://www.e-booksdirectory.com/details.php?ebook=2910

ASSIGNMENTS AND PROJECTS

You will be provided detailed instructions for your final project by your instructor. Ideally the final project for this course will require you to prepare final accounts for a sole trader from a list of transaction and source documents. The course has been designed to provide your guidance and activities that will prepare you to complete the final project assigned by your instructor.

ASSESSMENT METHODS

Assessments will take the form of responding to activities, as well as coursework assignments and a final project and examinations as determined from time to time by the institution. In cases where coursework, assignments, projects and examinations are used in combination, percentage rating for each component will be communicated to you at the appropriate time. Your instructor will provide you with guidance on how he or she will grade and provide feedback re: all graded activities.

TIME REQUIRED

The course is worth 14 credits, and each credit is equivalent to 10 notional hours. You are, therefore, advised to spend not less than 140 hours of study on this course. The notional time includes:

- Going over activities embedded in the study material
- Peer group interaction (where necessary)
- Face-to-face tutorials (where necessary)
- Working on tutor-marked assignments
- Preparing and sitting examinations (where that is required)

COURSE SCHEDULE

The institution and instructor will provide a specific schedule to guide students.

STUDENT SUPPORT

Note: This section should be customized by the institution delivering the course. Some suggestions for content are provided in the heading below.

ACADEMIC SUPPORT

<Insert the following information if relevant>

- How to contract a tutor/facilitator (Phone number, email, office hours, etc.).
- Background information about the tutor/facilitator if he/she does not change regularly. Alternatively provide a separate letter with the package describing your tutor/facilitator's background.
- Description of any resources that they may need to procure to complete the course (e.g. lab kits, etc.).
- How to access the library (either in person, by email or online).

HOW TO SUBMIT ASSIGNMENTS

<If the course requires that assignments be regularly graded, then insert a description of how and where to submit assignments. Also explain how the learners will receive feedback.>

TECHNICAL SUPPORT

<If the students must access content online or use email to submit assignments, then a technical support section is required. You need to include how to complete basic tasks and a phone number that they can call if they are having difficulty getting online>.

UNIT ONE – INTRODUCTION TO ACCOUNTING

UNIT INTRODUCTION

In order for any business to be successful, there should be proper control of its finances. In this unit you will begin by understanding basic accounting terms and principles that will get you started to proper financial control of your business.

UNIT OBJECTIVES

Upon completion of this unit you should be able to:

1. Define Accounting and Accounting terms
2. Appreciate the difference between bookkeeping and accounting
3. State the main purpose of accounting
4. Describe the different types of accounts
5. Identify different types of business
6. State and illustrate the accounting cycle
7. Examine the concepts and best practices of business accounting
8. Identify users of accounting information
9. Distinguish between financial and management accounting
10. Examine accounting assumptions, principles and conventions and how they are used
11. State the accounting equation
12. Describe the relationship of the accounting equation and the balance sheet
13. Understand what is meant by assets, liabilities and owners' equity

UNIT READINGS

The instructor will provide a list of readings.

ASSIGNMENTS AND ACTIVITIES

The instructor will provide guidance on the type of assignments and instructions.

TOPIC 1.1 DEFINITION OF ACCOUNTING AND ACCOUNTING TERMS

TOPIC INTRODUCTION

We will begin by taking and look at the definition for accounting and some accounting terms. As you have increase knowledge of various accounting terms it will enable you to analyze and interpret the accounting records of your business.

TOPIC OBJECTIVES

Upon completion of this topic you should be able to:

1. Define accounting and accounting terms
2. Appreciate the difference between bookkeeping and accounting
3. State the purpose of accounting
4. Identify users of accounting information
5. Identify different types of businesses
6. Distinguish between Financial and Management Accounting

WHAT IS BOOKKEEPING?

Let us begin this unit by defining two important terms in accounting: bookkeeping and accounting.

Activity 1 – A

From your knowledge of accounts what would be your define of

Bookkeeping ____

____

Accounting ____

____

Great start! Now let us look at these definitions

- Bookkeeping is defined as concerned with the recording of business data. "It is the process of recording the business transactions and the relations between the transactions. The process of bookkeeping is mainly mechanical and does not require any analysis. Instead of the analyzing, the bookkeeping relies only on the recording of the information". (difference between 2001)

- Accounting is concerned with the design, interpretation of data and the preparation of financial reports. “Accounting is also the systematic recording of business transactions but it includes additional reports and further financial analysis of the transactions. Accounting is also the systematic recording of business transactions but it includes additional reports and further financial analysis of the transactions”. (difference between 2001)

As you can see, accounting is made up of two elements:

1. Recording business transactions - Book keeping
2. Presenting the information

Difference Between Bookkeeping and Accounting

Now that we have defined both bookkeeping and accounting we can now look at the difference between them. Bookkeeping is a part of the accounting process that records the financial transactions. Accounting takes the recorded financial transactions entered by a bookkeeper and prepares financial statements, liabilities of the assets and the various results of the whole business. The accounting process uses the bookkeeping information, interprets the financial data of the business and compiles it into reports in a format that business managers can use to judge the financial health of the business based on their projected financial plan.

Bookkeeping is simply the recording of monetary transactions of a business, whereas accounting allows a business to record, analyse and retrieve critical financial information that can be used to determine a business financial status and provide reports and insights needed to make sound financial decisions.

Purpose of Accounting

The purpose of accounting is to provide a means of recording, reporting, summarizing and interpreting economic data.

> “The primary purpose of accounting is to identify and record all activities that impact the organization financially. All activities, including purchases, sales, the acquisition of capital and interest earned from investments, can be classified in monetary terms and posted to a specified account as an accounting record. These transactions typically are recorded in ledgers and journals and are part of the process known as the accounting cycle.” (ehow 1999-2001)

Types of Accounting Information

An accounting information system provides data to help decision makers both outside and inside the business. Decision makers outside the business are affected in some way by the performance of the business. Decision makers inside the business are responsible for the performance of the business. For this reason, accounting is divided into two categories:

- financial accounting for those outside; and
- managerial accounting for those inside.

MANAGEMENT ACCOUNTS

Management accounting refers to the processes and procedures implemented for internal decision making and reporting within an organization. It provides information that is useful in running a business by internal users, usually accomplished through custom designed reports. These are produced as often as a business wants them (usually monthly). They can be prepared using the business's own internal policies and bookkeeping/financial management system. Internal users, Senior and middle Management use accounting information to run business. Employees utilize accounting information to determine a business's profitability and profit sharing.

Management account information or reports should:

- Relate to the part of the business for which the manager is responsible. For example, a Production Manager wants information on costs of production but not on advertising.
- Involve planning for the future. For instance, a budget would show financial plans for the coming year.
- Meet two tests:
  - the accounting information must be useful and relevant; and
  - it must not cost more to gather and process than it is worth.

Managerial accounting generates information that managers can use to make sound decisions. The four major types of internal management decisions are:

1. **Financial Decisions**—determine what amount of capital (funds) are needed to run the business and whether to secure these funds from owners or creditors. In this sense, capital means money used by the business to purchase resources such as machinery and buildings and to pay expenses of conducting the business.
2. **Resource Allocation Decisions**—identify how the total capital of a business is to be invested, such as the amount of machinery to be purchased in any one year.
3. **Production Decisions**—decides what products are to be produced, by what means, and when.
4. **Marketing Decisions**—establishes selling prices and advertising budgets; determining the location of a business's markets and how to reach them.

FINANCIAL ACCOUNTS

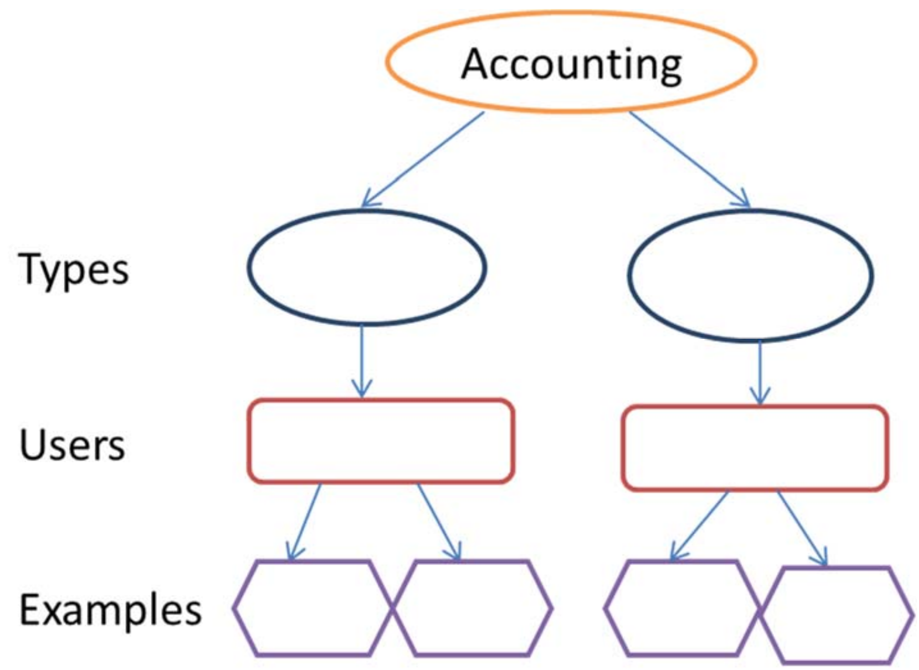
Financial accounting refers to the fundamental guidelines, polices, procedures and regulations mandated by the General Accepted Accounting Principles (GAAP), which was established by the Financial Standards Board (FASB) and/or government regulators. It provides information designed to satisfy the needs of external users. This reporting is done in the form of financial statements. These accounts are usually produced annually. They are based on historical information and are rarely used internally. Financial accounts are used by external users for several reasons.

The external users of accounting information fall into six groups; each has different interests in the business depending on how you are financially structure and thus will want answers to unique questions. The groups and some of their possible questions are:

- **Owners and Prospective Owners**. Has the business earned satisfactory income on its total investment? Should an investment be made in this business? Should the present investment be increased, decreased, or retained at the same level? Can the business install costly pollution control equipment and still be profitable?
- **Creditors and Lenders.** Should a loan be granted to the business? Will the business be able to pay its debts as they become due?
- **Employees and their Unions.** Does the business have the ability to pay increased wages? Is the business financially able to provide long-term employment for its workforce?
- **Customers.** Does the business offer useful products at fair prices? Will the business survive long enough to honour its product warranties?
- **Governments.** Is the business, such as a local public utility, charge a fair rate for its services? How much tax does the business owe?
- **The General Public.** Is the business providing useful products and gainful employment for the local citizens without causing serious environmental problems?

Activity 1 – B

Complete the illustration below to demonstrate your understanding of the types of accounting and the users of the accounting information using examples.



Were you able to complete the diagram above with the correct information? Now that you have distinguished between management and financial accounting and there users lets now look at the different types of account.

CLASSIFICATION OF ACCOUNTS

An '**account'** is a specific location for recording transactions of a like kind. The dual aspect of treating each transaction is then recorded in an account. An account shows us the 'history' of a particular business transaction.

Accounts can be divided into three categories:

1. **Personal Accounts** – these are the accounts of your creditors (accounts payable) and debtors (accounts receivable)
2. **Real Accounts** – are your tangible and intangible assets
3. **Nominal Accounts** – these are income and expense accounts of your business

Type	Represent	Examples
Personal	Accounts related to *individuals*, *firms*, *organizations*, or *companies*	Individuals; partnership firms; corporate entities; non-profit organizations; any local or statutory bodies including governments at the country, state or local levels
Real	Accounts related to *assets of a tangible or intangible nature*	• Tangibles – Plants and machinery, furniture and fixtures, computers and information processing equipment • Intangibles – Goodwill, patents, copyrights, trademarks
Nominal	Temporary income and expenditure accounts for *recognition of the implications of financial transactions during each fiscal term till finalization of accounts at term end*	Sales, purchases, utilities, dividends

Table 1.1

Accounts can be further divided into five types. The basic types of accounts are:

1. '**Assets:'** items of value that the business owns or has rights to. Examples include: cash, real estate, equipment, money or services that others owe you (accounts receivables), and even intangible items such as patents and copyrights.
2. '**Liabilities:'** obligations that are owed to other parties (accounts payables). Examples include: wages payable, taxes due, and borrowed money (also called debt).
3. '**Equity:'** the ownership value of a business. It is the investment by an owner in the business.
4. '**Revenues:'** the mechanisms where income enters the business (note that revenue and income is not the same thing--they are used here to describe each other in basic terms only. This will be explained later).
5. '**Expenses:'** the costs of doing business. Examples include: salary expense, rent, utilities expense, and interest on borrowed money.

We have now identified the different types of accounts for a business but do you know what a business is? Let's explore this concept.

WHAT IS A BUSINESS?

A business can be defined as a commercial organisation, which exists with a view to making a profit. A business will generally fall into one of the following categories (depending on the country you are establishing the business):

Sole Trader - This is a business that is owned and operated by one person. He or she is solely liable for all business debts but when successful, takes all the profits.

Partnership - This type of business is owned by several individuals, some of which will actively be involved in the business.

Companies (or Public Corporations) - This type of business is owned by shareholders and is operated on their behalf by a nominated board of directors.

Non-Trading Organisations (or Non-Profit Corporations) - Clubs, associations and other non-profit-making organisations are normally run for the benefit of their members to engage in a particular activity and not to make a profit. Their financial statements will take the form of income and expenditure accounts.

Cooperative Society - A legally constituted business entity formed for the explicit purpose of furthering the economic welfare of its members and that of the wider society by providing them with goods or services.

TOPIC SUMMARY

You just had your first insight of an operation of a business. You have distinguished between bookkeeping and accounting, management and financial accounting and you have also looked at the classification and types of accounts and forms of business entities.

We will now look at the Accounting Cycle.

TOPIC 1.2 THE ACCOUNTING CYCLE

TOPIC INTRODUCTION

We are now moving on to the accounting cycle. This is a series of steps that are repeated ever reporting period. The process starts with making accounting entries for each transaction and goes through closing the books. This is the name given to the collective process of recording and processing the accounting events of a business. It is a methodical set of rules to ensure the accuracy and conformity of financial statements.

TOPIC OBJECTIVES

Upon completion of this topic you should be able to:

1. State and explain the steps in the accounting cycle
2. Illustrate the accounting cycle in the form of a diagram

STEPS IN THE ACCOUNTING CYCLE

The accounting cycle is a series of steps that is followed to ensure that the records of a business are true and fair. Each business transaction goes through these steps. Let's have a look at these steps in detail.

Step 1 - Collecting and analyzing data from source documents.

When a transaction occurs, a document is produced. Most of the time, these documents are external to the business (e.g. purchase orders, sales slips, etc.), however, they can also be internal documents, such as inter-office sales, cheques, bills from providers, etc. These documents are referred to as source documents. Some additional examples of source documents include:

- The receipt you get when you purchase something at the store.
- Interest you earned on your savings account which is documented in your monthly bank statement.
- The monthly electric utility bill that comes in the mail.
- The telephone bill.
- Invoices from other service providers, contractors, etc.

Step 2 – Journalizing transactions.

The source documents are recorded in a Journal. This is also known as a book of first entry. The journal records both sides of the transaction recorded by the source document. These write-ups are known as Journal entries.

Step 3 – Post to the Ledgers.

The Journal entries are then transferred to a Ledger. The group of accounts (described earlier) is called ledger. A ledger is also known as a book of accounts. The purpose of a Ledger is to bring together all of the transactions for a similar activity. For example, if a business has one bank account, then all transactions that include cash would then be maintained in the Cash Ledger. This process of transferring the values is known as a posting.

Once the entries have all been posted, the Ledger accounts are added up in a process called Balancing. Balancing implies that the sum of all Debits equals the sum of all Credits.

Step 4 – Unadjusted Trial Balance.

A particular working document called an unadjusted trial balance is created. This lists all the balances from all the accounts in the Ledger. Notice that the values are not posted to the trial balance, they are merely copied.

At this point accounting happens. The accountant produces a number of adjustments, which make sure that the values comply with accounting principles. These values (such as depreciation of equipment) are then passed through the accounting system resulting in an adjusted trial balance. This process continues until the accountant is satisfied.

Steps 5 – Prepare adjustments.

Period-end adjustments (usually quarterly) are required to bring accounts to their proper balances after considering transactions and/or events not yet recorded. Under accrual accounting, revenue is recorded when earned and expenses when they are incurred. An entry may be required at the end of the period to record revenue that has been earned but not yet recorded on the books. Similarly, an adjustment may be required to record expense that may have been incurred but not yet recorded.

Step 6 – Prepare an adjusted trial balance.

This step is similar to the preparation of the unadjusted trial balance but this time the adjusting entries are included. Correction of any errors must be made.

Step 7 - Prepare Financial Statements.

Financial statements are drawn from the trial balance and are presented in the following forms:

- Income statement: prepared from revenue, expenses, gains and losses
- Balance sheet: prepared from assets, liabilities and equity accounts
- Statement of retained earnings: prepared from net income and dividend information
- Cash flow statement: derived from the other financial statement using either the direct or indirect method.

Finally, all the revenue and expense accounts are closed.

Step 8 – Closing entries.

Revenues and expenses are accumulated and reported by period, monthly, quarterly, or yearly. To prevent them not being added to or co-mingled with revenues and expenses of another period, they need to be closed out- that is, given zero balances at the end of each period. Their net balances, which represent the income or loss for the period, are transferred into owners' equity. Once revenue and expense accounts are closed, the only accounts that have balances are the asset, liability, and owners' equity accounts. These balances are carried forward to the next period.

Step 9 – Prepare post-closing trial balance.

The purpose of this final step is two-fold: to determine that all revenue and expense accounts have been closed properly and to test the equality of debit and credit balances of all the balance sheet accounts, that is, assets, liabilities and owners' equity.

TOPIC SUMMARY

You have just looked at the accounting cycle and the steps in the accounting cycle. As you continue with the other topics in this unit you will examine the accounting cycle in more detail. We will now continue and look at the business accounting processes and procedures.

TOPIC 1.3 BUSINESS ACCOUNTING PROCESS AND PROCEDURES

TOPIC INTRODUCTION

Accounting processes and procedures are usually based on the basic accounting cycle. The accounting process outlines how financial information flows through a business. It also identifies which individuals are responsible for the information. In order for the owners of a business to make sound decisions, they will need financial information that accurately reflects the "true and fair view" of the financial performance and position of the business.

TOPIC OBJECTIVES

Upon completion of this topic you should be able to:

1. examine accounting assumptions principles and conventions; and
2. identify how these assumptions, principles and conventions are used.

ACCOUNTING ASSUMPTIONS, PRINCIPLES AND CONVENTIONS

Accounting is used to communicate financial information. It is based on twelve fundamental concepts that form the basis for all the General Accepted Accounting Principles (GAAP). Once these concepts are used as the foundation, readers of financial statements and other accounting information do not need to make assumptions about what the number means. The concepts and conventions were adopted to support the "true and fair view" approach of preparing financial statement for a business.

The table 1.2 indicates the accounting assumptions, principles and conventions.

Assumptions	**Principles**	**Conventions**
Separate Entity	Historical Cost	Materiality
Going Concern	Matching	Cost Benefits
Money Measurement	Realization of Income	Conservatism
Time Period	Full Disclosure	Consistency
	Dual Aspect	

Table 1.2

Let's look further at these assumptions, principles and conventions.

ACCOUNTING ASSUMPTIONS

Separate Entity – this convention states that the business is an entity separate from its owner. Therefore, business records should be separated from the records of the owner. (Knol, 2009)

Going Concern – assumes that the entity will continue to operate indefinitely. It implies that the business will continue to operate for an indefinite period of time in the foreseeable future. This concept allows business to spread (amortize) the cost of fixed assets over its expected useful life. (Knol, 2009)

Money Measurement - assumes that items are not accounted for unless they can be quantified in monetary terms. (Knol, 2009) Financial statements shows only a limited picture of the business. They do not consider the business's other valuable resources (workforce, brand recognition, quality of management) because they cannot be quantified in monetary terms.

Time Period – allows the performance evaluated of a "Going Concern" business to be broken up into specific period of time such as month, a quarter or a year. (Knol, 2009)

ACCOUNTING PRINCIPLES

Historical Cost – requires that business assets be recorded at the actual price paid to acquire them. No account is made for the changing value of these assets. (Knol, 2009) Transactions are recorded at cost and not at its market value.

Matching – to avoid overstatement of income in any one period, the matching principle requires that revenue and related expenses be recorded in the same accounting period (moneyinstructor.com). Accountants should prepare accruals at the end for the reporting period to account for expenses incurred but for which there is no source document.

Realization of Income – revenue are recognized when they are earned. This occurs when the seller received cash or claim to cash in exchange for goods and services. (moneyinstructor.com)

Full disclosure – requires financial statements provide sufficient information to assist users of the information make knowledgeable and informed decisions about the business. (Knol, 2009)

Dual Aspect – is based on the accounting equation. All transactions must meet the equation in balance. Financial transactions are allocated both a debit and credit entry in the accounts. (Knol, 2009)

ACCOUNTING CONVENTIONS

Materiality – events are only recorded if it's significant enough to justify the usefulness of the information. (Moneyinstructor.com)

Cost Benefits – since the value of assets change over time it would be impossible to accurately record the market value for the assets. There it is recorded at the price paid to acquire it. (Moneyinstructor.com)

Conservatism – requires that profit should not be taken into account unless it's actually realized in cash while all possible losses must be fully provided for. This ensures that you financial statement does not overstate the business financial position. (Moneyinstructor.com)

Consistency – The same method of reporting should be used to ensure that any differences in the financial position between reporting periods is as a result of change in operating and not changes in the way items are accounted for. (Moneyinstructor.com)

The accounting process consists of the following groups of functions listed in illustration 1.2

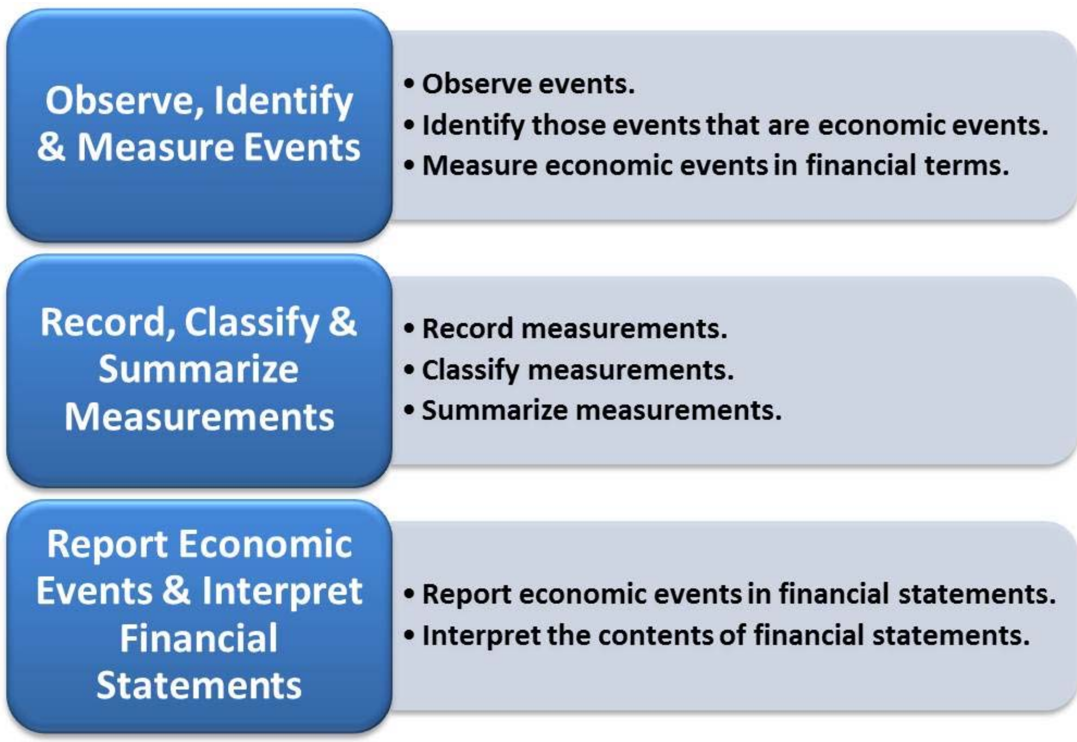


Illustration 1.2

Accountants observe many events (or activities) and identify and measure in financial terms (dollars) those events considered evidence of economic activity. (Often, these three functions are collectively referred to as analyse.) The purchase and sale of goods and services are economic events.

Next, the economic events are recorded, classified into meaningful groups, and summarized.

Accountants report on economic events (or business activity) by preparing financial statements and special reports. Often accountants interpret these statements and reports for various groups such as management, investors, and creditors. Interpretation may involve determining how the business is performing compared to prior years and other similar businesses.

TOPIC SUMMARY

In this unit we dealt with accounting assumptions, principles and conventions. These form the basis of the General Accepted Accounting Principles (GAAP) and support the true and fair view approach of preparing financial statements.

TOPIC 1.4 THE ACCOUNTING EQUATION AND BALANCE SHEET

INTRODUCTION

The whole of accounting is based a very simple idea called the accounting equation. It sounds complicated, but in fact it is easy to understand. This equation is expressed in the Balance Sheet and states the following:

Assets = Liability + Owners Equity

OBJECTIVES

Upon completion of this topic, you should be able to:

1. State the basic accounting equation
2. Describe the relationship of the accounting equation to the balance sheet.
3. understand what is meant by assets, liabilities and owners' equity

The **balance sheet**, sometimes called the *statement of financial position,* lists the business's assets, liabilities, and owners' equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. A balance sheet is like a photograph; it captures the financial position of a business at a particular *point* in time. As you study about the assets, liabilities, and owners' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

Catina's Beauty Saloon
Balance Sheet
As at 31st December 2010

Assets (in $)		Liabilities & Equity (in $)	
Cash	10,000	Accounts Payable (Creditors)	1,600
Accounts Receivables (Debtors)	1,700	Notes Payable	2,000
Motor Vehicle	20,000	**Total Liabilities**	**3,600**
Equipment	3,500	**Equity**	
Cash at Bank	15,000	Capital	25,600
		Retained Income	21,000
	50,200		**50,200**

Illustration 1.3

Let's examine the items in the Balance Sheet in illustration 1.3. It shows that the total assets should equal the total liabilities and owners' equity.

Assets as stated in Topic 1.1 are things of value owned by the business. They are also called the *resources* of the business. Assets have value because a business can use or exchange them to produce the services or products of the business. Assets are the economic resources of the entity, and include such items as cash, accounts receivable (amounts owed to a firm by its customers), inventories, land, buildings, equipment, and even intangible assets like patents and other legal rights and claims. Assets are presumed to entail probable future economic benefits to the owner.

In illustration 1.3 the assets of Catina's Beauty Salon amount to USD 50,200. Her assets consist of cash, **accounts receivable** (amounts due from customers for services previously rendered), Motor Vehicle, equipment and cash at bank.

Liabilities are the debts owed by a business. Typically, a business must pay its debts by certain dates. A business incurs many of its liabilities by purchasing items on credit. Liabilities are amounts owed to others relating to loans, extensions of credit, and other obligations arising in the course of business.

Catina's Beauty Saloon liabilities consist of **accounts payable** (amounts owed to suppliers for previous purchases) and **notes payable** (written promises to pay a specific sum of money) totalling USD 3,600.

Catina's Beauty Saloon is a sole proprietorship. The owners' interest in the business is referred to as **Owners equity**. Owners' equity is the owner's "interest" in the business. It is sometimes called net assets, because it is equivalent to assets minus liabilities for a particular business.

Catina's equity consists of (1) USD 25,600 capital investment and (2) retained income of USD21, 000. **Capital stock** shows the amount of the owners' investment in the business.

We will discuss these items later in the course. At this point, simply note that the balance sheet heading includes the name of the organization and the title and date of the statement (notice that the dollar amount of the total assets is equal to the claims on or interest in those assets). The balance sheet shows these claims under the heading "Liabilities and Equity".

THE ACCOUNTING EQUATION

The fundamental accounting equation is the backbone of the accounting and reporting system. It is central to understanding a key financial statement known as the balance sheet (sometimes called the statement of financial position). The accounting equation states:

Assets = Liabilities + Owners' Equity

Activity 1 – C

Using the accounting equation can you calculate the missing figures below

1	**$25,200**	________	**$10,100**
2	________	**$17,350**	**$21,750**
3	**$71,350**	**$29,100**	________

From activity 1 – C above, you should have determined that the accounting equation can be expressed in different forms. Let's have a look. The accounting equation can be expressed as:

Liabilities = Assets – Owner's Equity

So if we use question 1 in the activity above then your liabilities figure should be $15, 100

$25, 200 (Assets) – $10,100 (Owner's Equity)

The accounting equation could also be expressed as:

Assets = Liabilities + Owner's Equity

In question 2 above, your Asset figure should be $39,100

17,350 (Liabilities) + 21, 750 (Owner's Equity)

Another method of expressing the accounting equation is:

Owner's Equity = Assets – Liabilities

From the question 3 (in the activity above) you should have calculated $42, 250

71, 350 (Assets) - 29, 100 (Liabilities)

HOW TRANSACTIONS IMPACT THE ACCOUNTING EQUATION

Each passing transaction or event brings about a change in the overall financial condition. Business activity will impact various asset, liability, and/or equity accounts; but, they will not disturb the equality of the accounting equation. So, how does this happen? To reveal the answer to this question, let's look at four specific transactions for Catina's Beauty Saloon. You will see how each transaction impacts the individual asset, liability, and equity accounts, without upsetting the basic equality of the overall balance sheet.

Business transactions are measurable events that affect the financial condition of a business.

1. Purchase an Asset by Cash

On 12 January 2011, Catina purchased addition equipment valued $2,000 by cash.

Catina's Beauty Saloon **Balance Sheet** As at 31st December 2010			
Assets (in $)		**Liabilities & Equity (in $)**	
Cash	***8,000***	Accounts Payable (Creditors)	1,600
Accounts Receivables (Debtors)	1,700	Notes Payable	2,000
Motor Vehicle	20,000	**Total Liabilities**	**3,600**
Equipment	***5,500***	**Equity**	
Cash at Bank	15,000	Capital	25,600
		Retained Income	21,000
	50,200		**50,200**

Illustration 1.4

In illustration 1.4, you can see that the cash account has reduced by $2000 and the equipment increased by the same amount. However, the balance sheet still remained balanced.

2. Purchase stock on Credit

On 17th January 2011, she purchased stock for use in the Saloon on credit from Hair Suppliers Ltd $5,000.

Catina's Beauty Saloon **Balance Sheet** As at 31st December 2010			
Assets (in $)		**Liabilities & Equity (in $)**	
Cash	8,000	***Accounts Payable (Creditors)***	***6,600***
Accounts Receivables (Debtors)	1,700	Notes Payable	2,000
Motor Vehicle	20,000	**Total Liabilities**	**3,600**
Equipment	5,500	**Equity**	
Cash at Bank	15,000	Capital	25,600
Stock	***5,000***	Retained Income	21,000
	55,200		**55,200**

Illustration 1.5

Observe the difference in Accounts Payable and inclusion of Stock in illustration 1.5 above but the balance sheet still remain equal.

3. Payment of a Liability

On the 21st January, 2011 Catina made a payment to her suppliers $1,000 by cheque.

Catina's Beauty Saloon **Balance Sheet** As at 31st December 2010			
Assets (in $)		**Liabilities & Equity (in $)**	
Cash	8,000	***Accounts Payable (Creditors)***	***5,600***
Accounts Receivables (Debtors)	1,700	Notes Payable	2,000
Motor Vehicle	20,000	**Total Liabilities**	**3,600**
Equipment	5,500	**Equity**	
Cash at Bank	***14,000***	Capital	25,600
Stock	5,000	Retained Income	21,000
	54,200		**54,200**

Illustration 1.6

Changes have been made to the Accounts Payable and the Cash at Bank account to reflect the transaction, however, the Balance still remains balanced.

4. Collection of an Asset

On the 28th January 2011, J Brown one of Catina's debtors paid her amount owning $500 by cash.

Catina's Beauty Saloon **Balance Sheet** As at 31st December 2010			
Assets (in $)		**Liabilities & Equity (in $)**	
Cash	***8,500***	Accounts Payable (Creditors)	5,600
Accounts Receivables (Debtors)	***1,200***	Notes Payable	2,000
Motor Vehicle	20,000	**Total Liabilities**	**3,600**
Equipment	5,500	**Equity**	
Cash at Bank	14,000	Capital	25,600
Stock	5,000	Retained Income	21,000
	54,200		**54,200**

Illustration 1.7

The cash at Bank is affected whenever payment is made by cheque. Since the cheque is a means of depositing or withdrawing from your bank account. Again adjustments are made to the accounts affected by the transaction and the Balance Sheet.

Self-Reflection Question

Take this opportunity to review the topics in this unit and ask yourself the following questions.

1. Do I understand how a transaction affects items on the Balance Sheet?

2. Do I understand the various methods in which the accounting equation can be expressed?

3. Am I able to make adjustments to my Balance Sheet after business transactions?

Unit References

1. Wood, F., & Robinson, S. (2007). Principles of Accounts for the Caribbean (5th ed.). England, Pearson Education Limited.
2. Holdip, G., & Lamorell, C. (2010). Principles of Accounts for CSEC Examinations. Macmillan Publishers Ltd.
3. http://www.differencebetween.net/business/difference-between-accounting-and-bookkeeping-2/#ixzz1GfqZ4iSs
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6. http://www.scribd.com/doc/9295030/Accounting-Concepts-and-Conventions
7. http://docs.globaltext.terry.uga.edu:8095/anonymous/webdav/Accounting%20Principles/Accounting%20Principles%20Vol.%201.pdf
8. http://www.principlesofaccounting.com/chapter%201.htm
9. http://www.ehow.com/about_4679149_purpose-accounting_.html

UNIT SUMMARY

ASSIGNMENTS AND ACTIVITIES

Unit Assignment

Catina's Beauty Saloon
Balance Sheet
As at 28th January, 2011

Assets	**$**	**Liabilities and Equity**	**$**
Cash	8,500	Accounts Payable (Creditors)	5,600
Account Receivables (Debtors)	1,200	Notes Payable	2,000
Motor Vehicle	20,000	Total Liabilities	7,600
Equipment	5,500	**Equity**	
Cash at Bank	14,000	Capital	25,600
Stock	5,000	Retained Income	21,000
	54,200		54,200

Catina's Beauty Saloon had the following business transactions in the month of February 2011. Make the necessary adjustment to the accounts and update her Balance Sheet as at 28th February 2011.

Feb 1 Catina deposited $5,000 cash into her Cash at bank account

Feb 3 she purchased stock $2,500 by cheque

Feb 7 paid a cheque of $500 to a creditor'

Feb 12 A debtor paid Catina $300 by cheque

Feb 15 Received a Loan from L. Stennett $10,000 by cheque

Feb 20 bought equipment $8,000 by cheque

SUMMARY

If you understand how accounting information is prepared, you will be in an even stronger position when faced with a management decision based on accounting information. The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Reliable information is necessary before you can make a sound decision involving the allocation of scarce resources. Accounting information is valuable because it is used to evaluate the financial consequences of various alternatives.

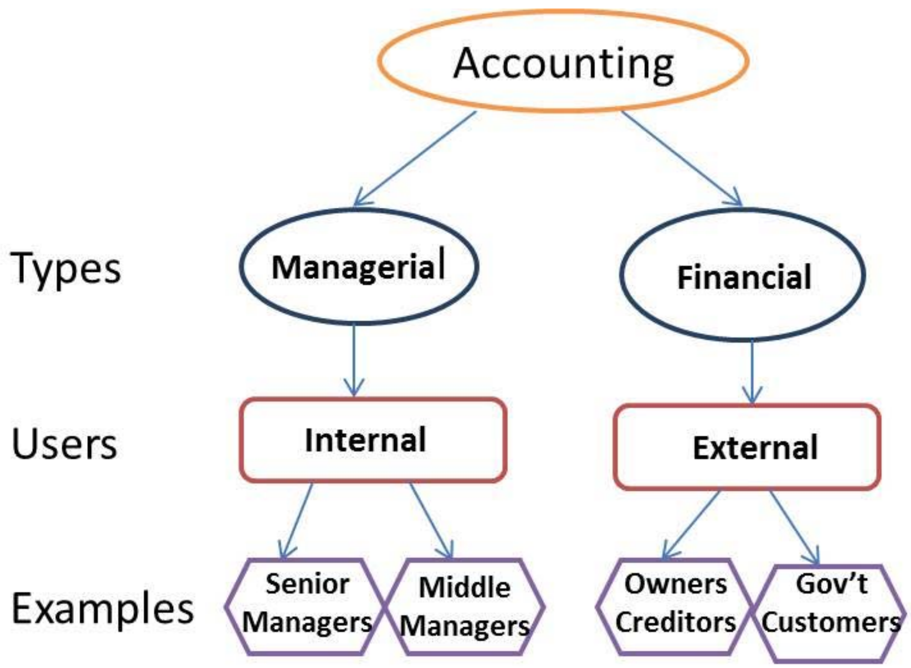
Accountants can reduce uncertainty by using professional judgment to quantify the future financial impact of taking action or delaying action. Although accounting information plays a significant role in reducing uncertainty within your business, it also provides financial data for persons outside the business. This information tells how management has discharged its responsibility for protecting and managing the business's resources.

Accounting is often confused with bookkeeping (discussed earlier). Bookkeeping is a mechanical process that records the routine economic activities of a business. Accounting includes bookkeeping but goes well beyond it in scope. Accountants analyse and interpret financial information, prepare financial statements, conduct audits, design accounting systems, prepare special business and financial studies, prepare forecasts and budgets, and provide tax services.

Unit 1 Suggested Answers

Activity 1 – B

Complete the illustration below to demonstrate your understanding of the types of accounting and the users of the accounting information using examples.



Activity 1 – C

Using the accounting equation can you calculate the missing figures below

	Assets	Liabilities	Owners Equity
	$	$	$
1.	25, 200	**15,100**	10,100
2.	**39,100**	17,350	21,750
3.	71, 350	29,100	**42,250**

UNIT 1 – ASSIGNMENT ANSWERS

Cash 8,500 – 5,000 = 3500

Bank 14,000 + 5,000 - 2,500 – 5,00 + 300 + 10,000 – 8,000 = 18, 300

Stock 5,000 + 2, 500 = 7,500

Accounts Payable 5,600 – 500 = 5,100

Accounts Receivable 1,200 – 300 = 900

Notes Payable 2, 000 + 10, 000 = 12,000

Equipment 5,500 + 8,000 = 13,500

Catina's Beauty Saloon

Balance Sheet

As at 28th February 2011

Assets	**$**	**Liabilities and Equity**	**$**
Cash	3,500	Accounts Payable (Creditors)	5,100
Account Receivables (Debtors)	900	Notes Payable	12,000
Motor Vehicle	20,000	Total Liabilities	17,100
Equipment	13,500	**Equity**	
Cash at Bank	18,300	Capital	25,600
Stock	7,500	Retained Income	21,000
	63,700		63,700

NEXT STEP

You have come to the end of Unit One. In Unit Two we will look at the Double Entry System of Accounting.

UNIT TWO – DOUBLE ENTRY SYSTEM OF ACOUNTING

INTRODUCTION

In Unit One, we illustrated the accounting cycle, we also examined the accounting equation and how each transaction affects items in the Balance Sheet. In Unit Two we will expand on the steps in the accounting cycle. We will begin by journalizing the information gathered from our source documents then continue with an exploration of the double entry system of bookkeeping.

There are two basic kinds of bookkeeping: single entry bookkeeping and double entry bookkeeping. In the case of single entry bookkeeping each transaction is carried to the debit column or the credit column. In the case of double entry bookkeeping we can find two entries for each transactions carried to the Ledger. One entry is carried to the credit side and the other to the debit side. This is done in the way that the two entries can be checked. Double entry bookkeeping is the fundamental concept underlying accountancy. All accounting transactions should be recorded using the double entry system.

After recording your business transactions in your ledger accounts, the different accounts will be balanced and the balances used to generate your trial balance for the period.

OBJECTIVES

Upon completion of this topic you should be able to:

1. Demonstrate the use of double-entry and accounting systems.
2. Record transactions and events.
3. Apply double entry bookkeeping to a list of transactions.
4. Use the account as the basic classifying and storage unit for accounting information.
5. Express the effects of business transactions in terms of debits and credits to different types of accounts.
6. Record the effects of business transactions in a journal.
7. Post journal entries to the accounts in the ledger.
8. Prepare a trial balance to test the equality of debits and credits in the journalizing and posting process.

UNIT READINGS

The instructor will provide a list of readings.

ASSIGNMENTS AND ACTIVITIES

The instructor will provide guidance on the type of assignments and instructions.

TOPIC 2.1 BOOKS OF ORIGINAL ENTRY

INTRODUCTION

As we take a more in depth look at the accounting cycle we will examine various source documents and how the information in these documents are transferred to the books of original entry. You will also have looked at the different books of original entry.

OBJECTIVES

Upon completion of this topic you should be able to:

1. Identify different forms of source documents.
2. Transfer information from the source document to the books of original entry.
3. Examine the various books of original entry.
4. State the use of the books of original entry.

SOURCE DOCUMENTS

Before we look any further at the books of original entry, let us look at the source documents that provide the information to be recorded in the books of original entry.

A source document describes all the basic facts of the transaction, such as the amount of the transaction; to whom the transaction was made; the purpose of the transaction and the date of the transaction. Some source documents include:

Source Document 1 - Invoices

Let us look at the invoice in illustration 2.1 below. An invoice is a document that contains a detailed description of the item sold, unit price and the terms and conditions of the sale.

The invoice is numbered and gives a detailed description of the item(s) sold or purchased: the quantity, the list price per unit, trade discounts allowed and the net cost of the item. Also, included on the invoice will be the terms of payment and the name and address of the customer and the name and address of the issuing firm. A number of copies are usually made and routed to different departments within the issuing firm.

There are two types of invoices:

1. Purchases Invoices - reflects credit purchases of stock (Holdip and Lamorell 2010)
2. Sales Invoices - reflects credit sales of stock (Holdip and Lamorell 2010)

Your Purchase Order 12/B/124

AJ Wholesale
Factory Road
St. John's
Antigua

Name and address of supplier (seller)

7-Sep-06

Date of transaction

To:

Buyer

MJ Retailers
Hilda Davis Drive
St. John's

INVOICE NO. 1654

Invoice number

Quantity		Per Unit	Total
		$	$
7	cases fruit juices	35.00	245.00
4	cases ideal milk	24.00	96.00
			341.00
	less 20% Trade Discount		68.20
			272.80

Sub-Total

Total

Discount given to encourage person to buy in bulk

Illustration 2.1

Discounts

A discount is a reduction in the price of an item. In order to encourage prompt payment by customers, cash discounts may be offered. Customers are allowed a specified percentage off the amount payable if paid within a stated time period. **Discount Received** is an allowance you receive for making prompt payment for the goods and services you receive from your suppliers. **Discount Allowed** is the allowance you give to your customers for making prompt payment for the goods and services they received from your business.

Trade discounts are reductions in the invoice price of the goods and are given to encourage trade and increase the volume of good purchased. Trade discounts are not recorded in the ledger accounts although they may be noted in the relevant day book. Cash discounts are recorded in the accounting records

Source Document 2 - Debit Notes

A Debit Note is sent by the business to the supplier giving details of a claim for an allowance in respect to goods returned. (Wood and Robinson 2007) *(Illustrated below).*

			MJ Retailers Hilda Davis Drive St. John's Antigua
			26-Sep-06
To:	A.M Bryden Fort Road St. John's		
	DEBIT NOTE NO. 237		
Quantity		Per Unit	Total
		$	$
2	cases fruit juices	35.00	70.00
1	case ideal milk	24.00	24.00
			94.00

Illustration 2.2

Source Document 3 - Credit Notes

The supplier will issue a credit note to the customer (debtor) showing the amount of the agreed reduction (Wood and Robinson 2007) (*Illustration 2.3)*

			MJ Retailers Hilda Davis Drive St. John's Antigua
			23-Sep-06
To:	Malika Diantha Green Bay St. John's		
	CREDIT NOTE NO. 1235		
Quantity		Per Unit	Total
		$	$
2	case ideal milk	24.00	48.00
1	case tomato paste	32.00	32.00
			80.00
	Less 10 % trade discount		8.00
			72.00

Illustration 2.3

Source Document 4 - Cash Receipts

The cash receipt is a simple document of a transaction that is often issued at the time of the completion of a sale. Many businesses issue cash receipt as a matter of course. While the printed document is normally a simple record of the transaction, some examples of the cash receipt can be very detailed. (www.wisegeek.com) *(Illustrated below 2.4)*

Number 00125
Date 21 Sept 2006

Cash Sales Receipt

Name Makayla Adora
Address 12 Old Road
Urlings

Sold By	**Cash**	**C.O.D**	**Charge**	**On Account**	**Paid Out**

Quantity	**Description**	**Price**	**Amount**
2	Cases milk	24.00	48.00
Received by		**Subtotal**	48.00
		Tax	
		Total	48.00

Illustration 2.4

Source Document 5 - Cheque Stubs

A **cheque** instrument (usually a piece of paper) that orders a payment of money. The person writing the cheque, the *drawer*, usually has a chequing account where their money was previously deposited. The drawer writes the various details including the money amount, date, and a payee on the cheque, and signs it, ordering their bank, known as the *drawee*, to pay this person or company the amount of money stated. (Source: Wikipedia)

1. drawee, the financial institution where the cheque can be presented for payment
2. payee
3. date of issue
4. amount of currency
5. drawer, the person or entity making the cheque
6. signature of drawer
7. Machine readable routing information

Other Source Documents

Below are some additional examples of source documents:

1. Petty Cash Vouchers – records of claims of small expenditures (Holdip and Lamorell 2010).
2. Time Cards – record of hours worked by employees (Holdip and Lamorell 2010).
3. Stock Cards – records of materials etc. Purchased (Holdip and Lamorell 2010).
4. Bank Statements – records of transactions with the bank (Holdip and Lamorell 2010).
5. Cash Bills/Invoices – given to customers and received from suppliers as proof of purchase. (Holdip and Lamorell 2010).

Books of Original Entry

Now that you know what source documents are you can now move on to the books of original entry.

The books of original entry consist of five Journals or Day Books and the Cash Book.

1. **Sales Journal (Day Book**) is used to record the credit sales of goods normally traded by the business. The information from the sales invoices is transferred to the sales day book. It is a list of all of your Accounts Receivables (Debtors).

2. **Purchase Journal (Day Book)** is used to record the credit purchases of goods normally traded by the business. The information from the purchases invoice is transferred to the purchases journal or day book. It is a list of the Accounts Payable (creditors).

3. **Purchases Return Journal (Day Book)** records all of the purchased returned to your suppliers. These may be returned for various reasons (wrong size, colour, damaged etc.). To indicated that goods were returned to the suppliers a debit note is used the information from the debit note is then transferred to the Purchased Return Day Book.

4. **Sales Return Day Book** records all your sales that have been returned to you by your customers. Your customer is issued a credit note to indicate what was returned and the allowance given for the return. This information is then transferred to the sales return day book.

5. **The General Journal** has several uses these include entries for the following
   - opening entry - this is a list of assets, liabilities, and capital used to open a new set of accounting books
   - the purchase and sale of fixed assets for cash and on credit
   - writing-off bad debts
   - the correction of errors
   - the creation of provision for bad and doubtful debits
   - the creation of provision for depreciation
   - adjusting entries for accruals and prepayments
   - closing entries
   - unusual one-of-a-kind transactions

6. **Cash Book** records all the cash transactions of your business. This includes transactions paid for by cash or by cheque. It also records an allowance given or received as a cash discount.

The journals generally contain the following columns:

1. Date - day, month, year
2. Details/Particulars - account titles
3. Folio - this is a reference code showing the ledger page to which the entry will be posted.
4. Amount - the net monetary amount shown invoice or other source on the document.

Books of Original Entry	Source Documents	Types of Transactions
Sales Journal	Sales Invoice	Credit sales of stock
Purchases Journal	Purchases Invoice	Credit purchases of stock
Purchases Return	Debit Note	Stock returned to suppliers
Sales Return	Credit Note	Stock returned by customers
General Journal	Invoices, bills, vouchers	All other types of transactions
*Cash Book	Receipts, bills, cheque	All cash and bank transactions
*Petty Cash Book	Petty Cash Vouchers	Small payments and receipts

******These books/journals all have the same format or layout with the exception of the cash and petty cash book.*

Table 2.1

(Holdip and Lamorell 2010)

Table 2.1 above shows the link between the books of original entry and the source documents. You can now have a further look at the links between the source documents and the books of original entry.

Purchase Order And Purchase Invoice

A purchase invoice is a document that is issued from a seller to a buyer. It is sent to the customer who has purchased a product or service. This can also be called a bill or a billing statement and it is generally a document that details the services that have been or will be provided (or the items purchased), quantity, price, and other details. By accepting an invoice, a buyer is basically making a contractual agreement to make the purchase.

A purchase order is a document that is issued from a buyer to a seller. A buyer who is interested in making a purchase of products or services sends the document to the seller. A purchase order will also detail the services or the items to be ordered or purchased, including the quantity, price and other details. A purchase order also serves as a contractual agreement. The buyer is agreeing to make the purchase, and the seller, upon accepting the purchase order, is agreeing to provide the goods or services according to the specifics in the purchase order.

After placing an order with the selected supplier, the supplier sends the purchasing firm a copy of the purchase invoice. This is then used to record the transaction in the Purchases Journal. The purchase invoice is then filed for future reference. The suppliers listed in the Purchases Journal are called creditors, because the business owes them money.

SALES ORDER AND SALES INVOICE

Sales orders indicate that the seller of the goods or services needs to take action (i.e., to complete the order). Usually this involves finding the product, packaging it, etc., or setting up a meeting so that services can be rendered.

Sales Invoices indicate that buyer needs to take action. This typically means that the buyer needs to compensate the business monetarily for the products or services received.

Sales Journal				
Date	**Details**	**Folio No.**	**Invoice No.**	**Amount**

GENERAL JOURNAL

The General Journal is one of the first books in which a transaction is recorded. In some cases, all transactions are first recorded in the General Journal. In larger firms, where other books or original entry are used, the General Journal is restricted to only recording specific kinds of transactions. The General Journal is used to record transactions which cannot be recorded in any other book of original entry, or unusual one -time transactions. The process of entering transaction in the General Journal is called journalising.

The journals generally contain the following columns:

1. Date - day, month, year
2. Details/Particulars - account titles
3. Folio - this is a reference code showing the ledger page to which the entry will be posted.
4. Debit – the monetary amount to be debited is shown,
5. Credit - the monetary amount to be credited is shown.

General Journal				
Date	**Details**	**Folio No.**	**Debit**	**Credit**
2006			**$**	**$**
	Name of account to be debited			
	Name of account to be credited			
	Narrative			

A **Narrative** is a brief description of an entry in the journal.

CASH BOOK

There are often several cash accounts because they serve different purposes. The Cash in Bank account represents the checking account that processes deposits, checks and memorandum items. The Cash Short and Over account is used to record any variance by sales clerks. The Cash on Hand Fund is used to provide change to conduct business with customers. The Petty Cash Fund is used to pay for small items with cash. Each of these cash accounts needs to be strictly controlled to prevent mishandling. The cash book replaces the need to have a separate cash account and cash at bank account since they both merged to form the cash book.

Cash Book											
Date	**Details**	**Folio**	**Discount**	**Cash**	**Bank**	**Date**	**Details**	**Folio**	**Discount**	**Cash**	**Bank**
2006			**$**	**$**	**$**	**2006**			**$**	**$**	**$**

WORKED EXAMPLE

Let us now look at the source documents and books of original entry at work by examining the worked example.

MJ Retailers started business on 1 September 2006 with the following assets and liabilities

Cash	$ 150
Bank	$ 800
Motor Van	$ 2 500
Loan from J Smith	$ 1 500
Stock of Goods	$ 1 200

He also had the following source documents:

Purchase Invoices

Your Purchase Order 12/B/124
AJ Wholesale
Factory Road
St. John's
Antigua

7-Sep-06
To: MJ Retailers
Hilda Davis Drive
St. John's
INVOICE NO. 1654

Quantity		Per Unit	Total
		$	$
7	cases fruit juices	35.00	245.00
4	cases ideal milk	24.00	96.00
			341.00
	less 20% Trade Discount		68.20
			272.80

7 September - Purchase goods on credit form AJ Wholesale $272.80

Your Purchase Order 12/B/123
A M Byden
Fort Road
St. John's
Antigua

09-Sep-06
To: MJ Retailers
Hilda Davis Drive
St. John's
INVOICE NO. 234

Quantity		Per Unit	Total
		$	$
5	cases fruit juices	35.00	175.00
3	cases ideal milk	24.00	72.00
2	cases tomato paste	32.00	64.00
			311.00
	less 20% Trade Discount		62.20
			248.80

9 September - Purchased goods on credit from A M Byden $248.80

Sales Invoices

Your Sales Order 12/B/123
MJ Retailers
Hilda Davis Drive
St. John's
Antigua

25-Sep-06
To: Malika Diantha
Green Bay
St. John's

INVOICE NO. 5324

Quantity		Per Unit	Total
		$	$
6	cases fruit juices	36.50	219.00
3	cases ideal milk	23.95	71.85
4	cases tomato paste	33.00	132.00
			422.85

25 September - Sold goods on credit to Malika Diantha $422.85

Your sales Order 12/B/124
MJ Retailers
Hilda Davis Drive
St. John's
Antigua

27-Sep-06
To: Oren Peters
Pigotts
St. John's

INVOICE NO. 249

Quantity		Per Unit	Total
		$	$
3	cases fruit juices	35.00	105.00
2	cases ideal milk	24.00	48.00
3	cases tomato paste	32.00	96.00
			249.00

27 September - Sold goods on credit to Oren Peters $249.00

Debit Notes

			J Retailers Hilda Davis Drive St. John's Antigua 16-Sep-06
To:	A.M Byden Fort Road St. John's		
	DEBIT NOTE NO. 236		
Quantity		**Per Unit**	**Total**
		$	$
2	cases fruit juices	35.00	70.00
1	case ideal milk	24.00	24.00
			94.00

7 September - MJ Retailers returned goods to AM Byden $94

			J Retailers Hilda Davis Drive St. John's Antigua 16-Sep-06
To:	AJ Wholesale Long Street St. John's		
	DEBIT NOTE NO. 237		
Quantity		**Per Unit**	**Total**
		$	$
1	cases fruit juices	35.00	35.00
1	case ideal milk	24.00	24.00
			59.00

25 September - MJ Retailers returned goods to AJ Wholesale $59

Credit Notes

			MJ Retailers Hilda Davis Drive St. John's Antigua 23-Sep-06
To:	Malika Diantha Green Bay St. John's		
	CREDIT NOTE NO. 1235		
Quantity		**Per Unit**	**Total**
		$	$
2	case ideal milk	24.00	48.00
1	case tomato paste	32.00	32.00
			80.00
	Less 10 % trade discount		8.00
			72.00

23 September - A customer Malika Diantha returned goods to MJ Retailers $72.00

			MJ Retailers Hilda Davis Drive St. John's Antigua 29-Sep-06
To:	Oren Peters Pigotts St. John's		
	CREDIT NOTE NO. 1236		
Quantity		Per Unit	Total
		$	$
3	cases fruit juices	35.00	105.00
2	case ideal milk	24.00	48.00
			153.00
	Less 10 % trade discount		15.30
			137.70

29 September - Oren Peters returned goods $137.70 to MJ Retailers

Cash Receipt

				Number 00125
				Date 21 Sept 2006

Cash Sales Receipt

Name Makayla Adora
Address 12 Old Road
Urlings

Sold By	**Cash**	**C.O.D**	**Charge**	**On Account**	**Paid Out**

Quantity	**Description**	**Price**	**Amount**
2	Cases milk	24.00	48.00
Received by		**Subtotal**	48.00
______________________________		**Tax**	
		Total	48.00

21 September - Cash Sales $48

				Number 00105
				Date 30 Sept 2006

Cash Sales Receipt

Name Prosper Thomas
Address 10 anchorage Road
Point Edge

Sold By	**Cash**	**C.O.D**	**Charge**	**On Account**	**Paid Out**

Quantity	**Description**	**Price**	**Amount**
3	Cases milk	24.00	72.00
1	Cases Tomato Paste	32.00	32.00
Received by		**Subtotal**	104.00
______________________________		**Tax**	
		Total	104.00

30 September - Cash Sales $104

Cheques

Dollar Bank

High Street
St. John's
Antigua

Date 25 September 2006

PAY *A M* Byden $ 100.00

One Hundred

MJ Retailers
Hilda Davis Drive
St. John's
Antigua

M John

O00-0009-00987-0124

25 September - Paid A M Byden $100 by cheque

Dollar Bank

High Street
St. John's
Antigua

Date 27 September 2006

PAY AJ Wholesale $ 75.00

Seventy-Five .

MJ Retailers
Hilda Davis Drive
St. John's
Antigua

M John

O00-0009-00987-0125

27 September - Paid AJ Wholesale $75 by cheque.

Record the above source documents in the Books of Original Entry for MJ Retailers.

General Journal

Let us begin with the General Journal. Remember that one of uses of the General Journal is to record opening entries of the business. The opening entries for MJ Retailers are recorded in the Journal below

General Journal				
Date	**Details**	**Folio No.**	**Debit**	**Credit**
2006			**$**	**$**
1Sept	Cash	CB	150.00	
	Bank	CB	800.00	
	Motor Van	GL	2 500.00	
	Loan: J Smith	PL		1 500.00
	Equipment	GL	1 200.00	
	***Capital**	GL		**3 150.00**
	Assets and Liabilities as at 1 Sept 2006		**4 650.00**	**4 650.00**

*The capital figure is calculated by using the accounting equation.

The figures in this general journal will be transferred as the opening balances in the respective accounts in the ledgers.

Sales Journal

The Sales Journal records the information from the sales invoice. It is a list of our customers who purchase our goods and services on credit. The total of the sales journal is transferred to the sales account in the general ledger.

Sales Journal				
Date	**Details**	**Folio No.**	**Invoice No.**	**Amount**
2006				$
Sept 25	Malika Diantha	SL	5324	422.85
Sept 27	Oren Peters	SL	249	249.00
	Total Credit Sales for the month	GL		**671.85**

Purchase Journal

The Purchases Journal is used to record all stock or inventory purchased on credit for resale. It lists our suppliers we purchase goods and services from on credit. The total of the purchases journal is transferred to the purchases account in the general ledger.

Purchases Journal				
Date	**Details**	**Folio No.**	**Invoice No.**	**Amount**
2006				$
Sept 7	AJ Wholesale		1654	272.80
Sept 9	A M Byden		234	248.80
	Total Credit Purchases for the month			**521.60**

Sales Return Journal

Information from your credit notes is recorded in your sales return journal. The total of this journal is then transferred to the sales return account in the general ledger.

Sales Return Journal				
Date	**Details**	**Folio No.**	**Note No.**	**Amount**
2006				$
Sept 23	Malika Diantha	SL	1235	72.00
Sept 29	Oren Peters	SL	1236	137.70
	Total Sales Return	GL		**209.70**

Purchases Return Journal

The debit note information is recorded in the purchases return journal and the total is transferred to the purchases return account in the general ledger.

Purchase Return Journal				
Date	**Details**	**Folio No.**	**Note No.**	**Amount**
				$
Sept 17	A M Byden	PL	236	94.00
Sept 25	AJ Wholesale	PL	237	59.00
	Total Purchases Returns	GL		**153.00**

Cash Book

The Cash Book is special in a number of ways:

1. All cash and bank transactions are recorded in the cash book.
2. Entries are made in the cash book on almost a daily basis and therefore these entries are similar to journal entries.
3. The cash book acts as a book of original entry or journal and is also part of the double entry system.
4. The cash book has its own particular format, which is a columnar T-Account format.
5. Cash discounts allowed and received are recorded in the cash book put posted to accounts in the general ledger.
6. The cash book is used strictly for transactions that involve the immediate transfer of cash, which makes it easier to track the inflows and outflows of cash.

The Cash Book is written up from information provided by several source documents, which include

- Cash bills and receipts
- cheques
- cash vouchers
- credit and debit card receipts

Bank Statement Cash Book											
Date	**Details**	**Folio**	**Discount**	**Cash**	**Bank**	**Date**	**Details**	**Folio**	**Discount**	**Cash**	**Bank**
2006			**$**	**$**	**$**	**2006**			**$**	**$**	**$**
01 Sept	Balance	b/d		150.00	800.00	25 Sept	A M Byden				100.00
21 Sept	Sales			48.00		27 Sept	AJ Wholesale				75.00
30 Sept	Sales			104.00							

TOPIC SUMMARY

In this topic, you studied source documents and the information contained and also the books of original entry their content and uses.   You learned to identify different source documents and transfer the information from these source documents to the relevant books of original entry.

UNIT ASSIGNMENT

Unit 2 Assignment A

A sole trader has the following opening balances at the beginning of November 2008

		$
Motor Van		1 500
Bank		2 910
Cash		2 600
Premises		2 000
Fixtures		600
Stock		1 289
Debtors:	H. Woods	120
	J Benjamin	40
	H Ross	180
Creditors:	A. Jackson	200
	L Luke	60
Loan:	R. Richardson	4 000

During the month of September the following transactions occurred.

Nov	1	Receipt for rent paid by Cheque $15
	2	Bought good on credit from A. Jackson $20, L Luke $38, C Harris $56, F. Walker $69
	3	Paid motor expenses in cash $13
	4	Antigua Commercial Bank Deposit slip for $1000
	5	Sold good on credit to J Benjamin $56, H. Ross $78, A Lewis $98, J Jacobs $118
	6	Good returned to A. Jackson $15, F. Walker $12
	7	Paid staff by cheque $150
	8	Bought a motor van on credit from Hadeed Motors $500
	9	Goods returned to us by A Lewis $14
	10	Sales Invoices A Lewis $25, J Benjamin $15
	11	Credit notes: J Benjamin $10, J Jacobs $25
	15	Debit note C Harris $10
	16	Repaid R Richardson $175 by cheque
	18	Cash Sales $250
	19	Purchase goods by cheque $300 receiving a 5% cash discount
	20	Receipt for rent paid by cheque $100
	21	Antigua Commercial Bank deposit slip for $500
	22	Paid carriage $218 by cash
	23	H. Ross paid us in cash $150 receiving a 2% cash discount
	24	The proprietor brought equipment $600 from his personal money for the business.
	25	Cash Sales $ 300

Prepare the relevant books of original entry from the transactions of MMR Retail Store for the month ended 30 November 2008.

TOPIC 2.2 RECORDING BUSINESS FINANCIAL TRANSACTIONS

INTRODUCTION

In this topic, we will examine how to identify business transactions and how to record the transactions in the financial records of your business.

The raw data of accounting are the business transactions. We learned how to record the transactions in Unit One, based on the increases or decreases in the assets, liabilities, and owners' equity items of the accounting equation. This procedure illustrated how various transactions affect the accounting equation. When working through the sample transactions, you should have noted that listing all transactions as increases or decreases in the balance sheet would be too cumbersome in practice. Most businesses, even small ones, enter into many transactions every day. Unit Two will demonstrate how to actually record business transactions in the accounting process.

We will learn how to post the information from the journal to the ledgers. The ledger will then be balanced and a Trial Balance extracted.

OBJECTIVES

Upon completion of this topic you should be able to:

1. Identify business transactions.
2. Record transactions in a double entry set of books.
3. Define an account.
4. State the steps in the recording business transactions.
5. Identify the effects of business transactions.
6. Identify the information to transfer to the different ledgers.
7. Record merchandising transactions in the ledgers.
8. Record accounts receivable and accounts payable transactions.
9. Record transactions for assets, liabilities and owners' equity.

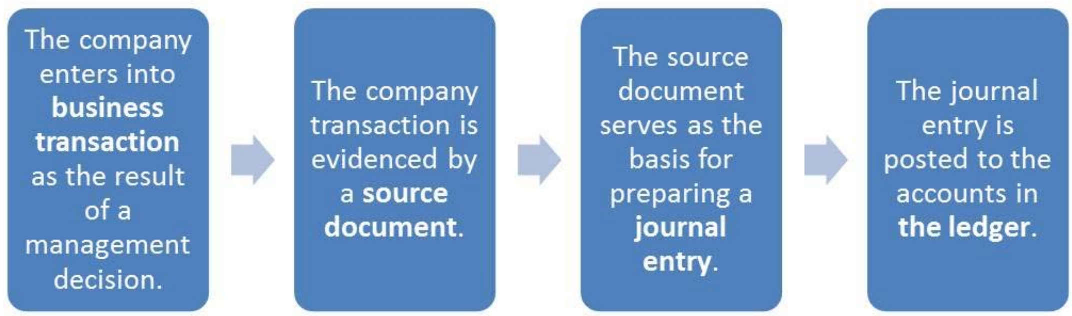
BUSINESS TRANSACTIONS

To explain the dual procedure of recording business transactions with debits and credits, you need to understand how to use the following new tools: the T-account, the journal, and the ledger. Using these tools, you can follow your business through its various business transactions. Like accountants, you can use a trial balance to check the equality of your recorded debits and credits. Understanding this system enables you to better understand the content of financial statements so you can use the information provided to make informed business decisions.

The Account and Rules of Debit and Credit

A business may engage in thousands of transactions during a year. An accountant classifies and summarizes the data in these transactions to create useful information. Business transactions are measurable events that affect the financial condition of a business.

Illustration 2.1 – The Steps in Recording and Posting the Effects of a Business Transaction



Look at illustration 2.1 and observe the steps in recording and posting the effects of a business transaction. Note that source documents provide the evidence that a business transaction occurred. These source documents include such items as bills received from suppliers for goods or services received, bills sent to customers for goods sold or services performed and cash register tapes. The information in the source document serves as the basis for preparing a journal entry. Then a firm posts (transfers) that information to accounts in the ledger. You can see from the illustration that after you prepare the journal entry, you post it to the accounts in the ledger.

However, before you can record a journal entry, you must understand the rules of debit and credit. To understand these rules, you must first understand the nature of an account.

Most business transactions are repetitive. This makes the task of accountants somewhat easier because they can classify the transactions into groups having common characteristics. For example, a business may have thousands of receipts or payments of cash during a year. Part of every cash transaction must be recorded and summarized in a single place called an account.

An Account

An **account** is a part of the accounting system used to classify and summarize the increases, decreases, and balances of each asset, liability, owners' equity, revenue, and expense items. Businesses set up accounts for each different business element, such as cash, accounts receivable, and accounts payable. Every business has a Cash account in its accounting system because knowledge of the amount of cash on hand is useful information.

Accountants may differ on the account title (or name) they give the same item. For example, one might name an account Notes Payable and another might call it Loans

Payable. Both account titles refer to the amounts borrowed by the business. The account title should be logical to help the accountant group similar transactions into the same account. Once you give an account a title, you must use that same title throughout the accounting records.

The number of accounts in a business's accounting system depends on the information needs by those interested in the business. The main requirement is that each account provides information useful in making decisions. Thus, one account may be set up for all cash rather than having a separate account for each form of cash (coins on hand, currency on hand, and deposits in banks). The amount of cash is useful information; the form of cash often is not.

To illustrate recording the increases and decreases in an account, texts use the **T-account**, which looks like a capital letter T. The name of the account, such as Cash, appears across the top of the T. We record increases on one side of the vertical line of the T and decreases on the other side. A T-account appears as follows:

Debit (Dr) Cash **Credit (Cr)**

Dr **Cash** **Cr**

Date	Details	Folio	Amount	Date	Details	Folio	Amount

- D
-
- Date - day, month, year.
- Details – account titles are written here.
- Folio - this is a reference column showing the journal page to which each entry is transferred from.
- Amount - the monetary amount is shown.

Accountants use the term **debit** instead of saying, "Place an entry on the left side of the T-account". They use the term **credit** for "Place an entry on the right side of the T-account". Debit (abbreviated Dr) simply means left side; credit (abbreviated Cr) means right side. Thus, for all accounts a debit entry is an entry on the left side, while a credit entry is an entry on the right side.

After recognizing a business event as a business transaction, you must analyse it to determine if it is an increase or decrease effect on the assets, liabilities owners' equity items, revenues, or expenses of the business. Then you must translate these increase or decrease effects into debits and credits.

The accounting requirement that each transaction be recorded by an entry that has equal debits and credits is called **double-entry procedure**, or duality. This double-entry procedure keeps the accounting equation in balance.

The dual recording process produces two sets of accounts—those with debit balances and those with credit balances. The totals of these two groups of accounts must be equal. Then, some assurance exists that the arithmetic part of the transaction recording process has been properly carried out. Below is an example of how to record business transactions in T-accounts using debits and credits.

While recording business transactions, remember that the foundation of the accounting process is the following basic accounting equation:

Assets = Liabilities + Owners' Equity

Recording transactions into the T-accounts is easier when you focus on the equal sign in the accounting equation. Assets, which are on the left of the equal sign, increase on the left side of the T-accounts. Liabilities and owners' equity, to the right of the equal sign, increase on the right side of the T-accounts. Remember the left side of the T-account is the debit side and the right side is the credit side. So you should be able to fill in the rest of the rules of increases and decreases by deduction, such as:

Dr	Assets	Cr
Increase		Decrease

Examples of Asset Accounts – Motor Vehicle Expenses, Equipment, Building, Goodwill, Copyrights, Cash, Accounts Receivable, Stock of Goods, Cash in Bank.

Dr	Liabilities	Cr
Decrease		Increase

Examples of Liability Accounts – Accounts Payable, Notes Payable or Loans, Mortgage.

Dr	Owners' Equity	Cr
Decrease		Increase

Dr	Revenue Amounts	Cr
Decrease		Increase

Examples of Revenue Accounts – Discount Received, Commission Received, Interest Received and Rent Received.

Dr	Expense Accounts	Cr
Increase		Decrease

Examples of Expense Accounts – Rent Payable, Salaries and Wages, Commission Payable, Interest Payable, Discount Allowed.

To summarize:

- Assets increase by debits (left side) to the T-account and decrease by credits (right side) to the T-account.
- Liabilities and owners' equity decrease by debits (left side) to the T-account and increase by credits (right side) to the T-account.
- Owners' equity decrease by debits and increase by credits
- Record increases in revenues on the right (credit) side of the T-account and decreases on the left (debit) side. The reasoning behind this rule is that revenues increase retained earnings, and increases in retained earnings are recorded on the right side.
- Record increases in expenses on the left (debit) side of the T-account and decreases on the right (credit) side. The reasoning behind this rule is that expenses decrease retained earnings, and decreases in retained earnings are recorded on the left side.
- Applying these two rules keeps the accounting equation in balance. Now we apply the debit and credit rules for assets, liabilities, and owners' equity to business transactions.

REMEMBER EVERY BUSINESS TRANSACTION SHOULD HAVE A DEBIT AND CREDIT ENTRY IN THE ACCOUNTS.

Let's record a list of transactions for ORE Retail for the month of February 2011 in their various accounts.

Dr			**Owners' Equity**				CR
Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
				Feb 1	**Cash**	**CB**	**15, 000**

1 Feb - Started business with $15, 000 in cash

- o **Debit** Cash Account
- o **Credit** Owners' Equity Account (Capital Account)

Dr **Cash** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 1	**Owners' Equity**	**GL**	**15, 000**				

The money invested to start a business is recorded in the Owners' Equity Account. This will need an increase in that account and also an increase in the cash account. To increase the Cash (which is an asset account) you debit that account as illustrated above. To increase the owners' equity account you credit that account.

Feb 4 **Bought a Motor Vehicle paying by cash $2,000**

- o **Debit** Motor Vehicle Account
- o **Credit** Cash Account

Dr **Motor Vehicle** **CR**

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 4	**Cash**	**CB**	**2, 000**				

Dr **Cash** **CR**

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 1	Owners' Equity	GL	15, 000	**Feb 4**	**Motor Vehicle**	**GL**	**2,000**

Because you have taken $2,000 out of your cash account to pay for the Motor Vehicle your cash amount has decreased. This is indicated by a credit entry in your cash account. By purchasing that motor vehicle you have increase your motor vehicle account. This is done by a debit entry in the Motor Vehicle accounts. Both the motor vehicle and the cash accounts are asset accounts.

Feb 8 Deposited $5, 000 of the cash into a bank account

- **Debit** Cash at Bank Account
- **Credit** Cash Account

Dr **Cash at Bank** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 8	**Cash**	**CB**	**5, 000**				

Dr **Cash** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 1	Owners' Equity	GL	15, 000	Feb 4	Motor Vehicle	GL	2,000
				Feb 8	**Cash at Bank**	**CB**	**5,000**

Your Cash Account is being further reduced by taking some of the cash in that account and depositing it into the cash at bank account, which is now being increased.

Feb 12 He paid his supplier Bargain Wholesale owed $1200 by cheque.

- **Debit** Bargain Wholesale Account
- **Credit** Cash at Bank Account

Dr **Cash at Bank** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 8	Cash	CB	5, 000	**Feb 12**	**Bargain Wholesale**	**PL**	**1,200**

Dr **Bargain Wholesale** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 12	**Cash at Bank**	**CB**	**1,200**				

Bargain wholesale is a supplier that you owed money that makes it a liability to you. Because you are paying them the liability is decreasing, therefore, a debit entry is needed in bargain wholesale account and a credit entry in the cash at bank account to reflect the payment being made from your cash at bank account by cheque.

Feb 15 Paid rent $500 by cash

- **Debit** Rent Account
- **Credit** Cash Account

Dr **Rent** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 15	**Cash**	**CB**	**500**				

Dr **Cash** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 1	Owners' Equity	GL	15, 000	Feb 4	Motor Vehicle	GL	2,000
				Feb 8	Cash at Bank	CB	5,000
				Feb 15	**Rent**	**GL**	**500**

Rent is an expense account, which should be debited to indicate that the expense has been paid. Your cash account is credited to indicate that funds were taken from the cash account to pay the rent.

Feb 20 Received $150 interest on you cash at bank account

- **Debit** Cash at Bank Account
- **Credit** Interest Received Account

Dr **Cash at Bank** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 8	Cash	CB	5, 000	Feb 12	Bargain Wholesale	PL	1,200
Feb 20	**Interest Received**	**GL**	**150**				

Dr **Interest Received** CR

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			$	2011			$
Feb 12	Cash at Bank	CB	1,200	**Feb 20**	**Cash at Bank**	**CB**	**150**

Interest Received is additional revenue received from your bank as an incentive for doing business with them. This account should be credited to indicate the receipt of the additional amount. Your cash at bank account is also increased by an additional $150 indicated by the entry in the account.

TYPES OF LEDGERS

The information in the various Journals is transferred to the ledgers. There are three types of ledgers.

1. **Sales Ledger**

   In the sales ledger are the individual accounts of your Accounts Receivable (Debtors). The information in these accounts are derived from the Sales Journal and the Sales Return Journal

2. **Purchases Ledger**

   The individual accounts of your Accounts Payable (Creditors). The information in the Purchase Journal or Purchases Return Journal is transferred to this Ledger.

3. **General Ledger**

   All other accounts not recorded in the Sales or Purchase Ledger is recorded in the General Ledger.

MERCHANDISING TRANSACTIONS

Merchandising Transactions requires that you understand how to record the asset of stock. The asset of stock is recorded in four different accounts. These accounts are purchases, sales, sales return and purchases accounts. Let us first look at a definition for these terms and then the use of the accounts.

Purchases, in the accounting sense, are only those items of merchandise inventory that a firm buys to resell to customers in the normal course of business.

Purchases Return – Merchandise purchased for resale would not always be as what the buyer expects. In this regard, buyers can return goods purchased due to a lot of reasons, for example, due to defects, wrong specifications, poor quality, etc. When merchandise bought is returned, or an allowance is requested, the buyer informs the seller in writing. The communication is done usually through the buyer's printed business form called debit note.

Sales, on the other hand, represent the selling price of merchandise previously bought and then sold. In the income statement, Sales is shown as an income item from which the cost of goods sold (consisting of merchandise inventory beginning and end and net cost of purchases), was deducted, the difference being the gross profit.

Sales Return - When the customer returns goods to the seller or requests for a deduction from the price of the goods delivered to him, the seller accepts the return or grants the request through a credit note.

The sale of merchandise may be for cash or on account. An invoice supports every sale. The seller's sales invoice is the buyer's purchase invoice. When a sale is for cash, the seller receives money in return for his merchandise. When the sale is made on credit, the seller acquires a receivable or right to collect from the buyer.

The uses of the merchandising accounts are:

1. **Sales Account** – Sales of merchandise are recorded in this account at selling prices. This is a temporary or nominal account representing income from selling of merchandise. This account has a normal credit balance.

2. **Purchases Account** – This is a temporary account to which the cost of goods bought during the period is debited. This account usually has a debit balance at the end of the accounting period.

3. **Sales Return Account** – This account is debited for all the merchandise returned by customers. The debit entry is at the original selling price of the merchandise. This account is also being used for all goods delivered to customers but is found to be defective or not as ordered and still the buyer desiring to retain the goods as is. The customer in this case is normally permitted to deduct a certain amount from the selling prices of the goods delivered.

4. **Purchases Return Account** – Goods bought and returned to supplier, or goods bought and received as defective, or not as ordered, when not returned to the supplier but is subjected to a certain reductions from their acquisition prices. These deductions and returns of purchased goods are credited to this account. Purchase returns and allowances account is a deduction from the Purchases account.

These accounts were briefly looked at above but let us now have a further look at these accounts as we take into account the double entries needed to record both credit and cash transactions in these accounts.

Purchases Transactions
Accounting Entries Used to Record the Purchase and Payment of Goods

1) When goods are purchased with cash, the following entry is necessary:

   - **Debit** **Purchases**
   - **Credit** **Cash**

2) When goods are purchased on credit, the following entry is necessary:

   - **Debit** **Purchases**
   - **Credit** **Accounts Payable**

3) When goods are purchased on credit, but are paid back early due to a cash discount incentive, the following entry is necessary.

   - **Debit** **Accounts Payable**
   - **Credit** **Cash**
   - **Credit** **Purchases Discount (discount received).**

Purchases Discounts (Discount Received)

A seller will often offer a cash discount to the buyer for an early payment. Credit terms are the conditions for the payment agreed upon by the buyer and the seller. Cash discounts are stated in a fractional form with the percentage of discount in the numerator and the number of days in the denominator. The credit period, or number of days a buyer can pay without incurring a finance charge, is stated in NET days or n/days.

Example

Terms 3/15, n/60 means a buyer will receive a 3% cash discount if paid within 15 days of the invoice date, and the buyer has a maximum of 60 days to pay the entire debt amount.

Purchases Returns Rules For Recording Returns For Goods Purchased On Credit

1) If merchandise is returned or a price adjustment is necessary, the buyer should.

   - **Debit** **Accounts Payable**
   - **Credit** **Purchases Returns account**

2) When the returned goods were purchased on credit, and a cash discount for early payment is available, the discount only applies to the price of the goods that are kept, (in addition, discounts are not taken on freight costs).

Sales Accounting

When goods are sold for cash or on credit, the Sales account should be credited. To encourage early payment of goods purchased on credit, the seller will often offer a cash discount. These discounts are recorded in the Sales Discounts Account (Discount Allowed). When goods are returned or an allowance is requested, the adjustment is made to the Sales Returns account. All sales discounts, returns, and allowances reduce sales revenues.

Sales Accounting - Rules for Recording Sales Transactions

1) When goods are sold and payment is made in cash.

   - **Debit** **Cash**
   - **Credit** **Sales**

2) When goods are sold on credit.

- o **Debit** **Accounts Receivable**
- o **Credit** **Sales**

Sales Accounting - Recording Sales Discounts

3) When a buyer takes advantage of a cash discount.

- o **Debit** **Cash**
- o **Debit** **Sales Discount (Discount Allowed)**
- o **Credit** **Accounts Receivable**

Example

Invoice for $950 with terms 3/15, n/30 is paid early by the buyer.

- o **Debit** Cash $921.50
- o **Debit** Sales Discount $28.50
- o **Credit** Accounts Receivable $950

SALES ACCOUNTING - RECORDING SALES RETURNS

When a seller grants a return or an allowance,

- o **Debit** **Sales Returns**
- o **Credit** **Accounts Receivable**

A buyer of goods can only take a cash discount on the goods that are actually kept (cash discounts do not apply to freight either).

Example

A seller issues a credit note for $70 of goods that were not ordered by ABC company. If the return is granted, the following entry is necessary.

Debit Sales Returns $70
Credit Accounts Receivable ABC company $70

SALES ACCOUNTING

Manufacturers and wholesalers often reduce catalogue list prices by allowing trade (or quantity) discounts. The discounts vary depending on customer and order size. Trade discounts permit flexible prices without having to print new catalogues. Trade discounts are not reflected in accounting records, only the agreed upon price between a buyer and seller is recorded.

TRANSPORTATION COSTS

Whenever goods are sold, the buyer and the seller must agree upon who pays shipping costs. When goods are shipped FOB shipping point, the buyer agrees to pay for shipping costs and ownership passes to the buyer when the merchandise is delivered to the shipper. When goods are shipped FOB destination, the seller agrees to pay for transportation costs and ownership of goods passes to the buyer when the goods are delivered.

ACTIVITY 2 - A

A Local Book Shop ordered 600 copies of an introductory accounting textbook from a publisher on March 21, 2011. The books were delivered on September 12, at which time a bill was sent requesting payment of $60 per book. However, a 5% discount was allowed if the publisher received payment by October 15. Local Book Shop sent the proper payment, which was received by the Publisher on October 10. On December 18, Local Book Shop returned 60 books to the publisher for a full cash refund.

1. Prepare the journal entries (if any) for the publisher on
    a. March 21
    b. September 12
    c. October 10
    d. December 18. Include appropriate narratives.

ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE

These accounts deal with our debtors (customer who we sell our goods and service to on credit) and our creditors (suppliers we purchase our goods and services from on credit). The list of your accounts receivables account are recorded in your Sales Ledger and Accounts Payable accounts in your Purchases Ledger

Let us now continue with our worked example from Topic 2.1 above. You now need to transfer the information in the various journals to the different ledgers and accounts.

Begin with the Sales and Sales Return Journals. The information included in these two journals is transferred to the respective accounts in the sales ledger with the totals transferred to the general ledger.

Sales Journal				
Date	**Details**	**Folio No.**	**Invoice No.**	**Amount**
2006				$
Sept 25	Malika Diantha	SL	5324	422.85
Sept 27	Oren Peters	SL	249	249.00
	Total Credit Sales for the month	GL		**671.85**

Sales Return Journal				
Date	**Details**	**Folio No.**	**Note No.**	**Amount**
2006				$
Sept 23	Malika Diantha	SL	1235	72.00
Sept 29	Oren Peters	SL	1236	137.70
	Total Sales Return	GL		**209.70**

Sales Ledger

Oren Peters

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 27	Sales	SJ	249.99	Sept 29	Sales Returns	SRJ	137.70

Malika Diantha

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 25	Sales	SJ	422.85	Sept 23	Sales Return	SRJ	72.00

Purchases Journal				
Date	Details	Folio No.	Invoice No.	Amount
2006				$
Sept 7	AJ Wholesale		1654	272.80
Sept 9	A M Byden		234	248.80
	Total Credit Purchases for the month			**521.60**

Purchase Return Journal				
Date	Details	Folio No.	Note No.	Amount
				$
Sept 17	A M Byden	PL	236	94.00
Sept 25	AJ Wholesale	PL	237	59.00
	Total Purchases Returns	GL		**153.00**

Purchases Ledger							
A.M. Bryden							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
Sept 17	Purchases Return	PRJ	59.00	Sept 9	Purchases	PJ	248.80
Sept 25	Bank	CB	100.00				
AJ Wholesale							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
Sept 25	Purchases Return	PRJ	94.00	Sept 7	Purchases	PJ	272.80
Sept 27	Bank	CB	75.00				
J Smith							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
				Sept 1	Balance	b/d	1 500.00

General Journal				
Date	**Details**	**Folio No.**	**Debit**	**Credit**
2006			**$**	**$**
1 Sept	Cash	CB	150.00	
	Bank	CB	800.00	
	Motor Van	GL	2 500.00	
	Loan: J Smith	PL		1 500.00
	Equipment	GL	1 200.00	
	***Capital**	GL		**3 150.00**
	Assets and Liabilities as at 1 Sept 2006		**4 650.00**	**4 650.00**

General Ledger

Motor Van

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 1	Balance	b/d	2 500.00				

Capital

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
				Sept 1	Balance	b/d	3 150.00

Equipment

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 1	Balance	b/d	1 200.00				

Sales Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
				Sept 21	Cash	CB	48.00
				Sept 30	Cash	CB	104.00
				Sept 30	Total Credit Sales	SJ	671.85

Purchases Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 30	Total Credit Purchases	PJ	521.60				

Sales Return Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 30	Total Returns	SRJ	209.70				

Purchases Return Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
				Sept 30	Total Returns	PRJ	153.00

Cash Book

Date	Details	Folio	Discount	Cash	Bank	Date	Details	Folio	Discount	Cash	Bank
2006			**$**	**$**	**$**	**2006**			**$**	**$**	**$**
Sept 1	Balance	b/d		150.00	800.00	Sept 25	AM Byden	PL			100.00
Sept 21	Sales	SL		48.00		Sept 27	AJ Wholesale	PL			75.00
Sept 30	Sales	SL		104.00							

UNIT ASSIGNMENT

Unit 2 Assignment B
Using your answers from Unit 2 Assignment A, prepare the double entry accounts for MMR Retail Store for the month of November 2008.

TOPIC SUMMARY

You would have observed from the examples given in this unit that the accounts on the balance sheet are affected by business transactions. In this unit we looked at the entries required to record different business transaction in a business. You would have learnt that every transaction affects two accounts one account is debited and the other credited. You would have also looked at the necessary entries needed to increase and decrease each type of account.

We have completed the double entry recording of different types of accounts and transactions. We can now continue by balance off these accounts to determine the balance on the accounts to be transferred to the trial balance.

TOPIC 2.3 BALANCING OFF ACCOUNTS

INTRODUCTION

We will now continue from where we left off in topic 2.2. In order for us to generate a trial balance we first need to balance off the ledger accounts. Balancing the accounts simply means that both the debit and credit side of each account should be equal.

OBJECTIVES

Upon completion of this topic you should be able to:

1. State what balancing off means.
2. list the steps of balancing off an account.
3. identify what figures are transferred to the income statement and the balance sheet.

BALANCING THE BOOKS

At the end of the financial accounting period a business must balance its books – the first step to summarizing and analyzing the financial position and income of the business. You have identified two sides of a ledger – a debit and a credit. All of your debit entries must equal your credit entries. You must balance off an account by taking a figure to the financial statements. All ledger accounts must be balances at the end of a period. Revenue and expense accounts do not have a brought down balance, since they are closed off and the figure transferred to the income statement. Other types of accounts use a balance brought down in order to determine the opening balance of the account in the subsequent trading period.

Steps to balancing off the accounts

1. Calculate the total of both side of the account (one side in the case of revenue and expense accounts.
2. The larger of the two totals are place in the total boxes on both side of the account (debit and credit totals). If the debit total is greater than the credit total then the account has a debit balance and vice versa for the credit balance.
3. You balance your account by introducing your balancing figure (which the difference between the largest and smaller figure) on the side the smallest amount. This figure should be your balance carried down at the end of the period and would be brought down at the start of the next period. The balances carried down figures are those that affect the balance sheet.
4. You bring down the balancing figure by going to the opposite side of the account and detailing the balance brought down, which is the same figure as the balance carried down figure. The balancing figure appears before the total boxes while the brought down figure appear under the total boxes on the opposite side to that of the balancing figure.

5. For revenue and expense accounts the difference between both sides of the account is the figure to be transferred to the income statement.

Balance sheet accounts have balancing figures, but revenue and expenses account do not. This is because the figures for revenue, expenses and drawing, when they are aggregated and offset in the income statement, to adjust the capital accounts. As such, the balances of those accounts appear in the capital account in the following period and do not just disappear in the next accounting period.

Now let's balance off the accounts in unit 2.2

Sales Ledger

Oren Peters

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 25	Sales	SJ	249.00	29-Sep	Sales Returns	SRJ	137.70
				30-Sep	Balance	c/d	111.30
			249.00				249.00
1-Oct	Balance	b/d	111.30				

Malika Diantha

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
Sept 30	Sales	SJ	422.85	23-Sep	Sales Return	SRL	72.00
				30-Sep	Balance	c/d	350.85
			422.85				422.85
1-Oct	Balance	b/d	350.85				

Purchases Ledger

A.M. Bryden

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
25-Sep	Bank	CB	100.00	9-Sep	Purchases	PJ	248.80
26-Sep	Purchases Return	PRJ	59.00				
30-Sep	Balance	c/d	89.80				
			148.80				248.80
				1-Oct	Balance	b/d	89.80

AJ Wholesale

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
17-Sep	Purchases Return	PRJ	94.00	7-Sep	Purchases	PJ	272.80
27-Sep	Bank	CB	75.00				
30-Sep	Balance	c/d	103.80				
			272.80				272.80
				1-Oct	Balance	b/d	103.80

J Smith

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
30-Sep	Balance	c/d	1 500.00	1-Sep	Balance	b/d	1 500.00
				1-Oct	Balance	b/d	1 500.00

General Ledger

Sales Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
				21-Sep	**Cash**	**CB**	**48.00**
				30-Sep	**cash**	**CB**	**104.00**
30-Sep	Income Statement		823.85	30-Sep	Total Credit Sales	SJ	671.85
			823.85				823.85
				1-Oct	Balance	b/d	823.85

Purchases Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
30-Sep	Total Credit Purchases	PJ	521.60	30-Sep	Income Statement		521.60
1-Oct	Balance	b/d	521.60				

Sales Return Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2006			**$**	**2006**			**$**
30-Sep	Total Returns	SRJ	209.70	30-Sep	Income Statement		209.70
1-Oct	Balance		209.70				

Purchases Return Account							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
30-Sep	Income Statement		153.00	Sept 30	Total Returns	PRJ	153.00
				1-Oct	Balance		153.00

Motor Van							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
1-Sep	Balance	b/d	2 500.00	30-Sep	Balance	c/d	2 500.00
1-Oct	Balance	b/d	2 500.00				

Equipment							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
1-Sep	Balance	b/d	1 200.00	30-Sep	Balance	c/d	1 200.00
1-Oct	Balance	b/d	1 200.00				

Capital							
Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2006			**$**	**2006**			**$**
30-Sep	Balance	c/d	3 150.00	1-Sep	Balance	b/d	3 150.00
				1-Oct	Balance	b/d	3 150.00

Cash Book											
Date	**Details**	**Folio**	**Discount**	**Cash**	**Bank**	**Date**	**Details**	**Folio**	**Discount**	**Cash**	**Bank**
2006			**$**	**$**	**$**	**2006**			**$**	**$**	**$**
1-Sep	Balance	b/d		150.00	800.00	25-Sep	AM Byden	PL			100.00
21-Sep	Sales	Gl		48.00		27-Sep	AJ Wholesale	PL			75.00
30-Sep	Sales	GL		104.00		30-Sep	Balance	c/d		302.00	625.00
				302.00	800.00					302.00	800.00
1-Oct	Balance	b/d		302.00	625.00						

Take note that at the end of the month those accounts with balances to be transferred to the Income Statement use the word income statement instead of balance c/d.

UNIT ASSIGNMENT

Unit 2 Assignment C

Let us continue the unit 2 assignment from topic 2.1 and 2.2. You have recorded the transactions in the books and original entry and post them to the various ledgers. **You now need to balance off those ledger accounts.**

TOPIC SUMMARY

You are doing well. You have balance off your accounts in the various ledgers. With this information you can now prepare your trial balance. You will also be able to determine which final account the balances will be transferred.

TOPIC 2.4 TRIAL BALANCE

INTRODUCTION

Now that we have balanced off our accounts we are now ready to prepare our trial balance. This will be prepared from the balances on the ledger accounts.

OBJECTIVES

Upon completion of this unit you should be able to:

1. Define trial balance.
2. State the uses of the trial balance.

DEFINITION OF TRIAL BALANCE

A Trial Balance is an essential stage in ensuring the accuracy of the book-keeping entries prior to the preparation of the financial statements. The trial balance lists the name of each account together with the balance shown in either the debit or credit columns. (Wood and Robinson, 2007) It is a list of the account balances in your records.

You can extract your trial balance from the balances on your ledger accounts. Before you prepare your trial balance let us look at the uses of the trial balance.

USE OF THE TRIAL BALANCE

According to Wood and Robinson (2007) Trial Balances may be used:

- To check that the books 'balance', i.e. every debit entry has been accompanied by a credit entry.
- To ascertain the net amount of the error(s), should an error(s) have been made.
- As a basis from which the financial statement are prepared.

The trial balance is used to check the arithmetically balance of our accounts. The trial balance has two monetary columns a debit and credit column. You would have seen in your ledger account that some balance b/d are on the debit side of the account and others are on the credit side. When you are transferring the balances from the ledger accounts to the trial balance the balances remain on the same side as the ledger accounts.

Below is the Trial Balance from the examples in this unit. Take note that it should have the following:

1. Heading that states the name of the business, the words Trial Balance as at (the date the trial balance is being prepared).
2. A details column for the name of the accounts
3. Folio column indicating the reference information
4. A debit and credit monetary column

MJ Retailers

Trial Balance

as at 30th September 2006

		Dr.	Cr.
		$	$
Accounts Receivable			
Oren Peters	SL	111.30	
Malika Diantha	SL	350.85	
Accounts Payable			
A.M. Bryden	PL		89.80
AJ Wholesale	PL		103.80
J Smith	PL		1,500.00
Sales	GL		823.85
Purchases	GL	521.60	
Sales Return	GL	209.70	
Purchases Return	GL		153.00
Cash	CB	302.00	
Equipment	GL	1,200.00	
Motor Van	GL	2,500.00	
Capital	GL		3,150.00
Bank	CB	625.00	
		5,820.45	5,820.45

Take not that both columns of your trial balance are equal. The information is recorded on the same side as the balances b/d in the ledger accounts. If your trial balance included expenses and revenue your expenses would be recorded in the debit column and revenue in the credit column.

TOPIC SUMMARY

Upon completion of this topic you should be able to balance your accounts. In addition you should be able to describe how to use the trail balance to help analyze your business activities.

UNIT SUMMARY

We have now completed the bookkeeping stage of the accounting process with our trial balance. Now that you have completed unit two take some time to review the content in both Units One and Two before you proceed to unit 3. It is very important that you fully understand the contents in these two units if you are to understand the information in the upcoming units. Also, review the activities and assignments and check your answers with the answers given.

At this stage you should be able to identify source document and transfer the information to the different books of original entry. You should also be able to post to you ledgers and balance them off and transfer those balances to the Trial Balance. The next step is to examine the adjustments necessary to ensure that your Financial Statements represents a true and fair view of your business.

Self-Reflection Questions

Now that you have completed Unit Two take some time to review the content in both Units One and Two before you proceed to Unit 3. Reflect on these questions:

1. *Do I know who are my accounts receivable and accounts payable?*
2. *Are you able to distinguish between accounts payable and accounts receivable?*
3. *Do you know the entries necessary to increase or decrease the amount on account based on the type of accounts?*
4. *Do you understand when different types of accounts should be debited and when it should be credited?*

UNIT ASSIGNMENT

Unit 2 Assignment D

You can now complete the unit assignment by preparing the Trial Balance from the balances on your ledger accounts.

UNIT REFERENCES

Holdip, G., & Lamorell, C. (2010). Principles of Accounts for CSEC Examinations. Macmillan Publishers Ltd.

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UNIT THREE – FINANCIAL ACCOUNTING AND ADJUSTMENTS

INTRODUCTION

In this unit you will look at the adjustments necessary before your financial statements can be prepared. You would look at the adjustments for prepaid and accrued expenses and revenue, depreciation and disposal of assets, bad debts and provision for bad debts. You will also take a look at the various methods to value closing stock.

OBJECTIVES

Upon completion of this unit you should be able to:

1. Determine the various adjustments necessary before financial statement can be prepared.
2. Make the necessary adjustments for accrued and prepaid expense and revenue accounts.
3. Make adjustments for the depreciation and disposal of fixed assets.
4. Make adjustments for bad debts and provision for bad debts.
5. Identify and prepare different types of financial statements.
6. Illustrate the different layouts for financial statements.

UNIT READINGS

The instructor will provide a list of readings.

ASSIGNMENTS AND ACTIVITIES

The instructor will provide guidance on the type of assignments and instructions.

TOPIC 3.1 DEPRECIATION AND DISPOSAL OF ASSETS

INTRODUCTION

There is a time period attached to the useful life of all assets owned by a business. Since assets depreciates in value as it is being used it can no longer be valued at cost price. In this topic you will calculate depreciation and determine the disposal value of assets.

OBJECTIVES

Upon completion of this topic you should be able to:

1. Define depreciation.
2. State reasons for depreciating assets.
3. Identify methods of calculating depreciation.
4. Determine book value and disposal value of assets.
5. Examine the different methods of calculating depreciation (straight line and diminishing balance method).
6. Show the treatment of depreciation in the financial statements.

WHAT IS DEPRECIATION?

Let us begin by defining depreciation. According to Woods and Robinson (2007), Depreciation is the part of the original purchase cost of a fixed asset consumed during its period of use by the business. It is an expense for services consumed and will be charged to the income statement and will therefore, reduce net profit.

Depreciation is a process of allocation, not valuation. Eventually, all assets except land wear out or become so inadequate or outmoded that they are sold or discarded; therefore, firms must record depreciation on every plant asset except land. They record depreciation even when the market value of a plant asset temporarily rises above its original cost because eventually the asset is no longer useful to its current owner.

CAUSES OF DEPRECIATION

Major causes of depreciation are:

- physical deterioration,
- inadequacy for future needs, and
- obsolescence.

Physical deterioration results from the use of the asset—wear and tear—and the action of the elements. For example, an automobile may have to be replaced after a time because its body rusted out.

Inadequacy of a plant asset is its inability to produce enough products or provide enough services to meet current demands. For example, an airline cannot provide air service for 125 passengers using a plane that seats 90.

Obsolescence of an asset is its decline in usefulness brought about by inventions and technological progress. For example, the development of the xerographic process of reproducing printed matter rendered almost all previous methods of duplication obsolete.

To compute depreciation expense, accountants consider four major factors:

COST OF THE ASSET

- Estimated salvage value of the asset. Salvage value (or scrap value) is the amount of money the company expects to recover, less disposal costs, on the date a plant asset is scrapped, sold, or traded in.
- Estimated useful life of the asset. Useful life refers to the time the company owning the asset intends to use it; useful life is not necessarily the same as either economic life or physical life. The economic life of a car may be 7 years and its physical life may be 10 years, but if a company has a policy of trading cars every 3 years, the useful life for depreciation purposes is 3 years. Various firms express useful life in years, months, working hours, or units of production. Obsolescence also affects useful life.
- Depreciation method used in depreciating the asset. We describe the four common depreciation methods in the next section.

HOW IS DEPRECIATION CALCULATED?

In order to have free and fair view of the Balance Sheet it is important that the assets on the balance sheet are correctly valued.

Today, businesses can use many different methods to calculate depreciation on assets. This section discusses and illustrates the two most common methods—straight-line, and reducing balance method.

According to accounting theory, a business should use a depreciation method that reflects most closely their underlying economic circumstances. Thus, businesses should adopt the depreciation method that allocates asset cost to accounting periods according to the benefits received from the use of the asset.

Before studying some of the methods that companies use to depreciate assets, make sure you understand the following definitions.

- **Useful life** is an estimate of the productive life of an asset. Although usually expressed in years, an asset's useful life may also be based on units of activity, such as items produced, hours used, or miles driven.

- **Salvage value** equals the value, if any that a company expects to receive by selling or exchanging an asset at the end of its useful life.
- **Depreciable cost** equals an asset's total cost minus the asset's expected salvage value. The total amount of depreciation expense assigned to an asset never exceeds the asset's depreciable cost.
- **Net book value** is an asset's total cost minus the accumulated depreciation assigned to the asset. Net book value rarely equals market value, which is the price someone would pay for the asset. In fact, the market value of an asset, such as a building, may increase while the asset is being depreciated. Net book value simply represents the portion of an asset's cost that has not been allocated to expense. (CliffsNotes.com. *Depreciation of Operating Assets*. 18 Apr 2011)

STRAIGHT-LINE DEPRECIATION

This is the method most commonly used by businesses for financial reporting. In this method the assets annual depreciation expense is calculated by dividing the assets cost by the number of years of useful life of the assets. Equal amount is transferred to the income statement for depreciation each year. The assumption is that each accounting period equally benefits from the use of the asset. The straight line method calculates an annual charge by:

using a formula; or

applying a fixed percentage to the depreciable amount of the asset.

Straight-line Depreciation Formula

$$\text{Depreciation} = \frac{\text{Cost} - \text{Scrap Value}}{\text{Number of years}}$$

- Cost – cost of the asset
- Scrap Value – the business's best estimate of the worth of the assets at the end of its useful life
- Numbers of years – the years the asset is expected to be useful to the business.

The fixed percentage is calculated by dividing 100% by the number of years of useful life

$$\text{5 years of useful life} \quad \frac{100}{5} = 20\ \%$$

Example 3.1 A

On the 1st January 2011, a business purchases a Motor Vehicle for $50,000. It is expected to give five years of service after which it will be sold for $5,000. Calculate the annual depreciation to be charged to the income statement for each of the five years.

$$\text{Depreciation} = \frac{\text{Cost} - \text{Scrap Value}}{\text{Number of Years}}$$

$$= \frac{50{,}000 - 5{,}000}{5}$$

$$= \frac{45{,}000}{5}$$

$$= \$9{,}000$$

$9,000 will be charge to the Income Statement for depreciation annually.

Using the fixed percentage

$$\frac{100}{5} = 20\%$$

$$45{,}000 \times 20\% = 9{,}000$$

The following table summarizes the application of straight-line depreciation during the Motor Vehicle five-year useful life.

Straight-Line Depreciation				
Year Ending 31 December	**Depreciable Cost**	**Annual Depreciation**	**Accumulated Depreciation**	**Net Book Value**
2011	50,000	9,000	9,000	41,000
2012	50,000	9,000	18,000	32,000
2013	50,000	9,000	27,000	23,000
2014	50,000	9,000	36,000	14,000
2015	50,000	9,000	45,000	**5,000**

At the end of year five, the $45,000 shown as accumulated depreciation equals the asset's depreciable cost, and the $5,000 net book value represents its estimated salvage value.

To record depreciation expense on the Motor Vehicle each year, the company debits depreciation expense–vehicles for $9,000 and credits accumulated depreciation–vehicles for $9,000.

REDUCING BALANCE METHOD

In this method also called the diminishing balance, a different amount is charged to the Income Statement each year for depreciation. A fixed percentage is applied to the net book value of the asset at the beginning of each year. The net book value reduces as the asset ages and the depreciation charge diminishes

Example 3.1 B

Looking at the same example above of a business that purchases a Motor Vehicle for $50,000. If the reducing balance is used at a fixed percentage of 20% per annum. Calculate the annual depreciation to be charged to the income statement for each of the five years.

Reducing Balance Depreciation			
Year Ending 31 December	**Depreciable Cost**	**Depreciation**	**Net Book Value**
2011	50, 000.00	10,000.00	40,000.00
2012	40,000.00	8,000.00	32,000.00
2013	32,000.00	6,400.00	25,600.00
2014	25,600.00	5,120.00	20,480.00
2015	20,480.00	4,096.00	**16,384.00**

Year 1 50,000 x 20 % = 10,000 Net Book Value 50,000 – 10,000 = 40,000

Year 2 40, 000 x 20% = 8,000 Net Book Value 40,000 - 8,000 = 32,000

The table below summarizes the application of reducing balance of depreciation during the Motor Vehicle five-year useful life.

In this method the depreciation was charge yearly to the net book value of the asset.

RECORDING DEPRECIATION

Usually separate records of the cost of each type of non-current asset and the accumulating depreciation on each type of non-current assets are kept. The provision for depreciation account is updated at the end of each financial year with the annual depreciation charge. This is done as follows:

- Record the annual depreciation charge in the general journal

- Post the journal entries to the accounts
  - Debit Profit & loss Account
  - Credit Provision for Depreciation Account

The Profit & loss account section of the income statement is debited with the depreciation to ensure that profits are reduced for the year under review. The credit entry in the provision account has the effect of reducing the value of the non-current asset. (Austen et al 2011)

Let us now prepare the double entry records for the reducing balance example above.

Example 3.1 C

At the end of each year prepare the journal entries to record the depreciation to be charged for the year as indicated below.

Journal

Date	Details	Dr $	Cr $
31 Dec. 2011	Profit & loss	10,000.00	
	Provision for Depreciation		10,000.00
31 Dec. 2012	Profit & loss	8,000.00	
	Provision for Depreciation		8,000.00
31 Dec. 2013	Profit & loss	6,400.00	
	Provision for Depreciation		6,400.00
31 Dec 2014	Profit & loss	5, 120.00	
	Provision for Depreciation		5, 120.00
31 Dec. 2015	Profit & loss	4,096.00	
	Provision for Depreciation		4,096.00

The journal entries are then posted to the accounts.

Example 3.1 D

Motor Vehicle

2011		$	2011		$
1-Jan	Bank	50,000	31-Dec	Balance c/d	50,000
2012			2012		
1-Jan	Balance b/d	50,000	31-Dec	Balance c/d	50,000
2013			2013		
1-Jan	Balance b/d	50,000	31-Dec	Balance c/d	50,000
2014			2014		
1-Jan	Balance b/d	50,000	31-Dec	Balance c/d	50,000
2015			2015		
1-Jan	Balance b/d	50,000	31-Dec	Balance c/d	50,000

Profit & loss Account (extract) for the year ended 31 December

		$
2011	Depreciation	10,000.00
2012	Depreciation	8,000.00
2013	Depreciation	6,400.00
2014	Depreciation	5,120.00
2015	Depreciation	4,096.00

Provision for Depreciation of Motor Vehicle

2011		$	2011		$
31-Dec	Balance c/d	10,000	31-Dec	Profit & loss	10,000
2012			2012		
31-Dec	Balance c/d	18,000	1-Jan	Balance b/d	10,000
			31-Dec	Profit & loss	8,000
		18,000			18,000
2013			2013		
31-Dec	Balance c/d	24,400	1-Jan	Balance b/d	18,000
			31-Dec	Profit & loss	6,400
		24,400			24,400
2014			2014		
31-Dec	Balance c/d	29,520	1-Jan	Balance b/d	24,400
			31-Dec	Profit & loss	5,120
		29,520			29,520
2015			2015		
31-Dec	Balance c/d	33,616	1-Jan	Balance b/d	29,520
			31-Dec	Profit & loss	4096
		33,616			33,616

How Does Depreciation Affect the Balance Sheet?

The balance sheet at the end of each financial year should show the noncurrent assets at cost less the balance on the provision for depreciation account. At the end of each year that year's depreciation is charged to the Profit & loss account but it is the accumulated depreciation to date that is charged to the balance sheet. Let's have a look at the balance sheet extract for the example above.

Example 3.1 E

Balance Sheet (extract) as at 31 December 2011

	Cost	Accumulated Depreciation	Net Book Value
	$	$	$
Motor Vehicle	50,000	10,000	40,000

Balance Sheet (extract) as at 31 December 2012

	Cost	Accumulated Depreciation	Net Book Value
	$	$	$
Motor Vehicle	50,000	18,000	32,000

Balance Sheet (extract) as at 31 December 2013

	Cost	Accumulated Depreciation	Net Book Value
	$	$	$
Motor Vehicle	50,000	24,400	25,600

Balance Sheet (extract) as at 31 December 2014

	Cost	Accumulated Depreciation	Net Book Value
	$	$	$
Motor Vehicle	50,000	29,520	20,480

Balance Sheet (extract) as at 31 December 2015

	Cost	Accumulated Depreciation	Net Book Value
	$	$	$
Motor Vehicle	50,000	33,616	16,384

The Sale of an Asset

When an asset is sold it should be deleted from your records. This is done by take out the cost from the asset account, the amount of accumulated depreciation removed from the provision for depreciation account, and then the profit or loss on sale is calculated. These entries are record in the asset disposal account.

The Account Entries Needed

On the sale of non-current asset, example Motor Vehicle, the following entries are needed.

1. Transfer the cost of the asset to be sold to an asset disposal account (for this example a Motor Vehicle Disposal Account).

    - **Debit** Motor Vehicle Disposal Account
    - **Credit** Motor Vehicle Account

2. Transfer the accumulated depreciation to the asset disposal account.

    - **Debit** Provision for Depreciation – Motor Vehicle
    - **Credit** Motor Vehicle Disposal Account

3. Record the funds received from the sale of the asset.

    - **Debit** Cash Book
    - **Credit** Motor Vehicle Disposal Account

4. Transfer the balance on the asset disposal account to the Profit & loss account.

    a) If the Motor Vehicle Disposal Account show a balance on the debit side of the account then it is a profit on sale.

    - **Debit** Motor Vehicle Disposal Account
    - **Credit** Profit & loss Account

    b) If the Motor Vehicle Disposal Account shows a balance on the credit side of the account then it is a loss on sale.

    - **Debit** Profit & loss Account
    - **Credit** Motor Vehicle Disposal Account

Now let us assume that the motor vehicle in the example above was disposed of at the end three years. Assume that on the 1st January 2014 the Motor Vehicle was sold for $20,000 by cheque, then the following entries would be made to record this disposal.

Motor Vehicle

2011		$	2011		$
1-Jan	Bank	50,000	31-Dec	Balance c/d	50,000
2012			2012		
1-Jan	Balance b/d	50,000	31-Dec	Balance c/d	50,000
2013			2013		
1-Jan	Balance b/d	50,000	31-Dec	Balance c/d	50,000
2014			2014		
1-Jan	Balance b/d	50,000	1-Jan	Motor Vehicle Disposal Account	50,000

Provision for Depreciation of Motor Vehicle

2011		$	2011		$
31-Dec	Balance c/d	10,000	31-Dec	Profit & loss	10,000
2012			2012		
31-Dec	Balance c/d	18,000	1-Jan	Balance b/d	10,000
			31-Dec	Profit & loss	8,000
		18,000			18,000
2013			2013		
31-Dec	Balance c/d	24,400	1-Jan	Balance b/d	18,000
			31-Dec	Profit & loss	6,400
		24,400			24,400
2014			2014		
1-Jan	Motor Vehicle Disposal Account	24,400	1-Jan	Balance b/d	24,400
		24,400			24,400

Example 3.1 F

Cash Book

Date 2014		**Cash $**	**Bank $**	**Date 2014**		**Cash $**	**Bank $**
1-Jan	Motor Vehicle Disposal		20,000				

Motor Vehicle Disposal Account

2014		$	2014		$
1-Jan	Motor Vehicle	50,000	1-Jan	Provision for Depreciation	24,400
			1-Jan	Cash Book	20,000
			1-Jan	Profit & loss (loss on Sale)	5,600
		50,000			50,000

Profit & loss Account (extract) for the year ended 31 December 2014

	$
Gross Profit	x xxxx
Less Loss on sale of Motor Vehicle	5,600

TOPIC SUMMARY

You have just looked at the entries necessary to record depreciation of non-current assets and the disposal of non-current assets. You should remember that the depreciation for the current year is charged to Profit & loss account but the accumulated depreciation is charged to the balance sheet each year.

You will now continue by look at other necessary adjustment that are required before the final accounts can be prepared.

TOPIC 3.2 ADJUSTMENTS FOR FINANCIAL REPORTING

INTRODUCTION

In order to give true and fair view of your financial statement there are adjustments required to account for prepaid and accrued expenses and revenue. These adjustments should be dealt with before you proceed to your financial statements.

OBJECTIVES

Upon completion of this topic you should be able:

1. Define the terms accrued and prepaid.
2. Make the necessary adjustment to expense and revenue accounts.
3. Account for these adjustments in the financial statements.
4. Understand why it is necessary to adjust expense and revenue accounts for amounts accrued or prepaid.

MAKING ADJUSTMENTS

So far we have assumed that all the expense and revenue incurred are for the present financial period. However there are instances where the amounts paid for expense or received for revenue would be for the previous financial period (accrued) or the upcoming financial period (prepaid). When this happens the figure charged to the financial statements for this period need to be adjusted to reflect the accrued or prepaid amounts.

Let's first look at the entries necessary for accrued and prepaid expenses. Let us assume that two businesses paid rent for the premises $8,000 by cheque per year. For the year 2011 the following accrued

Business A pays $6,500 during the year and owes $1,500 at the end of the year

Rent for the year	$8,000
Rent paid	$6,500
Rent owed	$1,500

Business B pays $9,000 during the year which includes $1,000 prepaid for the following year.

Rent for the year	$8,000
Rent paid	$9,000
Rent prepaid	$1,000

ACCRUED EXPENSES (EXPENSES OWING)

Remember that expenses are the cost of doing business for example salary, rent, utilities, carriage outwards, discount allowed and interest on money borrowed. From the example above the amount that should be debited to the Profit & loss account for rent should be $8,000 since that is amount that should be used up for this period.

Example 3.2A

Business A

Rent Account

Date	Details	folio	Amount	Date	Details	Folio	Amount
2011			**$**	**2011**			**$**
31-Dec	Bank	CB	6,500	31-Dec	Profit & Loss		8,000
31-Dec	Accrued	c/d	1,500				
			8,000				8,000
2012				**2012**			
Jan 1	Accrued	b/d	1,500	1-Jan	Accrued	b/d	1,500

Profit & loss (extract) for year ended 31 December 2011

	$	$
Rent	6,500	

Balance Sheet (extract) as at 31 December 2011

Current Liabilities		**$**
Expenses Accrued		1,500
Add Rent Accrued	1,500	**8,000**

Observe that even though only $6,500 was paid for rent during the year the Profit & loss should include the total amount that should have been paid for the year. Also observe that accrued expense is added in the Profit & loss account. Accrued expenses are a liability to your business therefore any accrued expenses should be shown as a current liability in your balance sheet.

PREPAID EXPENSES

Let us now look at Business B and the entries necessary in your records to record prepaid expenses. Remember that the amount that should be debited to the Profit & loss account for rent is $8,000.

Example 3.2 B

Business B

Rent Account

Date	**Details**	**folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2011			**$**	**2011**			**$**
31-Dec	Bank	CB	9,000	31-Dec	Profit & loss		8,000
				31-Dec	Prepaid	c/d	1,000
			9,000				9,000
2012							
1-Jan	prepaid	b/d	1,000				

Profit & loss (extract) for year ended 31 December 2011

	$	$
Rent	9,000	
Less Prepaid Rent	1,000	**8,000**

Balance Sheet (extract) as at 31 December 2011

Current Assets	**$**
Prepaid Expenses	1,000

Looking at the entries above you will see that prepaid expenses is subtracted in the Profit & loss account and included in the current assets in the balance sheet.

We can now continue by looking at accrued and prepaid revenue. Remember that revenue accounts are those accounts that bring income into the business, for example discount received, interest received, rent received and commission received.

Let us look at two businesses that sublet their premises for $5,000 per year. In 2011 the following accrued

Business C received $4200 by cheque for rent in 2011

Rent that should be received for the year	$5,000
Rent received	$4,200
Rent received owed for the year	$ 800

Business D received $6,800 by cheque for rent in 2011

Rent that should be received for the year	$5,000

Rent received	$6,800
Rent received prepaid for the year	$1,800

ACCRUED REVENUE (REVENUE OWING)

From our example the amount that should be credited to the Profit & loss account for rent received is $5,000. Therefore the following entries are required to show the adjustment for revenue owing.

Example 3.2 C

Business C

Rent Received Account

Date	**Details**	**folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2011			**$**	**2011**			**$**
31-Dec	Profit & loss		5,000	31-Dec	Bank	CB	4,200
				31-Dec	Owings	c/d	800
			5,000				5,000
2012							
1-Jan	Owings	b/d	800				

Profit & loss (extract) for year ended 31 December 2011

	$	$
Gross Profit		xxxx
Add Revenue		
Rent Received	4,200	
Add Owings	800	**5,000**

Balance Sheet (extract) as at 31 December 2011

Current Assets	**$**
Revenue owing	800

Take note that revenue is added to the gross profit in the Profit & loss account and that revenue owing is recorded as a current asset in the balance sheet.

PREPAID REVENUE

Observe in the entries below that prepaid revenue is recorded as a current liability in the balance sheet.

Example 3.2 D

Business D

Rent Received Account

Date	Details	folio	Amount	Date	Details	Folio	Amount
2011			**$**	**2011**			**$**
31-Dec	Profit & Loss		5,000	31-Dec	Bank	CB	6,800
31-Dec	Prepaid	c/d	1,800				
			6,800				6,800
				2012			
				1-Jan	Prepaid	b/d	1,800

Profit & loss (extract) for year ended 31 December 2011

	$	$
Gross Profit		xxxx
Add Revenue		
Rent Received	6,800	
Less Prepaid	1,800	**5,000**

Balance Sheet (extract) as at 31 December 2011

Current Liabilities	**$**
Revenue prepaid	1,800

There is a credit entry in the rent received account above to indicate the cash received for the rent the debit entry is recorded in the cash book since the funds was received by the business.

TOPIC SUMMARY

There are number of things to remember from this topic

1. Accounts should be adjusted at the end of each period to account for any prepayments or accruals during the period.
2. Accruals are added in the Profit & loss account while prepayments are subtracted.
3. In the balance sheet prepaid expenses and revenue owing is included in the current assets while expenses owing and revenue prepaid are included in the current liabilities

TOPIC 3.3 BAD DEBTS AND PROVISION FOR BAD DEBTS

INTRODUCTION

Once a business decides to offer its goods and/or services on credit to its customers that business has to be prepared for some of its customers not paying for the goods and/or services they received. When this occurs the necessary adjustment should be made to account for these unpaid debts. In accounting when a business is unable to collect the amount due from its customers the amounts owed should be transferred to a bad debts account. In this topic you will look at bad debts and provisions that should be made for bad debts in your business.

OBJECTIVES

Upon the completion of this topic you should be able to:

1. identify a bad debt;
2. describe how bad debts are written off;
3. explain how provisions for bad debts are made;
4. make accounting entries,
   (a) to recorded bad debts and provision for bad debts,
   (b) for increasing and reducing the provision for bad debts, and
   (c) for bad debts recovered.

BAD DEBTS

When a business decides to sell its goods/services to customers for credit there is a possibility of some of these customers not paying for the goods/services received. A customer may not be able to pay because their business has suffered a loss or they may have gone bankrupt. Bad debt is an expense to your business. Bad Debt is a debt that is unlikely to be paid

Examine the following example.

Example 3.4 A

You sold goods on credit to M. Label for $500 on the 21 January 2011. On March 15, you sold $725 goods on credit to J. Jackets. On the 1st June you received $375 by cash from M Label and on the 30 August you received $650 by cheque from J Jackets. At the end of your financial year you were notified that both M Label and J Jacket would not be able to pay the balance of their debts. You then decide to write the debts off.

The following accounting entries are required:

Debit - Bad Debt Account - to transfer the amount of the unpaid debit.

Credit - Debtors Account - to reduce the liability for the debtor who is unable to pay.

Debit - Profit & loss Account - to record the amount of bad debt for the accounting period.

Credit - Bad Debt Account - to transfer the amount of bad debt to the profit and loss account.

Your accounts should be as follows:

M. Label

Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2011			**$**	**2011**			**$**
21-Jan	Sales	GL	500	1-Jun	Cash	CB	375
				31-Dec	Bad Debts Account	GL	125
			500				500

J Jacket

Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2011			**$**	**2011**			**$**
15-Mar	Sales	GL	725	30-Aug	Bank	CB	650
				31-Dec	Bad Debts Account	GL	75
			725				725

Bad Debts Account

Date	**Details**	**Folio**	**Amount**	**Date**	**Details**	**Folio**	**Amount**
2011			**$**	**2011**			**$**
31-Dec	M. Label	SL	125	31-Dec	Profit & loss	a/c	200
31-Dec	J. Jacket	SL	75				
			200				200

Profit & loss (extract) for year ended 31 December 2011

	$	$
Gross Profit		xxxx
Less Expenses		
Bad Debts		200

PROVISION FOR BAD DEBTS

Because your business sell goods to its customers on credit you should make provision for the likely hood that some of customers will not pay their debt in full. A provision for bad debts account is created to show the estimated amount of debts that your business may not be able to recover. The amount for provision for bad debts can be estimates as follows

- By looking at each debt and estimate which one will be bad
- On the basis of experience estimate what percentage of the debts will result in bad debts

Normally a business decides what percentage of its debtors at the end of financial year it would estimate as being unrecoverable. Once the percentage is decide then the accounting entries are required

In the first year:

- **Debit** - Profit & loss Account with the amount of the provision
- **Credit** - Provision for Bad Debts Account

Increase in Provision of Bad Debts Amount

In the years that follows if the amount of the provision is greater than the year before then the difference between both years is recorded as follows

- **Debit -** Profit & loss Account (with the difference between previous and present year)
- **Credit** - Provision for Bad Debts (with the difference between the previous and present year)

Decrease in Provision of Bad Debts Amounts

If the amount of the provision is less than the previous year the entries would be

Debit - Provision for Bad Debts (with the difference between the previous & present year)

Credit - Profit & loss Account (with the difference between previous and present year)

Example 3.4 B

A business estimates that 2% of its debtors at the end of each year will be bad debts. The debtors figure for that business for the years 2011 – 2013 are:

2011	Debtors	$ 10,000
2012	Debtors	$ 12,000
2013	Debtors	$ 8,000

Show the accounting entries necessary to record the above.

The calculation is shown in the table below:

Year	Debtors	Provision Percentage	Provision Amount	Profit & Loss
	$	%	$	$
2011	10,000	2	200	200
2012	12,000	2	240	40
2013	8,000	2	160	80

You can how show the accounting entries to record these calculations

Provision for Bad Debts Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2011			**$**	**2011**			**$**
31-Dec	Balance	c/d	200	31-Dec	Profit & Loss	a/c	200
2012				**2012**			
31-Dec	Balance	c/d	240	1-Jan	Balance	b/d	200
				31-Dec	Profit & Loss	a/c	40
			240				240
2013				**2013**			
31-Dec	Profit & Loss	a/c	80	1-Jan	Balance	b/d	240
31-Dec	Balance	c/d	160				
			240				240
				2014			
				1-Jan	Balance	b/d	160

Profit & loss (extract) for year ended 31 December 2011 - 2013

		$			$
2011	Provision for Bad Debts	200			
2012	Provision for Bad Debts	40			
			2013	Provision for Bad Debts	80

Balance Sheet (extract) as at 31 December 2011 - 2013

		$	$
2011	Debtors	10,000	
	Less Provision for bad debts	200	9,800
2012	Debtors	12,000	
	Less Provision for bad debts	240	11,760
2011	Debtors	8,000	
	Less Provision for bad debts	160	7,840

Take note that a reduction in the provision for bad debts is revenue to your business and should be added to your gross profit. Also note that the balance on the provision for bad debts account at the end of each financial period is subtracted from the debtors figure in the balance sheet.

Let now look at fully worked example:

Example 3.4 C

A business started on 1 January 2005 and its financial year end is 31 December annually. The table of the debtors, the bad debts written off and the estimated provision for bad debts at the end of the year is:

Year	Debtors	Bad Debts written off	Provision for Bad Debts Amount
	$	$	$
2005	12,000	298	100
2006	15,000	386	130
2007	14,000	344	115
2008	18,000	477	150

You are required to show the bad debts account and the provision for bad debts account, as well as the extracts from the Profit & loss account for each year and the balance sheet extracts.

The double entry records to show the above is as follows

Provision for Bad Debts

Date	Details	Folio	Amount	Date	Details	Folio	Amount
2005			**$**	**2005**			**$**
31-Dec	Balance	c/d	100	31-Dec	Profit & loss	a/c	100
2006				2006			
31-Dec	Balance	c/d	130	1-Jan	Balance	b/d	100
				31-Dec	Profit & loss	a/c	30
			130				130
2007				2007			
31-Dec	Profit & loss	a/c	15	1-Jan	Balance	b/d	130
31-Dec	Balance	c/d	115				
			130				130
2008				2008			
31-Dec	Balance	c/d	150	1-Jan	Balance	b/d	115
				31-Dec	Profit & loss	a/c	35

		150					150
2009			2009				
			1-Jan	Balance		b/d	150

Profit & loss Account (extracts) for the year ended 31 December

		$		$
2005	Bad Debts	298		
	Provision for Bad Debts	100		
2006	Bad Debts	386		
	Provision for Bad Debts	30		
2007	Bad Debts	344	Reduction in Provision for Bad Debts	15
2008	Bad Debts	477		
	Provision for Bad Debts	35		

Balance Sheet (extract) as at 31 December

		$	$
2005	Debtors	12,000	
	Less Provision for Bad Debts	100	11,900
2006	Debtors	15,000	
	Less Provision for Bad Debts	130	14,870
2007	Debtors	14,000	
	Less Provision for Bad Debts	115	13,885
2008	Debtors	18,000	
	Less Provision for Bad Debts	150	17,850

There are instances where bad debts that are written off are recovered in the future. When this occur the debt should be reinstate by:

- **Debit** - Debtors Account
- **Credit -** Bad Debts recovered Account

When cash or a cheque is received from the debtor in settlement of the account the entries should be:

- **Debit -** Cash Book
- **Credit -** Debtors Account

TOPIC SUMMARY

You just looked at the accounting entries required to bad debts and provision for bad debts. You should remember that after the first entry for provision for bad debts in the Profit & loss account the difference between the previous year and the present year is recorded in the Profit & loss account. Note that balance on the provision for bad debts account at the end of the financial period is deducted from the balance on the debtors account in the balance sheet. You should also remember that a reduction in the provision of bad debts is revenue to your business and should be added to your gross profit while an increase is an expense and should be deducted from your gross profit.

TOPIC 3.4 INVENTORY ACCOUNTING

INTRODUCTION

At the beginning and end of every period there will be items of stock remain on your selves and in your warehouse. These stocks have to be valued and accounted for in the financial statements. In this topic we will look at the valuation of stock and the various methods of valuing closing stock.

OBJECTIVES

Upon the completion of this topic you should be able to:

1. Identify different methods of stock valuation.
2. Examine different methods of stock valuation (LIFO, FIFO, AVCO).
3. Illustrate the different adjustment required to arrive at the closing stock.
4. Show how the necessary adjustments are recorded in the financial statements.

STOCK VALUATION

Stock are goods purchased for re-sale. Keeping a record of stock involves adding new stock purchased and deducting any stock sold. Stocktaking (taking inventory) is the process of physically checking stock. This involves physically counting the stock on hand and comparing the findings with figures on the stock record. Stocktaking helps to assess the amount of loss due to theft or breakage and ensure that ht stock records are being kept effectively.

There are two ways that stock may be recorded by a business.

1. Perpetual method or continuous method where stocks are updated after each purchase, sale or return of stock.
2. Periodic method where the closing stock figure is determined by physically counting and valuing stock on hand at the end of a period.

Methods of Stock Valuation

There are three methods of valuing stock. These are:

1. First In First Out (FIFO) assumes that the first set of stocks purchased are the first set of stocks that would be sold.
2. Last In First Out (LIFO) assumes that last set of stocks purchase are the first set of stock that would be sold.
3. Average Cost (AVCO) values closing stock by using the average cost of the stocks available for sale. This is done as follows:

Cost of goods available for sale

Average Cost = number of units available for sale

You can now examine the valuation of closing stock using each method in the example below.

Example 3.4 A

For 2011 the receipt and issue of stocks are as follows

Receipt		Sales	
Jan	20 items at $30 each	June	6 items for $45 each
May	10 items at $33 each	Aug	22 items for $46 each
July	16 items at $38.50 each	Dec	10 items for $48 each
Oct	12 items at $39 each		

There was no opening stock.

- Calculate the closing stock using (i) FIFO (ii) LIFO (iii) AVCO.
- Draw up the trading account for the year ended 31 December 2011 showing the different reported gross profits from the figures given in (a)

FIFO	**Received**	**Issued**	**Stock after each transaction**	**$**	**$**
January	20 @ $30		20 @ $30		600
May	10 @ $33		20 @ $30 10 @ $33	600 <u>330</u>	930
June		6 @ $30	14 @ $30 10 @ $33	420 <u>330</u>	750
July	16 @ 38.50		14 @ $30 10 @ $33 16 @ $38.50	420 330 <u>616</u>	1,366
August		14 @ $30 8 @ $33	2 @ $33 16 @ $38.50	66 <u>616</u>	682
October	12 @ $39		2@ $33 16 @ $38.50 12 @ 39	66 616 <u>468</u>	1,150
December		2 @ $33 8 @ $38.50	8 @ $38.50 12 @ $39	308 <u>468</u>	682

Take note that the first items of stock purchased are the first to be sold. Also note that stock is valued at cost price not at selling (sales) price. The valuation of stock should not include profit amounts.

LIFO	**Received**	**Issued**	**Stock after each transaction**	**$**	**$**
January	20 @ $30		20 @ $30		600
May	10 @ $33		20 @ $30 10 @ $33	600 330	930
June		6 @ $33	20 @ $30 4 @ $33	600 132	732
July	16 @ 38.50		20 @ $30 4 @ $33 16 @ $38.50	600 132 616	1,348
August		16 @ $38.50 4 @ $33 2 @ $30	18 @ $30		540
October	12 @ $39		18 @ $30 12 @ $39	540 468	1,008
December		10 @ $39	18 @ $30 2 @ $39	540 78	618

You can observe that when the LIFO method of valuation is used the last item of stock received becomes the first item of stock to be issued.

AVCO	**Received**	**Issued**	**Average Cost per unit**	**Number of units**	**Value of stock**
			$		$
January	20 @ $30		30	20	600
May	10 @ $33		30 + 33 = 31 10 + 20	30	930
June		6 @ $31	31	24	744
July	16 @ 38.50		31 + 38.50 24 + 16 = 34	40	1,360
August		22 @ $34	34	18	612
October	12 @ $39		34 + 39 40 + 12 = 36	30	1,080

AVCO	Received	Issued	Average Cost per unit	Number of units	Value of stock
December		10 @ $36	36	20	720

You can move on to look at the trading account taking into account the different valuations of stock just calculated.

Trading Account for the year ended 31 December 2011

	FIFO		LIFO		AVCO	
	$	$	$	$	$	$
Sales		1,762		1,762		1,762
Less Cost of Goods Sold						
Purchases	2014		2014		2014	
Less Closing Stock	776	1,238	618	1,396	729	1,294
Gross Profit		524		366		468

The sales figure is calculated by adding all the sales

June	6 x 45	270
August	22 x 46	1,012
December	10 x 48	480
		1,762

The purchase figure is calculated by adding all the purchase amounts

January	20 x 30	600
May	10 x 33	330
July	16 x 38.50	616
October	12 x 39	468
		2014

The use of different methods of valuation of stock would give a different value of gross profit and net profit for the same business.

TOPIC SUMMARY

You just observed that different methods can be used to value closing stock. You would have noted that these different methods of valuation have a different effect on the profit calculation.

TOPIC 3.5 FINAL ACCOUNTS FOR SOLE TRADER

INTRODUCTION

So far in this unit you have looked at different adjustment needed before the final accounts can be prepared. The final accounts for a sole trader business are the Income Statement (Trading and Profit & loss Account) and the Balance Sheet. The final accounts give a picture of the financial position of your business. It shows where or not your business has made a profit or loss during the accounting period and whether you are able to pay your debts as they become due. Let's now have a look at the final accounts of a sole trader business.

OBJECTIVES

Upon the completion of this topic you should be able to;

1. understand how profit/loss is calculated,
2. calculate the cost of goods sold, gross profit and net profit,
3. transfer net profit and drawings to the capital account at the end of the period, and
4. prepare an Income Statement from a trial balance.

FINAL ACCOUNTS

After your trial balance is completed your final accounts are prepared. The final accounts of a sole trader business include the Income Statement (trading and Profit & loss account) and the balance sheet. Remember that your trial balance is the summary of the balances in all your accounts. Some of these balances (those from your nominal accounts) affect the profit and are transferred to the Income statement; the others (real and personal accounts) are transferred to your balance sheet. The Income Statement and the Balance Sheet are prepared at the end of each financial period to record how well the business operated during that financial period.

Income Statement

One of the most important financial statements of any business is the Income Statement. It is used to determine the following:

1. how profitable a business is being run; and
2. comparing the results received with the results expected.

The Income Statement can be divided into two sections the trading account and the Profit & loss account. The gross profit which is the amount of profit made before the expenses are deducted is calculated in the trading account. The purpose of the trading account is to determine the gross profit made from sales. Therefore the accounts that are directly related to buying and selling (trading) will be transferred to the trading account. The accounts directly related to trading are:

- Sales

- Purchase
- Sales Return
- Purchases Return
- Carriage Inwards

Gross profit is calculated as:

Gross Profit = Net Sales – Cost of Goods Sold (COGS)

Along with gross profit the net sales, cost of goods sold and the cost of goods available for sale is also calculated in the trading account:

Net Sales = Sales – Sales Return (Return Inwards)

Net sales are the total sales figure after allowances have been made for sales returned to the business.

COGS = Cost of goods available for sale (COGAFS) – Closing Stock

COGAFS = Opening Stock + (Purchases – Purchases Return) + Carriage Inwards

The net profit of your business is calculated in the Profit & loss account. Net profit is the balance of profit after allowance is made for revenue and expenses. It is calculated as:

Net Profit = Gross profit + Revenue – expenses

The revenue and expense charged to the Profit & loss account are those that are not directly related to trading but more to do with the running of the business. Some of these accounts are:

- Rent
- Telephone
- Carriage outwards
- Discount allowed
- Discount received
- Commission received
- Commission paid
- Salary

In Unit Two these accounts were closed off and transferred to the income statement. The income statement can be shown horizontally or vertically.

BALANCE SHEET

The other half of our final accounts is the Balance Sheet. The Balance Sheet is a financial statement showing the book values of the assets, liabilities and capital at the end of the financial period. It shows what the business owes and what it owns.

The assets of the business is divided into two categories and recorded as follows

1. **Non-Current Assets** are assets that:

    - are expected to be of use in the business for long time;
    - are to be used in the business; and
    - were not bought only for the purpose of resale.

    Non-current assets are recorded in the balance sheet starting with those assets that will in the business the longest down to those that will be kept for a shorter period. Example of non-current assets and the order of record are:

    - Land and Buildings.
    - Fixtures and Fittings.
    - Machinery.
    - Motor Vehicles.

2. **Current Assets** are recorded next. These are assets will change within the next twelve months. They are recorded as follows:

    - Stock (goods bought for resale)
    - Debtors.
    - Cash at Bank.
    - Cash in Hand.

3. **Non-current Liability -** Sometime referred to as long term liability are those debts that take more than a year to settle. This includes large loans and mortgages.

4. Current Liability - are debts that will be settled in one year or less. This includes creditors and small loans.

Let's now prepare the final accounts from the trial balance on the next page.

Example 3.5A

MDAR Retailer

Trial Balance as at 31 December 2011

	Dr. $	Cr. $
Discount Allowed	410	
Discount Received		506
Carriage Inwards	309	
Carriage Outwards	218	
Return Inwards	1,384	
Return Outwards		810
Sales		120,320
Purchases	84,290	
Stock 31 December 2010	30,816	
Motor expenses	4,917	
Repairs to premises	1,383	
Pay	16,184	
Sundry expenses	807	
Rates and insurance	2,896	
Premises at cost	40,000	
Motor Vehicle at cost	11,160	
Provision for depreciation motors as at 31 December 2010		3,860
Debtors	31,640	
Creditors		24,320
Cash at bank	4,956	
Cash in hand	48	
Drawings	8,736	
Capital		50,994
Loan from P. Holland		40,000
Bad Debts	1,314	
Provision for bad debts as at 31 December 2010		658
	241,468	241,468

The following should be considered on 31 December 2011

1) Stock $36,420
   a) Expenses owing
   b) Sundry expenses $62
2) Motor expenses $33
3) prepayments
   a) Rates $166
4) Provision for bad debts to be reduced to $580
5) Depreciation for motors to be $2,100 for the year
6) Part of the premises were let to a tenant who owed $250 at 31 December 2011
7) Loan interest owing to P. Holland, $4,000

Prepare the Income Statement and Balance Sheet as at 31 December 2011.

Horizontal presentation of the Income Statement and Balance Sheet.

MDAR Retailer
Income Statement
for the year ended 31 December 2011

	$	$		$	$
Opening Stock		30,816	Sales	120,320	
Add Purchases	84,290		Less Sales Returns	1,384	118,936
Less Purchases Return	810	83,480			
Add Carriage Inwards		309			
COGAFS		114,605			
Less Closing Stock		36,420			
COGS		78,185			
Gross Profit c/d		40,751			
		118,936			118,936
Less Expenses			**Gross Profit b/d**		40,751
Motor Expenses	4,917		Add Revenue		
Add Motor expenses owing	33	4,950	Discount Received	506	
Pay		16,184	Rent Receivable	250	
Carriage Outwards		218	Reduction in Provision for Bad Debts	78	834
Discount Allowed		410			41,585
Repairs to Premises		1,383			
Sundry Expenses	807				
Add sundry expenses owing	62	869			
Bad Debts		1,314			
Rates and Insurance	2,896				
Less prepaid rates and insurance	166	2,730			
Loan Interest		4,000			
Depreciation: Motor		2,100			
Net Profit		7,427			
		41,585			**41,585**

MDAR Retailer
Balance Sheet
as at 31 December 2011

Non-Current Assets	**$**	**$**	**$**	**Capital**	**$**	**$**	**$**
Premises at cost			40,000	Balance as at 1 Jan 2011			50,994
Motor Vehicle at cost		11,160		Add Net Profit			7,427
Less Depreciation to date		5,960	5,200				58,421
			45,200	Less Drawings			8,736
Current Assets							49,685
Stock		36,420		**Non-Current Liability**			
Debtors	31,640			Loan from P. Holland			40,000
Less Provision for Bad Debts	580	31,060					89,685
Prepaid Expense		166					
Revenue owing		250		**Current Liabilities**			
Cash at bank		4,956		Creditors		24,320	
Cash in hand		48	72,900	Expenses owing		4,095	28,415
			118,100				**118,100**

Vertical presentation of the Income Statement and the Balance Sheet.

The vertical presentation is the most common method of presenting final accounts today. In the vertical presentation of the balance sheet the working capital is indicated. This is calculated as:

Working Capital = Current Assets - Current Liabilities

The working capital indicates the liquidity of your business. This means the ability of your business to pay its debts when they become due. It gives an idea of the amount of funds available to run the business on a day to day basis.

MDAR Retailer
Income Statement
for the year ended 31 December 2011

	$	**$**	**$**
Sales		120,320	
Less Sales Returns		1,384	
Net Sales			118,936
Opening Stock		30,816	
Add Purchases	84,290		
Less Purchases Return	810	83,480	
Add Carriage Inwards		309	
COGAFS		**114,605**	
Less Closing Stock		36,420	
COGS			**78,185**
Gross Profit			**40,751**
Add Revenue			
Discount Received		506	
Rent Receivable		250	
Reduction in Provision for Bad Debts		78	834
			41,585
Less Expenses			
Motor Expenses	4,917		
Add Motor expenses owing	33	4,950	
Pay		16,184	
Carriage Outwards		218	
Discount Allowed		410	
Repairs to Premises		1,383	
Sundry Expenses	807		
Add sundry expenses owing	62	869	
Bad Debts		1,314	
Rates and Insurance	2,896		
Less prepaid rates and insurance	166	2,730	
Loan Interest		4,000	
Depreciation: Motor vehicles		2,100	34,158
Net Profit			**7,427**

MDAR Retailer
Balance Sheet
as at 31 December 2011

Non-Current Assets	**$**	**$**	**$**
Premises at cost			40,000
Motor Vehicle at cost		11,160	
Less Depreciation to date		5,960	5,200
			45,200
Current Assets			
Stock		36,420	
Debtors	31,640		
Less Provision for Bad Debts	580	31,060	
Prepaid Expense		166	
Revenue owing		250	
Cash at bank		4,956	
Cash in hand		48	
		72,900	
Current Liabilities			
Creditors	24,320		
Expenses owing	4,095	28,415	
Working Capital			**44,485**
			89,685
Financed by			
Balance as at 1 January 2011			50,994
Add Net Profit			7,427
			58,421
Less Drawings			8,736
			49,685
Non-Current Liability			
Loan from P. Holland			40,000
			89,685

TOPIC SUMMARY

You have just examined the final account of a sole trader business. Remember that the final accounts are made up of the income statement and the balance sheet. The income statement can be further divided into a trading account and also a Profit & loss account. You would have noted that the information to draw up the final accounts is taken from your trial balance. Some of the information in your trial balance is transferred to the income statement and others to the balance sheet.

A number of important information about your business is calculated in the income statement. This included the gross profit/loss and net profit/loss of your business. These indicate how well your business is running. Your balance sheet shows your assets in relation to your capital and liabilities. In the vertical presentation of the balance sheet you are able to calculate your working capital which is an indication of liquidity of your business.

UNIT SUMMARY

In this unit you had a look at adjustments that should be made to your accounts before your final accounts are prepared. These adjustments included adjustments for depreciation and provision for depreciation, bad debts and provision for bad debts, accrued and prepaid expenses and revenue and also at the different valuation of closing stock. All these adjustments are necessary if your final accounts are to present a true and fair view of your business.

Once you would complete all the necessary adjustment your final accounts can be prepared. Your final accounts include your income statement and balance sheet. Your income statement comprise of your trading account where your gross profit/loss is calculated and your Profit & loss account where your net profit/loss is calculated. You also had a look at the two ways to present your final account the horizontal and vertical presentations.

Now that you have completed the final accounts for a sole trader you will now continue by analysing and interpreting these financial statements and have a look at the control systems of a business in Unit 4.

UNIT REFERENCES

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UNIT FOUR – ANALYSING/INTERPRETING FINANCIAL STATEMENTS AND CONTROL SYSTEMS

INTRODUCTION

In this unit you will analyse and interpret the information in the financial statements. Earlier you learnt that the financial statements are used by different persons for various reasons. You can tell a lot about a business by looking at its financial statements, however to get a true picture of the performance of your business these record can be further analysed by the use of different ratios and formulas. We would have a more in-depth look at the financial statements of a business in this unit. You will also have a look at control systems that business put in place to monitor various aspects of their business

OBJECTIVES

Upon completion of this unit you will be able to:

1. identify ratios that can analyse the performance of sole trader business;
2. state he formula to be used when calculating accounting ratios;
3. calculate ratios based on the end of period financial statements;
4. calculate and analyse ratios on profitability, liquidity and efficiency to assess your business performance;
5. employ accounting ratios to calculate missing figures in financial statements;
6. explain why the petty cash book is used;
7. describe the imprest system;
8. list the need for control accounts;
9. examine the double entry aspect of control accounts;
10. reconcile cash book balances with bank statement balances;
11. state the reasons for preparing bank reconciliation statement;
12. list the functions of the payroll;
13. calculate employees' pay using various methods;
14. distinguish between statutory and non-statutory deductions;
15. complete the payroll and wage documents from time cards;
16. distinguish between the different types of errors; and
17. correct errors using the journal.

UNIT READINGS

The instructor will provide a list of readings.

ASSIGNMENTS AND ACTIVITIES

The instructor will provide guidance on the type of assignments and instructions.

TOPIC 4.1 ACCOUNTING RATIOS

INTRODUCTION

There are a number of ratios used to analyse and interpret the performance of a business. They are valuable means of comparing the performance of your business. These ratios can be classified as trading account ratios, profit and loss ratios and balance sheet ratios. In this topic we will examine each of these ratios.

OBJECTIVES

Upon completion of this lesson you will be able to:

1. identify ratios that can be used to analyse the performance of your business;
2. calculate ratios based on the end of year financial statements;
3. state the formulas to be used when calculating accounting ratios; and
4. calculate and analyse ratios on profitability, liquidity and efficiency to assess a business's performance.

INTERPRETATION OF ACCOUNTS

In order to assess the performance of business, financial information is recorded, classified and communicated to the different users of accounting information. The financial information can be evaluated by the use of accounting ratios. Ratios provide a valuable means of comparing the performance of a business

- From one year to the next
- With other similar businesses

They enable changes in important aspects of a business's performance to be pinpointed and quantified. If ratios are calculated every year, it is possible to see whether any significant trends are becoming apparent. (David, A., et al 2011)

An important factor in a business is to ensure that it operates at a profit and that it can pay its creditors and expenses when they become due. The ability for a business to pay its debts when they become due is known as liquidity and the ability to make a profit is known as profitability.

We will have a look at the profitability and liquidity ratios and which part of the financial statement should be used to calculate these ratios.

TRADING ACCOUNT RATIOS

Accounting ratios that uses the information from your trading account can be classified as trading account ratios. These ratios are

1. Margin which is gross profit is shown as a percentage of selling price

$$\frac{\text{Gross Profit}}{\text{Selling Price}} \times 100$$

2. Mark-up is gross profit shown as a percentage of cost price

$$\frac{\text{Gross Profit}}{\text{Cost Price}} \times 100$$

3. Rate of stock turnover or stock turn measures quickly a business sells its goods without losing its profitability.

$$\frac{\text{Cost of goods sold}}{\text{Average stock}} = \text{stock turnover}$$

$$\text{Average stock} = \frac{\text{opening stock + closing stock}}{2}$$

4. Gross profit as percentage of sales this measures the amount of gross profit from ever $100 of sales

$$\frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

The gross profit as a percentage of sales and rate of stock turnover ratios are ratios that measures the profitability of a business.

Example 4.1

A business's trading account include the following information

Trading Account
For the year ended 31 December 2010

	$	$	$
Sales			240,000
Opening Stock		16,000	
Add Purchases		178,000	
		194,000	
Less Closing Stock		14,000	180,000
Gross Profit			60,000

Margin	Gross Profit x 100 / Selling Price	60,000 x 100 / 240,000	25%
Mark-up	Gross Profit x 100 / Cost Price	60,000 x 100 / 180,000	33 1/3 %
Rate of Stock Turnover	Cost of goods sold / Average stock	180,000 / 15,000	12 times
Gross Profit as a percentage of Sales	Gross Profit x 100 / Sales	60,000 / 240,000	25 %

PROFIT AND LOSS ACCOUNT RATIOS

Accounting ratios classified as profit and loss account ratios are

1. Net profit as a percentage of sales this shows how much net profit has been made for every $100 of sales.

$$\frac{\text{Net Profit}}{\text{Sales}} \times 100$$

This ratio takes into account the expenses incurred and shows the amount of profit remaining. Changes in this ratio can be linked to

- Changes in the gross profit/sales percentage
- Changes in the expenses.

2. Expenses to sales ratio

$$\frac{\text{Expenses}}{\text{Sale}} \times 100$$

Example 4.2			
A business's total sales for the year ended 31 December 2010 was $400,000. Its Profit and Loss included the following information.			
	$	$	$
Gross Profit			140,000
General expenses		24,000	
Wages		82,000	106,000
Profit			34,000
Net Profit as Percentage of sales	Net Profit / Sales x 100	34,000 / 400,000 x 100	8.5%
Expenses as Percentage of Sales	Expenses / Sales x 100	106,000 / 400,000 x 100	26.5%

BALANCE SHEET RATIOS

Manager uses different information to determine the performance of the business. The ratios that analyse the balance sheet are

1. Current ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

This shows the relationship between the current assets and the current liabilities. It determines the amount of money the business has to pay its debts as they become due. The ability of a business to pay its debts when they become due is called liquidity. The business will have liquidity problems if this ratio is below 2:1.

2. Acid Test Ratio

$$\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

The acid test ratio also measures the liquidity of a business since it measures the amount of liquid assets it has to pay its current liabilities

3. Return on Capital Employed

$$\frac{\text{Profit}}{\text{Capital Invested}} \times 100$$

This ratio compares the amount of profit made in relation to the amount of money invested into the business.

4. Debtors Ratio

$$\frac{\text{Debtors}}{\text{Sales}} \times 12$$

The debtor's ratio measures how long the debtors take to pay what they owe to the business.

5. Creditors Ratio

$$\frac{\text{Creditors}}{\text{Purchases}} \times 12$$

This measures how long it takes the business to pay the debts owed to its suppliers within a year.

Example 4.3

J. Richardson Retail Store Balance Sheet as at 31 December 2011 is as follows:

J. Richardson Retail Store
Balance Sheet
As at 31 December 2011

Fixed Assets	$	$
Equipment at cost	10,000	
Less Depreciation to date	8,000	2,000
Current Assets		
Stock	15,000	
Debtors	25,000	
Bank	5,000	
	45,000	
Less Current Liabilities		
Creditors	5,000	40,000
		42,000
Financed by:		
Capital		38,000
Add Net Profit		10,000
		48,000
Less Drawings		6,000
		42,000

The following information is also available

Sales	$80,000
Purchases	$50,000
Net Profit	$10,000

Current ratio	Current Assets / Current liabilities	45,000 / 5,000	**9:1**
Acid Test Ratio	Current Assets – Stock / Current Liabilities	30,000 / 5,000	**6:1**
Return on Capital Employed	Profit / Capital Invested x 100	10,000 / (38,000 + 42,000)÷2 x 100	**25%**
Debtors Ratio	Debtors / Sales x 12	25,000 / 80,000 x 12	**3.75 months**
Creditors Ratio	Creditors / Purchases x 12	5,000 / 50,000 x 12	**1.2 months**

TOPIC SUMMARY

You have completed the examination of your financial records with the use of accounting ratios. You would have learnt that ratios shows and identifies different performances of your business. You can now compare how your business performs from one period to the next and with similar businesses. They inform you and guide you to make necessary changes to improve your business performance.

TOPIC 4.2 CORRECTION OF ERRORS

INTRODUCTION

A Trial Balance is drawn up at the end of the accounting period using the balances on each account in the ledgers. Even thought the trial balance totals may agree there are instances where errors may be made in the recording of accounting entries. In this topic you will look at those errors that may occur that do not affect the trial balance and agreement and how these errors are corrected. We will also look at those errors that will affect the agreement of the trial balance totals and how to correct these errors.

OBJECTIVES

Upon completion of this lesson you will be able to:

1. understand that there are two types of errors;
2. appreciate that errors are identified after a period of time;
3. distinguish between the different types of errors; and
4. use the journals to correct errors.

TYPES OF ERRORS

There are two types of errors.

1. Those that affect the trial balance totals agreement.
2. Those that don’t affect the trial balance agreement.

Whenever these errors are identified they are corrected by using the journal. You have learnt how the trial balance is used to check the arithmetic accuracy of the financial records. You will how learn that not all errors are revealed in the trial balance. We will now look at these errors in more detail

Errors that don't affect the trial balance agreement

Your trail balance can still balance even though errors were made in your records. These errors are

1. **Errors of Commission** – this occurs when the correct amount is entered in the records but in the wrong persons account.

Example

V. Peters paid us $150 by Cheque on 7th September 2011. This is correctly entered in the cash book, but was entered by error in A. Peters. The error was found on 30 September 2011. This will now have to be corrected and requires two entries

Debit A Peters' Account To cancel out the error on the credit side of that account
Credit V Peters Account To enter the amount in the correct account

A Peters

2011		$	2011		$
Sept 31	V Peters: Error Corrected	150	Sept 7	Bank	150

V. Peters

2011		$	2011		$
Sept 1	Balance b/d	150	Sept 31	Cash entered in error In A. Peters account	150

2. **Errors of Principle** – occurs when an item is entered in the wrong type of account. Eg. A fixed asset entered in an expense account.

Example

You purchase motor car for $6,700 by cheque on 12 September 2011 has been debited in error to the motor expenses account. In the cash book it is shown correctly. This means that there has been both a debit of $6,700 and a credit of $6,700.

The error is detected on 30 September 2011 and is corrected. To do so two entries are needed;

Debit Motor Car Account to put the amount in the correct account
Credit Motor Expenses to cancel the error previously made in the motor expenses account

Motor Expenses

2011		$	2011		$
Sept 12	Bank	6,700	Sept 30	motor car (error corrected)	6,700

Motor Car

2011		$	2011		$
Sept 30	Bank (error corrected)	6,7000			

3. **Error of Omission** – occurs when a transactions has been completely omitted from the books

Example

You sold goods to P. Jackson for $250 on 7th September 2011 but did not enter the transaction in the accounts. There were no debit and credit entries made. The error was identified on 30 September. The entries to correct it will be thus:

Sales

2011		$	2011		$
			Sept 30	P. Jackson	250

P. Jackson

2011		$	2011		$
Sept 30	Sales	250			

4. **Error of Original Entry** – occurs when an item is entered, but both debit and credit entries are of the same incorrect amount.

Example

Purchases of $150 to T Henry on 13 September 2011 have been entered as both a debit and credit of $125. The account would appear thus:

T. Henry

2011		$	2011		$
			Sept 13	Purchases	125

Purchases

2011		$	2011		$
Sept 13	T Henry	125			

The error is found 30 September 2011, The entries to correct is are now shown:

T. Henry

2011		$	2011		$
			Sept 13	Purchases	125
			Sept 30	purchases (error corrected)	25

Purchases

2011		$	2011		$
Sept 13	T Henry	125			
Sept 30	T. Henry (error corrected)	25			

5. **Compensating Errors** – where two or more unrelated errors cancel each other out.

Example

In a case where incorrect totals has purchases of $7,900 and sales of $9,900. The purchases day book adds up to be $200 too much. In the same period, the sales day book also adds up to be $200 too much.

If these were the only errors in your books, the trial balance totals would equal each other. Both totals would be wrong – they would both be $200 too much- but they would equal. In this case, the accounts would have appeared as follows:

Sales

2011		$	2011		$
			Sept 13	Total sales	9,900

Purchases

2011		$	2011		$
Sept 13	Total Purchases	7,900			

When corrected, the accounts will appear as:

Sales

2011		$	2011		$
Sept 30	Journal (error corrected)	200	Sept 13	Total sales	9,900

Purchases

2011		$	2011		$
Sept 13	Total Purchases	7,900	Sept 30	Journal (error corrected)	200

The Journal entries to correct these two errors will be

Journal

2011		DR	CR
		$	$
Sept 30	Sales	200	
	Purchases		200
	Correction of compensating error		

Errors that affect the trial balance agreement

These errors will cause a difference in the trial balance totals. These errors are

1. Under-casting and over-casting – figures that are larger or smaller than they should be.
2. Transposition – that is figures turned around eg. 23 instead of 32
3. Entries made on the wrong side of accounts – that is a debit entry made instead of a credit entry.
4. Half the double entry omitted – only one part of the double entry completed

When there is difference in the trial balance, the amount is transferred to the suspense account on the same side as the difference in the trial balance. A **suspense account** is opened to record the difference in the trial balance totals. When the errors are located they are first recorded in the journal and the correction is recorded in the suspense account.

In order to correct these errors several entries are needed to make a correction, first entries to cancel the original entry which is wrong and second the entries that should have been made in the first place.

Example

Your Trial Balance on 31 December 2010 shows a difference of $350. It was a shortage on credit side. A suspense account is opened and the difference of $350 is entered on the credit side.

On 30 September 2011 the error is found. You had received payment of $350 from V. Peters to close her account. It was correctly entered in the cash book, but it was not entered in V. Peters' account.

To correct the error, the account of V. Peters is credited with $350, as it should have been 2010, and the suspense account is debited with $350 so that the account can be closed.

V. Peters

2011		$	2011		$
Jan 1	Balance b/d	350	Sept 30	Bank	350

Suspense Account

2011		$	2010		$
Sept 30	V. Peters	350	Dec 31	Difference per trial balance	350

Journal			
2011		DR	CR
		$	$
Sept 30	Suspense Account	350	
	V. Peters		350
	Correction of non-entry of payment made by V. Peters account		

TOPIC SUMMARY

You would have learnt that all errors cannot be identified from simply looking at your records. You would also learnt that all errors do not affect your Trial Balance total. Some errors are only identified after careful examination of your books.

You would also realize that an error has occurred once the trial balance totals doesn't agree. When this happens the difference on the trial balance is transferred to a suspense account. Once the error is identified it is corrected through the Journal and then the suspense account.

TOPIC 4.3 PAYROLL

INTRODUCTION

With any business with employees one of its major expenses are the payment of wages and/or salaries to its workers. In this section we will look at how wages and salaries are calculated and their various deductions

OBJECTIVES

Upon completion of this lesson you will be able to:

1. Understand the function of the payroll.
2. Use various methods to calculate salaries.
3. Identify the difference between statutory and non-statutory deductions.
4. Complete the payroll and wage documents from time cards.

Every business pays its employees' wages and/or salaries for the labour they supply to carry out the business activity. Wages are paid weekly or forth nightly at a rate that considers the number of hours or number of pieces of work produced. Salaries are a fixed amount paid monthly no matter the amount of pieces produced or hours worked.

METHODS OF CALCULATING PAY

Wages can be calculated using various methods or a combination of methods. The main methods of calculating wages are;

- **Flat rate** – a basic rate is based on a standard number of hours. This agreed monthly salary or weekly wage.
- **Piece rate** – employees are paid based on the number of units produced during the pay period.

Example

JYPR Ltd manufactures chairs. There are several process involved in assembling the chairs. Employees are paid the following piece rates:

Process 1: $2.00 per chair
Process 2: $3.00 per chair
Process 3: $4.00 per chair

Elrie works in the assembly department, during the week ended 30 September 2011 he completed the following tasks:

Process 1: 20
Process 2: 40
Process 3: 30

Elrie will be paid the following

		$
Process 1	20 x 2	40.00
Process 2	40 x 3	120.00
Process 3	30 x 4	120.00
	Total	280.00

- **Time rate** – is a fixed rate per hours is paid multiplied by the number of hours worked.

Example

Ann works part-time at a supermarket. Ann is pay $24 per hour. During the week ended 30 September 2011, Ann was employed for 17 hours.
Ann will be paid a wage of 17 hours x $24 = $408

- **Overtime rate** – any hours worked above the regular standard working hours are paid at a higher rate. Overtime rates can be charged as one and half, two times and three times the regular rates.

Example

Catina is paid $30 per hour working in a restaurant. Catina is contracted to work 35 hours per week. During the week ended 23 September 2011, she worked 39 hours. Overtime is paid at time and a half.

Catina will be paid 35 hours x $30 per week = $1,050 per week
During the week ended 23 September 2011, she will be paid $1,050 plus overtime

Overtime payment = 4 hours x ($30 x 1.5) = 4 hours x $45 = $180

Wage for the week ended 23th September is $1,230

- **Commission** – is based on the amount of sales made by the employee. It could be paid in addition to the basic salary or instead of a salary. It is normally calculated as a percentage of the employee's sale.

Example

Ulrick works in a department store. He is paid $3 000 per month, but is also entitled to a commission of 1.5% based on his department's monthly sales. His department's monthly sales were.

	$
August 2011	32 000
September 2011	27 400

Ulrick will be paid as follows

	Basic Salary	Commission	Total
	$	**$**	**$**
August 2011	3,000	1.5% x $32,000 = $480	3,480
September 2011	3,000	1.5% x 27,400 = $411	3,411

CALCULATING EMPLOYEES EARNINGS

Each employee receives a pay slip at the end of their pay period. A pay slip shows the calculation of the employees' gross pay their deductions and their net pay. Gross pay is the amount due to the employees at the end of their pay period for the work done before any deductions. Once the gross pay is calculated there are some statutory and non statuary deductions that must be deducted before we arrive at the net pay.

Statutory deductions are those deductions that are required by law. These deductions includes

1. **Income tax** – many countries have a tax system known as the Pay As You Earn (PAYE). The amount paid in tax increases the higher your gross pay is. However most system allows a part of the gross to be exempt from tax (tax fee allowance) any amount above that allowance would be taxable
2. **National Insurance or Social Security contributions –** this deduction is paid to provide funds to provide income to workers during illness, injury, retirement etc.
3. **Pension Plan contribution** – some employers require employees to contribute to a scheme that will ensure that when they retire they are entitled to receive a pension from their employers as well from the state.

Non-statutory deductions as those deductions that **e**mployees may request be made to meet their personal needs. Examples of non-statutory deductions are:

- Membership fees to clubs.
- Membership to union (union dues).
- Health insurance.
- Life insurance.
- Contribution to credit unions.

SOURCE DOCUMENTS TO CALCULATE PAYROLL

The information to calculate the employees earning are derived from various documents:

- **Personal Record Card** – this includes information about the employees. This information includes the employee's correct name, address, contact number, tax numbers and other information.
- **Employees Earning Records** – is a history of the employees pay rates, gross pay, deductions, net pay over a period of time.

Example

JYPR LTD
EMPLOYEE EARNING RECORD

Name_________________________ Employee No. ____________ Position ___________

Address _________________________ Birth Date ________________ Sex _________

_____________________________ Marital Status _________ No. Of Dependents _______

Tel. No. _________________________ NIS # ______________ Starting Date ____________

PERIOD ENDED	ACCUMULATED OR YEAR TO DATE EARNINGS $	REGULAR $	OVERTIME $	GROSS $	NAT. INS. $	INCOME TAX $	LIFE INS. $	CREDIT UNION $	TOTAL DEDUC. $	NET PAY $

- **Time Card** – shows the number of hours worked by the employees. It is used to calculate the total house worked during the period. They are used to clock in and out of the work place.

Example

JYPR LTD

TIME CARD

Employee's Name: J. Jackson　　Work Period: Sept 21 to Sept 27 .

Employee;s Number: 09234　　Department: Sales .

DAY	AM		PM	
	IN	OUT	IN	OUT
Sunday 21 September	7:50	12:02		
Monday 22 September	6:50	12:06	12:55	4:01
Tuesday 23 September	6:55	12:05	12:59	4:02
Wednesday 24 September	6:57	12:05	12:58	7:05
Thursday 25 September	6:52	12:03	12:55	7:00
Friday 26 September	6:59	12:02	12:58	4:01
Saturday 27 September	7:55	12:02		

- **Time Sheet** – are used by employees to record the overall attendance of the employees.

Example

JYPR LTD

TIME SHEET

Employee's Name: J. Jackson　　Work Period: Sept 21 to Sept 27 .
Employee's Number: 09234　　Department: Sales .

DAY	AM		PM		Regular Hours	Overtime Hours	Total Hours
	IN	OUT	IN	OUT			
Sunday 21 Sept.	7:50	12:02			-	4	4
Monday 22 Sept.	6:50	12:06	12:55	4:01	8	-	8
Tuesday 23 Sept.	6:55	12:05	12:59	4:02	8	-	8
Wednesday 24 Sept.	6:57	12:05	12:58	7:05	8	3	11
Thursday 25 Sept.	6:52	12:03	12:55	7:00	8	3	11
Friday 26 Sept.	6:59	12:02	12:58	4:01	8	-	8
Saturday 27 Sept.	7:55	12:02			-	4	4
Total					40	14	54

- **Employees' Payroll Sheet** is completed at the end of work period for all employees.

Example

If the employees of JYPR LTD regular work week is 40 hours at a rate of $30 per hour. They received time and quarter (1 ¼) for any overtime worked during the regular work week and time and half (1 ½) for any overtime worked on Saturdays and double time (2) for any overtime worked on Sundays. Calculate J Jackson gross pay for the period 21 – 27 September.

Employees Payroll Register

Names	Employee No.	Regular Pay	Overtime				Gross Pay
			Week	Saturday	Sunday	Total	
J. Jackson	09234	2400	225	180	240	645	3 045

- **Payslip** – is prepared for each employee, who receives it on "pay day". The information on the employee earnings record is transferred to the payslip.

Example

PAYSLIP

SEPTEMBER 27, 2011

Name	Gross Pay	Nat. Ins	Income Tax	Life Ins.	Credit Union	Total Deductions	Net Pay
J. Jackson	3 045						

PAYROLL

The payroll is the document that summaries for each employees. It shows all the information used to calculate the Net Pay.

Example

With the following information calculate the net pay JYPR Ltd employees

National Insurance 2 ½ % of Gross
Income tax 15% of gross pay less credit union contribution
Life insurance 2% of gross pay
Credit union 1% of gross pay

Credit union = 1% x $3045 = 30.45
National Insurance 2 ½% x $3045 = $76.13
Income tax 15% x (3045 – 30.45) = 452.18
Life insurance 2 % x 3045 = 60.90

JYPR LTD PAYROLL REGISTER											
Employees	Total hours	Regular hours $	Overtime hours $	Gross pay $	Accumulated or year to date earnings	Deductions					Net Pay $
						Nat Ins $	Income Tax $	Life Ins $	Credit Union $	Total $	
J. Jackson	54	2 400	645	3 045	3 045.00	76.13	452.18	60.90	30.45	619.70	2 423.34

TOPIC SUMMARY

It is important to note the different ways in calculating your employees' wages and salary. There are both statuary and non-statutory deductions that are deducted from the wages and salaries of your employees. Statutory deductions are those deductions required by law. Non statutory are requested by the employee.

The information for preparing the wages and salaries are taken from the time cards of the employees. Each employee should receive a copy of their payslip which provides them with information about their pay before deductions (gross pay) and the take home pay after deductions (net pay).

TOPIC 4.4 BANK RECONCILIATION STATEMENT

INTRODUCTION

In this unit you will learn how to reconcile your cash book so that its balance aggress with the balance on your bank statement

OBJECTIVES

Upon completion of this lesson you will be able to:

1. Explain terms used on the bank statement.
2. Compare the cash book with the bank statement.
3. Update the cash book.
4. Prepare the bank reconciliation statement.

BANK STATEMENTS AND THE CASH BOOK

When you make or receive payment by cheques they are recorded in the bank column of your cash book. When these cheques are presented at you bank there would be a part of your monthly bank statement. A bank statement is a copy of the bank's record of your account. The balances on you bank statement is calculated after each transaction this is the running balance of recording. Items on the debit side of the cash book (bank column) would be recorded on the credit side of the bank statement and vice versa.

At the end of each month they would be items on your bank statement that is not recorded in your cash book and items in the cash book not in bank statements.

Items on the bank statement that is not recorded in the cash book

1. **Returned cheques** (dishonoured cheques) – these are cheques that are returned by the bank for various reasons. Reasons which include insufficient funds or word and figures on the cheque do not agree. On it written refer to drawer.
2. **Bank charges** – fees that the bank charges for operating your account.
3. **Interest received** – from the bank.
4. **Standing order** – is an agreement between you and your bank for it to make monthly payments, of fixed amount on a specific date, on your behalf.
5. **Credit transfer** – you may instruct your bank to pay a supplier on your behalf.

Items in the Cash Book that is not recorded on the Bank Statement

1. **Unrecorded Deposits** - deposits made to the bank that is not recorded on your bank statement
2. **Un-presented cheques** - cheques written but has not been presented to bank for cashing.

You can use either of two methods to reconcile your cash book with your bank statement after revising your Cash book.

1. Begin with balance on your revise cash book the end total should be the balance on your bank statement
2. Begin with the balance on bank statement with the end balance being the balance on you revised cash book.

Step to reconciliation your cash book and bank statement.

1. Tick the items that are recorded on both your bank statement and your cash book
2. Revise you cash book by including the items in your bank statement that are not in your cash book and then find the new balance for your cash book.
3. You can now use either method and complete you reconciliation.

The bank reconciliation statement would be as follows:

Name of business
Bank Reconciliation as at (date)

Balance per revised cash book
    Add unpresented cheques
    Less unrecorded deposits
Balance per bank statement

OR

Name of business
Bank Reconciliation as at (date)

Balance per bank statement
    Add unrecorded deposits
    Less unpresented cheques
Balance per revised cash book

Let now look at an example.

Example

The following is an extract from the bank statement and cash book (bank column) of JYPR Ltd for the month of September 2011

Cash Book (bank column only)

Sept 1	Balance	800	Sept 3	Insurance (chk 0892)	360
Sept 16	Sales	890	Sept 11	Drawings (chk 0893)	250
Sept 27	Sales	750	Sept 19	E. Peters (chk 0894)	440
			Sept 27	Electricity (chk 0895)	220
			Sept 31	Balance c/d	1,170
		2,440			2,440
Oct 1	Balance b/d	1,170			

Peters Bank Ltd

Bank Statement for JYPR Ltd

Date	Details	Dr	Cr	Balance	
2011		$	$	$	
Sept 1	Balance			800	Cr
Sept 5	Anjo Insurance plc (0892)	360		440	Cr
Sept 5	Direct Debit iMoble co.	230		210	Cr
Sept 14	Chk 0893	250		40	Dr
Sept 18	Sundries		890	850	Cr
Sept 21	Standing Order Aires Property Ltd	280		570	Cr
Sept 24	Credit Transfer – Ann Carter		480	1,050	Cr
Sept 27	Bank charges	80		970	Cr

The closing balance shown in two documents are different; cash book balance is $1,170, but the bank statement shows a balance of $970.

Let begin by ticking off the items that are in both the cash book and the bank statement.

Cash Book (bank column only)

Sept 1	Balance	✓	800	Sept 3	Insurance (chk 0892)	✓	360
Sept 16	Sales	✓	890	Sept 11	Drawings (chk 0893)	✓	250
Sept 27	Sales		750	Sept 19	E. Peters (chk 0894)		440
				Sept 27	Electricity (chk 0895)		220
				Sept 31	Balance c/d		1,170
			2,440				2,440
Oct 1	Balance b/d		1,170				

Peters Bank Ltd Bank Statement for JYPR Ltd					
Date	Details	Dr	Cr	Balance	
2011		$	$	$	
Sept 1	Balance			✓800	Cr
Sept 5	Anjo Insurance plc (0892)	✓360		440	Cr
Sept 5	Direct Debit iMoble co.	230		210	Cr
Sept 14	Chk 0893	✓250		40	Dr
Sept 18	Sundries		✓890	850	Cr
Sept 21	Standing Order Aires Property Ltd	280		570	Cr
Sept 24	Credit Transfer – Ann Carter		480	1,050	Cr
Sept 27	Bank charges	80		970	Cr

You will now revise or update your cash book on the 1st October 2011. This is done by including in the cash book the items from the bank statement that are not included

Revised Cash Book (bank column only)

Sept 1	Balance	800	Sept 3	Insurance (chk 0892)	360
Sept 16	Sales	890	Sept 11	Drawings (chk 0893)	250
Sept 27	Sales	750	Sept 19	E. Peters (chk 0894)	440
			Sept 27	Electricity (chk 0895)	220
			Sept 31	Balance c/d	1,170
		2,440			2,440
Oct 1	Balance b/d	1,170	Oct 1	Direct Debit iMobile co.	230
Oct 1	Credit Transfer	480	Oct 1	Standing Order	280
			Oct 1	Bank charges	80
			Oct 1	Balance c/d	1,060
		1,650			1,650
Oct 1	Balance b/d	1,060			

JYPR Ltd cash book is now updated. You can now prepare the bank reconciliation statement. To do this you include the items in the cash book that was not recorded in the bank statement.

JYPR Ltd

Bank Reconciliation Statement as at 1st October 2011

	$	$
Balance per revised cash book		1,060
Add Un-presented cheques		
E. Peters (chk 0894)	440	
Electricity (chk 0895)	220	660
		1,720
Less unrecorded deposits		750
Balance per bank statement		970

OR

JYPR Ltd

Bank Reconciliation Statement as at 1st October 2011

	$	$
Balance per bank statement		970
Add unrecorded deposits		750
		1,720
Less Unpresented cheques		
E. Peters (chk 0894)	440	
Electricity (chk 0895)	220	660
Balance per revised cash book		1,060

There are instances where both your bank statement and your cash book may record an overdraft. When this occurs you follow the same method to revise your cash book but your reconciliation statement would be done as follows.

Name of business

Bank Reconciliation as at (date)

Overdraft per revised cash book
Add un-recorded deposits
Less un-presented cheques
Overdraft per bank statement

OR

Name of business

Bank Reconciliation as at (date)

Overdraft per bank statement

Add un-presented cheques

Less un-recorded deposit

Overdraft per revised cash book

TOPIC SUMMARY

You would have learnt that there are various reasons why the balance in your cash book would be different from the balances on the Bank Statement. Once you have identified the these items you then revise or update your cash book by including in your cash book those items in your bank statement that are not in your cash book. The new total in your cash book is reconciled with your bank statement. You reconcile by starting with either the revised cash book balance or the bank statement balance.

TOPIC 4.5 PETTY CASH BOOK AND THE IMPREST SYSTEM

INTRODUCTION

Most business make small cash payments for goods and services in there day to day operations. These payments are too small to incur the bank changes for writing a cheque. This is what a petty cash system is used for making these small payments.

OBJECTIVES

Upon completion of this lesson you will be able to:

1. Write up a petty cash book.
2. Understand the Imprest system.

PETTY CASH SYSTEM

The petty cash system records small payments, leaving large sum for the cash book. The petty cash is usually kept by a junior clerk. An imprest system is used where fixed sum, or cash float is advanced by the cashier to the petty cashier. The total of the petty payments is refunded to the cashier at the end of the month, leaving the cashier with the same fixed or imprest amount in hand for the petty expenses of the following months. The petty cashier will produce the petty cash vouchers as evidence of the amount spent. The petty cash in hand should them be equal to the original amount with which the period started. This amount is called the “float”.

The receipt column is on the debit side of the petty cash book. On the credit side the date and details of each payment is record. Each payment is not only recorded in the total column but also in the analysis column. Analysis column are columns that indicate the various expenditure headings.

In order for employees to access the petty cash, a petty cash voucher has to be completed indicating what the funds will be used for and signed by requesting employee and approved by a supervisor or senior cashier.

Let us look at a worked example. Below are two petty cash vouchers for the month of October 2011 as completed by the petty cashier of JYPR Ltd.

No. 10 .	No. 7 .
PETTY CASH VOUCHER Date 29 Oct. 2011	PETTY CASH VOUCHER Date 20 Oct. 2011

For what required	Amount $	For what required	Amount $
Petrol	32.00	Postage	20.00
	32.00		20.00

Signature J. Jackson	Signature V. Peters
Approved by M. Richardson	Approved by M. Richardson

Petty cash vouchers were also completed for the following transactions.

2011		$
Oct 1	The cashier gave $600 as float to the petty cashier	
Oct 2	Petrol	22
Oct 3	L. Thomas – travelling expenses	24
Oct 10	Refund C Charles sales ledger account over paid	65
Oct 12	Cleaning expenses	50
Oct 15	J Harris – travelling	75
Oct 20	settle of P Phillip's account in the purchases ledger	35
Oct 22	petrol	30
Oct 27	Cleaning expenses	65
Oct 30	Postage	25

The petty cash book for October 2011 would be as follows:

Petty Cash Book

Receipts	Folio	Date	Details	Voucher No.	Total	Cleaning Expenses	Motor Expenses	Travelling Expenses	Postage	Ledger Folio	Ledger Accounts
$		2011			$	$	$	$	$		$
600	CB	1-Oct	Cash								
		2-Oct	Petrol	1	22		22				
		3-Oct	L Thomas	2	24			24			
		10-Oct	C Charles	3	65					SL	65
		12-Oct	Cleaning expenses	4	50	50					
		15-Oct	J Harris	5	75			75			
		20-Oct	P Phillip	6	35					PL	35
		20-Oct	Postage	7	20				20		
		22-Oct	Petrol	8	30		30				
		27-Oct	Cleaning expenses	9	65	65					
		29-Oct	Petrol	10	32		32				
		30-Oct	Postage	11	25				25		
					443	115	84	99	45		100
		31-Oct	Balance c/d		157	GL	GL	GL	GL		
600					600						
157		1-Nov	Balance b/d								
443	CB	1-Nov	Cash								

The information in the petty cash book is then transferred to the various ledger accounts.

Cash Book (Bank Column only)

2011			$	2011			$
				1-Oct	Petty Cash	PCB	600
				1-Nov	Petty Cash	PCB	443

General Ledger

Motor Expenses

2011			$				
2-Oct	Petty Cash	PCB	22				
22-Oct	Petty Cash	PCB	30				
29-Oct	Petty Cash	PCB	32				

Travelling Expenses

2011			$				
3-Oct	Petty Cash	PCB	24				
15-Oct	Petty Cash	PCB	75				

Cleaning Expenses

2011			$				
12-Oct	Petty Cash	PCB	50				
27-Oct	Petty Cash	PCB	65				

Postage

2011			$				
20-Oct	Petty Cash	PCB	20				
30-Oct	Petty Cash	PCB	25				

Sales Ledger

C. Charles

2011			$	2011			$
10-Oct	Petty Cash	PCB	65	1-Oct	Balance	b/d	65

Purchases Ledger

P. Phillip

2011			$	2011			$
20-Oct	Petty Cash	PCB	35	1-Oct	Balance	b/d	35

TOPIC SUMMARY

You have just examined the petty book of a JYPR Ltd. The information recorded in the petty cash book is derived from the petty cash vouchers which must be completed and approved before funds can be disbursed. The petty cash funds (float) are disbursed by the petty cashier. At the end of each period the petty cashier reimbursed the amount of the float spent to start the new period.

TOPIC 4.6 CONTROL ACCOUNTS

INTRODUCTION

Earlier you learned that certain errors were not revealed in the trial balance. In a large business you would have to check every item in every ledger.   This is done with the control accounts. This ensures that it is only the ledgers whose control accounts does not balance that need detailed checking to find errors.

OBJECTIVES

Upon completion of this topic you will be able to:

1. Draw up sales ledger accounts.
2. Draw up purchase ledger accounts.
3. Know the sources of information for control accounts.

CONTROL ACCOUNT PRINCIPLES

Control accounts are based on simple principle. If the opening balance of an account is known, together with the information on the additions and deductions entered in the account the closing balance can be calculated. The information to draw up control accounts are

Sales ledger control	**Source**
Opening debtors	List of debtors balances drawn up at end of previous period
Credit sales	Total from the sales journal
Return inwards	Total from returns inwards journal
Cheques received	Cash book bank column
Cash received	Cash book cash column
Discount allowed	Total of discount allowed column in the cash book
Closing debtors	List of debtors' balances drawn up at the end of the period

Purchases Ledger Control	**Source**
Opening creditors	List of creditors balances drawn up at end of previous period
Credit purchases	Total from the purchases journal
Return outwards	Total from returns outwards journal
Cheques paid	Cash book bank column payments side
Cash paid	Cash book cash column payment side
Discount received	Total of discount received column in the cash book
Closing creditors	List of creditors' balances drawn up at the end of the period

Control Accounts are prepared in the form as an account with the totals of the debit entries in ledger on the left hand side of the control account, and the totals of the credit entries in the ledger on the right hand side.

Worked Example

Ann runs a small business selling computer parts to wholesalers. Since he has numerous debtors and creditors she keeps sales and purchases ledgers and maintains both sales and purchases control accounts. The following information is available from Ann's books for 31 December 2010.

2011		$
1-Dec	sales ledger debit balances	4,756
1-Dec	sales ledger credit balances	350
1-Dec	purchases ledger credit balances	3,681
1-Dec	purchases ledger debit balances	287
Totals for the month ending December 31, 2011		
	cash sales	6,743
	bank sales	9,838
	cash purchases	4,231
	cheques and cash received from customers	11,742
	discount allowed	618
	return inwards	371
	cheques paid to suppliers	6,000
	petty cash paid to suppliers	120
	discount received	364
	return outwards	278
	bad debts written off	446
	cheques refunded to customers	280
	Dishonoured cheques	194
	sales ledger credit set-off with the purchases ledger	335
	sales ledger debit balances	2,335
	purchase ledger debit balances	165
	purchase ledger credit balances	4,021

Let's look at the solution for this question.

Ann

Sales Ledger Control Account For December 2011

2011		$	2011		$
1-Dec	balance b/d	4,756	1-Dec	balances b/d	350
31-Dec	sales	10,967	31-Dec	Cheques and Cash received	11,742
	cheques refunded	280		discount allowed	618
	dishonoured cheques	194		return inwards	371
				bad debts written off	446
				sales ledger credit set off	335
				balances c/d	2,335
		16,197			16,197
1-Jan	Balance b/d	2,335			

Ann

Purchases Ledger Control Account For December 2011

2011		$	2011		$
1-Dec	balance b/d	287	1-Dec	balances b/d	3,681
31-Dec	cheques paid	6,000	31-Dec	Purchases	7,559
	cheques refunded	120		Balances c/d	165
	discount received	364			
	return outwards	278			
	sales ledger set off	335			
	balance c/d	4,021			
		11,405			11,405
1-Jan	Balance b/d	165	1-Jan	balance b/d	4,021

UNIT REFERENCES

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UNIT SUMMARY

In unit four you were able to use different methods to analyse and interpret the financial statement of the business. You looked at accounting ratio that are useful to compare a business with another or with one period to another. You also examined errors that may occur in financial records and how to identify and correct these errors. You also looked a payroll system, how to reconcile your cash book with your bank statement and how control accounts are also used to identify errors in your books.

UNIT FIVE – FINANCIAL STATEMENTS OF OTHER ORGANIZATIONS

UNIT INTRODUCTION

So far we have look at the complete accounting records of a sole trader. In this unit we would take a introductory look at the accounts of different forms of business such as non-profit organizations, partnership and company. We will begin this unit by taking a look at incomplete records of sole traders and how the financial positions of these can be determined from these incomplete records.

UNIT OBJECTIVES

Upon completion of this unit you should be able to:

1. Draw up a trading and profit and loss account and balance sheet from records not kept on a double entry system.
2. Deduce the figures of sales and purchases form incomplete records.
3. Draw up income and expenditure accounts and balance sheets for non-trading organizations.
4. Calculate profit and losses from special activities and incorporate them into the final accounts.
5. Determine the financial positions of these non-trading organizations.
6. Understand exactly what a partnership is.
7. What are the main features of a partnership agreement.
8. Draw up final accounts for a partnership.
9. Understand exactly how limited companies differ from other organizations.
10. Calculate how distributable profits are available for dividends are divided between the different classes of shares.
11. Realize the differences between shares and debentures.
12. Draw up the trading and profit and loss accounts for a limited company.
13. Draw up a balance sheet for a limited company.

UNIT READINGS

The instructor will provide a list of readings.

ASSIGNMENTS AND ACTIVITIES

The instructor will provide guidance on the type of assignments and instructions.

Topic 5.1 Single Entry And Incomplete Records

Topic Introduction

We have been able thus far to prepare final accounts of sole traders who keeps a complete set of records. However many small business do not keep complete records and may have difficult determining if there business is making a profit or a loss. In this topic will look at these incomplete records.

Objectives

Upon completion of this topic you should be able to:

1. Draw up a trading and profit and loss account and balance sheet from records not kept on a double entry system.
2. Deduce the figures of sales and purchases form incomplete records.

Records Keeping

Many small businesses do not keep proper financial records which makes it difficult at first glance to determine the financial position of that business. Even with these incomplete records you are still able to determine whether or not this business is making a profit or loss.

However there are a couple of things you must remember before you continue. Firstly remember that profit increases capital. As you determined from the balance sheet of sole trader

Net Profit = closing capital - Opening capital

In the balance you are able to determine this year's capital by doing the following calculations

Opening Capital + Profit - Drawings = closing Capital

Usually when using incomplete records you are given two year's information to derive information about that business. The first year's information is used to draw up a statement of affairs to calculate the opening capital of the business. The second year's information is used to determine if the business is making a profit or loss.

Let look at a worked example.

J. Anderson kept records of her business transactions in a single entry form. Her bank account for the year 2010 is as follows:

	$		$
Balance 1.1.2010	1,890	cash withdrawn from bank	5,400
Receipts from debtors	44,656	trade creditors	31,695
Loan from T. Hughes	2,000	rent	2,750
		Rates	1,316
		Drawings	3,095
		Sundry expenses	1,642

Records of cash paid were: sundry expenses $122, trade creditors $642. Cash sales amounted to $698; cash drawings were $5,289. The following information is also available:

	31.12.2009	31.12.2010
	$	$
Cash in hand	48	93
Trade creditors	4,896	5,091
Debtors	6,013	7,132
Rent owing	-	250
Rates in advance	282	312
Motor van (at valuation)	2,800	2,400
Stock	11,163	13,021

We begin by calculation the capital at the end of 2009. This is done by drawing up a Statement of Affairs as at 31 December 2009.

J. Anderson

Statement of Affairs

As at 31 December 2009

Fixed Assets	$	$
Motor Van		2,800
Current assets		
Stock	11,163	
Debtors	6,013	
Bank	1,890	
Cash	48	
Rates prepaid	282	
	19,396	
Less current liabilities		
Creditors	4,896	14,500
		17,300 .
Financed by		
Capital (difference)		17,300
		17,300

You can now prepare total debtors and total creditors account. The total creditors account will be used to calculate the purchases figure and the total debtors account to calculate the sales figure.

Total Creditors' Account

	$		$
Cash	642	Balances b/d	4,896
Bank	31,695	Purchases (missing figures)	32,532
Balance c/d	5,091		
	37,428		37,428

Total Debtors' Account

	$		$
Balances b/d	6,013	Receipts: Bank	44,656
Sales (missing figure)	46,473	cash	698
		Balances c/d	7,132
	52,486		52,486

Cash Book

Details		Cash	Bank	Details		Cash	Bank
		$	$			$	$
Balance	b/d	48	1,890	Cash	C		5400
Receipt from debtors			44,656	Trade Creditors		642	31,695
cash sales		698		rent			2,750
Loan from Carter			2000	rates			1,316
Bank	c	5,400		drawings		5,289	3,095
				sundry expenses		122	1,642
				Balance	c/d	93	2,648
		6,146	48,546			6,146	48,546

J. Anderson
Trading and Profit and Loss Account
For the year ended 31 December 2010

	$	$
Sales		46,473
Less cost of goods sold		
Opening Stock	11,163	
Add Purchases	32,532	
	43,695	
Less closing stock	13,021	30,674
Gross Profit		15,799
Less Expenses		
Rent (2,750 + 250)	3,000	
Rates (1,315 + 282 -312)	1,286	
Sundry expenses	1,764	
Depreciation: Motor Van	400	6,450
Net Profit		9,349

TOPIC SUMMARY

You would have realized that you are still able to determine the profit or loss from a business that don't keep complete records. The basic information you are still able to determine the profitability of a business and prepare final accounts of that business.

TOPIC 5.2 RECEIPTS AND PAYMENTS ACCOUNT

TOPIC INTRODUCTION

So far we have only look at business that aim is to make a profit. However there a businesses and organizations whose may interest are not to make a profit but to provide a service. We will now have a look at these not profit making businesses.

OBJECTIVES

Upon completion of this topic you should be able to:

1. Draw up income and expenditure accounts and balance sheets for non-trading organizations.
2. Calculate profit and losses from special activities and incorporate them into the final accounts.
3. Determine the financial positions of these non-trading organizations.

NON-PROFIT ACCOUNTS

Organizations such as schools, clubs and churches do not have trading and profit and loss accounts drawn up as their main purpose is not trading or profit making. The final accounts prepared for these organizations are Receipts and Payments account in place of a Cash Book and the Income and Expenditure Account in place of the trading and profit and loss accounts. The same rules that a apply for the preparation and use of the cash book and trading and profit and loss account still applies to the receipt and payment accounts and the income and expenditure accounts. There are some other differences in the terms used.

Profit Making Business Terms	Non-Profit Making Organizations Terms
Trading And Profit And Loss Accounts	Income And Expenditure Accounts
Net Profit	Surplus Of Income Over Expenditure
Net Loss	Excess Of Expenditure Over Income
Capital	Accumulated Fund

Accumulated fund = Assets - Liabilities

There are instances where non-profit making organization will hold functions or activities to make profit. A trading account for this activity will have to draw up to determine if a profit or loss was made from the activity. That profit or loss is then transferred to the income and expenditure account. Many non-profit organization generate income by charging there members fees to be a part of the organization (subscriptions or membership fees), they may also charge new members entrance fees and they may also receive donations from other groups or organizations.

Let us look at worked example.

On 31 December 2011 the following information for the Sugar Bridge Social Club is made available to you.

Balances on the 1st January 2011	$
Bank	3,070
Subscriptions in arrears for 2010	290
Subscription received in advance for 2009	420
Equipment	1,800

In respect of the year to 31 December 2010, the following information is given to you:

Subscription received (including 2009 arrears)	5,920
Equipment bought	700
Groundsman's wages	2,880
Sale of lottery tickets	1,090
Receipts from discos	7,510
Disco cost – including musicians	4,970
Teams' travelling expenses	1,220
Competition prizes bought	580
Rent of buildings	2,170
Receipt for ground hire	900
Committee expenses	690
Donations from well-wishes	1,500

Subscription due but unpaid at 31 December 2009 amounted to $370. Depreciate equipment 10%.

We begin by drawing up the subscription account

Subscription Account

	$		$
Arrears b/d	290	Received in Advance b/d	420
Income and Expenditure account	6,420	cash	5,920
		Arrears c/d	370
	6,710		6,710

Sugar Bridge Social Club
Receipts and Payments Account
for the year ended 21 December 2011

Receipts	$	**Payments**	$
Balance b/d	3,070	Equipment	700
Subscriptions	5,920	Pay	2,880
Sale of Lottery tickets	1,090	Disco costs	4,970
Receipts from discos	7,510	travel expenses	1,220
ground hire	900	competitions prizes	580
donations	1,500	committee expenses	690
		rent of buildings	2,170
		balance c/d	6,780
	19,990		19990

Sugar Bridge Social Club
Income and Expenditure Accounts
For the year ended 31 December 2011

	$	$
Income		
Subscriptions		6,420
Sale of lottery tickets		1,090
Receipts from discos	7,510	
less cost of disco	4,970	2,540
ground hire		900
donations received		1,500
		12,450
Less expenditure		
Groundsman's pay	2,880	
team's travelling expenses	1,220	
competitions prizes	580	
rent	2,170	
committee's expenses	690	
depreciation	250	7,790
surplus of income over expenditure		4,660

TOPIC SUMMARY

Not all businesses are trading or profit making business. Some businesses are in operation to other as service to the community. These non-profit organizations however do keep records of their financial transactions. Instead of a cash book they have a receipt and payments account, instead of capital they have accumulated fund and instead of trading and profit and loss account they have income and expenditure account.

TOPIC 5.3 PARTNERSHIP ACCOUNTS

INTRODUCTION

A partnership is formed when two or more person decide to go into business together. The terms and conditions of the partnership should be determined by all parties before the business venture begins. The partnership act gives guidelines on the formation and dissolving of partnership agreement.

OBJECTIVES

Upon completion of this topic you should be able to:

1. Understand exactly what a partnership is.
2. Describe the main features of a partnership agreement.
3. Draw up final accounts for a partnership.

PARTNERSHIP AGREEMENTS

In the earlier units we had a look at sole trader businesses. However many businesses that are set up to make a profit have more than one owner. This could be:

- To raise the capital required to support business growth.
- Gain the experience and abilities needed to operate the business.
- Expand the product line.
- Share management.

The Partnership Agreement

A partnership arrangement has the following desire outcomes.

- It is formed to make a profit
- It must follow the laws as laid out in the partnership act
- Normally there is a minimum of two partners and a maximum of twenty partners
- Each partner (except for limited partners) must pay his or her share of any debts that the partnership cannot pay.

Unlimited liability partners can be forced to sell their private possessions to pay their share of the debts. Limited liability partners are not liable for the debts of the business. They have the following characteristics

1. Their liability is limited to the capital they have put in the business. They can lose the capital but they cannot be asked for any more money
2. They are not allowed to take part in the management of the business

A partnership agreement usually contains the following information

- The capital to be contributed by each partner

- The ratio in which profits or losses should be shared
- The rate of interest if any to be paid on capital before profits
- The rate of interest if any to be charged on partner's drawings
- Salaries to be paid to partners
- Arrangements for the admission a new partners
- Procedures to be carried out when a partner dies or retires.

If there is not agreement in place then the partnership act states that

- Profits and losses will be shared equally
- There is no interest on capital
- No interest is to be charged on drawings
- Salaries are not allowed

Capital Accounts

The value of the partners holding in the business will consist of:

- The original capital put into the business by the partner.
- His or her spare of the profits, interest on capital (if any), salary (if any), less interest on drawings (if any) and drawings themselves. This is the amount of undrawn profits.

Each partner will have an account that contains both sets of information. The balance on this account would fluctuate each year as drawings rarely equal profits. This is called fluctuating Capital Account.

On the other hand, we could keep the original capital figure in an account for each partner. These we would keep at the same figure and we would call these fixed capital accounts. We would should the share of profits and interest on capital for each partner in a separate account called Current Account.

Jack and Jill are in partnership, sharing profits and losses equally. The following is their trial balance as at trial balance as at 30 June 2011.

	Dr. $	Cr. $
Building at cost	50,000	
Fixtures at cost	11,000	
Provision for depreciation: fixtures		3,300
Debtors	16,243	
Creditors		11,150
Cash at bank	677	
Stock at 30 June 2010	41,979	
Sales		123,650
Purchases	85,416	
Carriage outwards	1,288	
Discount allowed	115	
Loan interest: Williams	4,000	
Office expenses	2,416	
Wages	18,917	
Bad debts	503	
Provision for Bad debts		400
Loan from J. Williams		40,000
Capital:		
Jack		35,000
Jill		29,500
Current Accounts		
Jack		1,306
Jill		298
Drawings:		
Jack	6,400	
Jill	5,650	
	244,604	244,604

Additional information for Jack and Jill.

- Stock 30 June 2011; $56,340.
- Expenses to be accrued: office expenses, $96; wages $200.
- Depreciate fixtures 10% on reducing balance basis. Depreciate buildings $1,000.
- Reduce provision for bad debts to $320.
- Partnership salary: $800 Jack.
- Interest on drawings $180, Jack, $120.
- Interest on capital account balances at 10%.

Jack and Jill
Trading and Profit and Loss Account
for the year ended 30 June 2011

	$	$	$
Sales			123,650
less cost of goods sold:			
Opening stock		41,979	
Add Purchases		85,416	
		127,395	
Less closing stock		56,340	71,055
gross profit			52,595
add reduction in Provision for bad debts			80
			52,675
less expenses			
Pay (18,917 + 200)		19,117	
Office expenses (2,416 + 96)		2,512	
Carriage outwards		1,288	
Discount Allowed		115	
Bad Debts		503	
Loan interest		4,000	
Depreciation: fixtures	770		
buildings	1,000	1,770	29,305
Net Profit			23,370
Add Interest on drawings			
Jack		180	
Jill		120	300
less interest on capital:			
Jack	3,500		
Jill	2,950	6,450	
Less Salary: Jill		800	7,250
			16,420
Balance of profits shared:			
Jack		8,210	
Jill		8,210	16,420

Jack and Jill
Balance Sheet
as at 30 June 2011

Fixed Assets	**Cost**	**Depreciation**	
	$	$	$
Buildings	50,000	1,000	49,000
Fixtures	11,000	4,070	6,930
	61,000	5,070	55,930
Current Assets			
Stock		56,340	
Debtors	16,243		
Less Provision for bad debts	320	15,923	
bank		677	
		72,940	
Less current liabilities			
creditors	11,150		
expenses owing	296	11,446	
working capital			61,494
			117,424
Less Long-term			
loan from J. Williams			40,000
			77,424
Financed by			
capital			
Jack		35,000	
Jill		29,500	64,500
Current Accounts	**Jack**	**Jill**	
Balance 1.7.2010	1306	298	
Add interest on capital	3,500	2,950	
Add Salary	800	-	
Add balance of profits	8,210	8,210	
	13816	11458	
Less Drawings	6,400	5,650	
Less Interest on Drawings	180	120	
	7,236	5,688	12,924
			77,424

TOPIC SUMMARY

When two or more individuals come together to do business a partnership is formed. Each partner is required to make contribution the business' capital. A partner can have limited or unlimited liability but at least on partners should have unlimited liability.

TOPIC 5.4 COMPANY ACCOUNTS

TOPIC INTRODUCTION

So you have looked at the financial records for a sole trade and a partnership business. You can examine the financial records of another form of business a company. Limited liability companies are needed because of the disadvantages of the partnership business. A partnership can have a maximum of twenty persons who may not be able to raise the capital needed to fund a very large corporation. Also if a partnership falls the partners can lose part or all of his private and business assets. Limited companies enable large businesses to be formed and help the owners safeguard their private assets

TOPIC OBJECTIVES

Upon completion of this topic you should be able to:

1. understand exactly how limited companies differ from other organizations
2. calculate how distributable profits are available for dividends are divided between the different classes of shares
3. realize the differences between shares and debentures
4. draw up the trading and profit and loss accounts for a limited company
5. draw up a balance sheet for a limited company

TYPE OF COMPANY ACCOUNTS

There are two types of limited companies public company and private company. A private company must have a minimum of two and a maximum of fifty members. It must also ask people to buy shares privately it cannot do so publicly. The public company can have at least seven members and can have as many members as it wants. It can also advertise its shares to the public for purchase.

The capital of a limited liability company is divided into shares. To be a member or shareholder of a limited liability company you must purchase shares. Once the shareholder have paid up fully for their shares their liability in limited to those shares. If the company loses all its assets, the shareholder can only lose their shares. They cannot be forced to pay anything of their private money in respect of the company's losses.

An individual who purchase shares in a company is called a shareholder. A shareholder has the right to attend general meetings of the company and vote at these meetings. Shareholders use their vote to appoint **directors** who manages the business on behalf of the shareholders. A shareholder receives a share of the profits known as a **dividend.**

A company is a "separate legal entity" from its members. This means that a company is not considered to be the same as its members. A company and sue and be sued by even its own shareholders.

TYPES OF SHARES

There are two types of shares:

- **Preference shares** – these get an agreed percentage rate of dividend before the ordinary shareholders.
- **Ordinary shareholders**- receive the reminder of the total profits available after preference share holders have received their dividend.

Preferences Shares can be further divided into:

- **Cumulative preference shares** – these have an agreed maximum percentage dividend. Any shortage of dividend paid in one year can be carried forward to the next year. The arrears of cumulative preference share must be paid before ordinary shareholders receive their dividend.
- **Non-cumulative preference shares** – these receive a dividend up to an agreed percentage each year. Any shortage is lost and cannot be carried forward to the next year.

Normally preferences as 5% preference shares the percentage that is shown is the rate of dividend that the shareholder will receive. So if a shareholder has $2000 5% preference share then they will receive 5% x 2000 = 100 in *dividend.*

A company has different types of share capitals.

- Authorized share capital known as nominal or registered capital. It is the total of the share capital that the company is allowed to issue to the public.
- Issued share capital is the total of the actual share capital that has been offered to the public.
- Called-up share capital is the total amount asked for on all the shares. It may be only part of the amounts payable on each share.
- Uncalled share capital is the total amount that is to be received in future but which has not yet been asked for.
- Calls in arrears the total amount for which payments have been asked for but has not yet been paid by shareholders.
- Paid up capital is the total amount of share capital that has been paid for by shareholders.

FINAL ACCOUNTS

The trading account of a limited company is no different from that of a sole trader or a partnership. There are some differences in the profit and loss account. There are two main expenses that would only be found in company accounts.

- **Directors' remuneration**. Directors are legal employees of company appointed by the shareholders. Their remuneration is charged to the main profit and loss account.
- **Debenture interest.** Debenture is the money a company receives as a loan. The lender is paid interest at an agreed percentage this is known as the debenture interest.

Under the profit and loss account for a company is an appropriation account. The appropriation account shows how the net profits are to be used. The following is recorded in the appropriation account

Credit side

- Net profit from the year – this the net profit brought down from the profit and loss account
- Balance brought forward from last year – any profits that remain from the last year is also brought forward.

Debit side

- Transfer to reserves – directors may decide that some of the profits should not be included in the calculation of how much should be paid out as dividends. These profits are transferred to the reserve account. There may be a specific reason for the transfer, such as a need to replace fixed assets; in this case the amount would be transferred to a fixed assets replacement reserve. Or the reason may not be specific; in this case an amount would be transferred to a general reserve account.
- Amounts written off as goodwill.
- Amounts written off as preliminary expenses. When a company is formed there are many kinds of expenses concerned with its formation e.g. legal expense and various government taxes.
- Taxation payable on profits.
- Dividends out of the remainder of the profits.
- Balance carried forward to the next year.

Worked Example

C. Black Ltd has an authorized share capital of 90,000 ordinary shares of $1 each and 10,000 10% preference shares of $1 each. The company's trial balance extracted after one year of trading was as follows on 31 December 2011.

	$
Net profit for 31 December 2011	11,340
Debentures	30,000
issued ordinary share capital, fully paid	60,000
issued preference share capital, fully paid	10,000
creditors	3,550
debtors	4,120
cash	2,160
stock	8,800
provision for bad debts	350
provision for depreciation: equipment	4,500
Equipment at cost	45,000
Premises at cost	50,000
bank (use missing figure)	?

The directors decide to transfer $1,500 to the general reserve and to recommend a dividend of 12 ½ % on the ordinary shares. The preference dividend was not paid in until after January 2012

C. Black Ltd
Appropriation Account
for the year ended 31 December 2011

	$	$
Net Profit b/d		11,340
Less Appropriation		
transfer to general reserve	1,500	
preference dividend 10%	1,000	
Proposed ordinary dividend 12 1/2 %	7,500	10,000
retained profits carried forward		1,340

C. Black Ltd
Balance Sheet
as at 31 December 2011

Fixed Assets	$	$	$
Premises at cost			50,000
equipment at cost		45,000	
less Depreciation		4,500	40,500
			90,500
Current Assets			
Stock		8,000	
Debtors	4,120		
less provision	350	3,770	
bank		9,660	
cash		2,160	
		23,590	
less current liabilities			
creditors	3,550		
Proposed dividends	8,500	12,050	12,340
			102,840
less long-term liability			
Debentures			30,000
			72,840
Financed by			
share capital			
Authorized		100,000	
Issued:			
60,000 ordinary shares $1		60,000	
60,000 preference shares $1		10,000	70,000
Reserves			
General reserve		1,500	
Retained profits		1,340	2,840
			72,840

TOPIC SUMMARY

You have completed your examination of the final accounts of Limited Liability Company. Be sure to take not of the difference in their final accounts to the final accounts of sole trader and partnership businesses. Remember that a company raises capital by offer shares individuals. Shareholders will in turn receive dividend on the amount of shares that they purchase

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Wood, F., & Robinson, S. (2007). *Principles of Accounts for the Caribbean (5th ed.).* England, Pearson Education Limited

UNIT SUMMARY

Throughout this unit you were introduced of different forms of business and the financial records of these businesses. You should be able to identify the difference between a sole trader, partnership and company. You should also be able to identify how each form of business raises its capital. As you move along in your studies you would come upon complicated forms of these financial records. However before you move along be sure that you are able to master the information provided in this unit.

FINAL ASSIGNMENT/PROJECT

The final assignment/project will be provided by your instructor. The ideal project is should be based on the following.

Ideally the final project for this course will require you to prepare final accounts for a sole trader from a list of transaction and source documents. The course has been designed to provide your guidance and activities that will prepare you to complete the final project assigned by your instructor.

The instructor should post final project instructions here.

COURSE SUMMARY

This course has provided the entrepreneur the basic accounting principles and practices to manage the day to day finances of a small business. The ideal business environment is one where the entrepreneur works with a bookkeeper and account to effectively manage the financial activities of the company. The second course in the diploma programme will add to your knowledge of financial management and provide guidance on how to effectively create, implement and manage a small business financial plan that allows the business to grow and succeed in accordance with the company's strategic plan.