The State of Eritrea
Ministry of Education

Business and Economics Education

For
Grade 10

Textbook

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Preface

Dear learners!! Welcome to this Business and Economics Education Textbook. We hope that students will find the textbook interesting and worthwhile. This Textbook is carefully prepared to help the learners understand basic Business and Economics Education. The Textbook is designed in such a way to contribute to the change of values, attitudes and behavior of the learners. Moreover, it will contribute to building the critical thinking capacity, analysis and understanding of business and economics concepts. Accumulating business and economics knowledge and skills will help you to have a sound foundation for your future career and personal life in the real world.

The content of this textbook is organized as follows: Each unit starts with a set of expected learning achievements which highlight the main concepts you should aim at while studying. Each unit has several sub-units which are well explained and every new technical term in each sub-unit is highlighted. There are several activities in each unit. At the end of each sub-unit, review questions, exercises and problems are provided and there are lists of key terms in order to help you recall their meaning. At the end, projects and references are also provided.

Studying Business and Economics Education will help you get more job opportunities both in the private and pubic sector. Thus, the prime responsibility in studying the Textbook depends on your dedication to attain the expected learning outcomes of the textbook. While studying the textbook, you have to answer all activities, review questions, exercises and problems. Moreover, you will be assigned into groups and you will work on exercises, projects and cases. Thus, you will be required to actively participate in group discussions and presentations. You should also do a self-assessment on the list of key terms given at the end of each unit with a view to the expected learning outcomes.

A Teacher's Guide to accompany this student Textbook is available as a resource material to teachers. It provides competencies targeted, teaching suggestions, additional information, solutions to focus questions, activities, review questions, exercises and problems, and provides assessments of each sub-unit.

Parents have to encourage the learners to read and study the Textbook and answer all activities, review questions, exercises and problems. Depending on their level of capacity, parents should support the learners in overcoming difficulties while studying the Textbook.

Communities at large also have their role in achieving the expected learning objectives of the Textbook by creating an environment of harmonized teaching-learning culture; by cooperating with the school management and by encouraging the parents to actively participate in following the academic activities of their children.

Finally, please note that even though some company names mentioned in this text may be real companies operating in Eritrea, the financial data presented are hypothetical figures used for learning purposes only.

Introduction

This Business and Economics Textbook is designed for Grade 10. The Textbook is comprehensive comprising three interrelated areas of Economics, Business, and Bookkeeping.

Business and Economics Education for Grade 10 is a foundation for the subsequent Business and Economics Education to be offered in Grade 11 and 12 as well as at the tertiary levels. It also lays the basis for critical thinking, analysis, decision making of the learners as consumers, potential producers, professionals and entrepreneurs. It paves the way for critical analysis in resource utilization, recording, analysis, and decision for a better achievement.

The subject will be given in two semesters to Grade 10 students. Hence, Business and Economics Education-I will be given in the first semester and Business and Economics Education II in semester two.

Studying Business and Economics Education is crucial for a number of reasons. It helps the aspiring learners to develop their knowledge, analytical skills and decision making powers and supports them in making career choices in the area of study. Furthermore, students will also learn the record keeping procedures that are useful to keep track of the financial affairs of the business or any other organization.

Expected learning outcomes

At the end of the course of Business and Economics Education, learners will be able to develop basic knowledge and understanding of business and economic concepts and principles; use tools of business and economic analysis in particular situation; apply business and economic skills with reference to individuals, groups and organizations in order to better understand the environment in which the learners live; demonstrate knowledge and understanding of how the main types of business and economic institutions are organized, financed and operated and how their relations with other organizations and clients are regulated.

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UNIT 1

Basic Economics concepts

This first unit deals with the basic concepts of business and economics. It consists of the following subunits: Introduction to Economics, Production of Goods and Services, Business Organizations, Transportation and Communication Systems.

Expected learning outcomes

After the completion of Unit 1, you are expected to:

- Explain what economics is about;
- Identify the common causes of economic problems;
- Find solutions to economic problems through principles of opportunity cost;
- Explain the relationships between scarce resources and unlimited wants;
- Differentiate between needs and wants;
- Explain the basic concepts of production of goods and services;
- Describe the different factors of production;
- Identify the different types of business organizations; and
- Explain the different types of modern transportation and communication systems.

1. Introduction to Economics

Focus Questions:

1. Can you list some essential things for our daily life?
2. What do you think are the main reasons why people do not meet all their desires using their incomes?
3. How do you think individuals as consumers or producers cope with scarcity in their daily life?

Have you ever noticed that people are never satisfied with the material things they have? Some people with no houses may want to own houses ; some people who own small houses may want to own larger and more houses; some others may want to own luxurious cars, kilograms of jewelry; television, refrigerator, washing machine; while some people may want to get the highest level of education as well as to have access to the best quality of health services. Some people are seen to hardly meet their basic needs and may want to own more material things to meet their basic needs. Whether people are poor or rich they all want to own more material things because human wants are unlimited.

As a student, you could choose whether to study Business and Economics for one hour or watch television and whether to help your mother at home or to go to a library to finish your home work. If you choose to study Business and Economics, you have to give up watching television. Similarly, if you choose to go to the library, you have to give up helping your mother. The choices you make are simply economic decisions on the use of your time-which is a scarce resource. Other people also make various choices which have aspects of economics.

Economics is thus concerned with the making of choices in our daily life as consumers or producers of goods and services. For instance, with an income of 2,000 Nakfa, Mussa would be required to make a choice on what goods– food, clothing, watch, bicycle, etc. to purchase due to of his limited income. He could spend his income on purchasing the goods which give him the greatest level of satisfaction or utility.

Producers make choices on what goods to produce or what services to provide with their limited resources. A producer is motivated by the desire to earn profit. He/she will therefore produce those goods and services which are in greatest demand. For instance, if the demand for milk is greater than the demand for potatoes, a producer will produce more milk in order to earn more profit.

But economics is not only concerned with the choices that individual consumers like Mussa and producers of goods and services make. Economics also deals with the choices governments make on what services to provide to their people out of their limited tax revenue. That is, governments choose where to spend their limited income: on housing? Education? Health services? Or on the construction of power supply? Governments spend their revenues in a way that they think will increase the welfare of their citizens.

Individuals like Mussa, business/producers and governments always make choices. But why are these choices necessary? Choices have to be made because the productive resources required to produce goods and services are scarce in all societies. *Scarcity* of resources is the inability of societies to produce enough goods and/or services to satisfy all their material wants and needs. Scarcity of resources forces societies to make choices on how to use their scarce resources. Economic choices are thus deciding between different uses of scarce resources because resources used to produce one output, say food, cannot simultaneously be used for the production of other goods, say shoes. The choices that individuals and societies make in response to scarcity are the subject matter of economics. Choices also involve sacrifice or cost. If a society chooses to produce more food, it means that it will allocate more of its resources for the production of food. The society will thus have fewer resources for the production of other goods and services. Figure 1.1 shows the choices consumers have to make while purchasing various consumer goods. Economics is the science of making choices with the objective to meet human wants as much as possible.

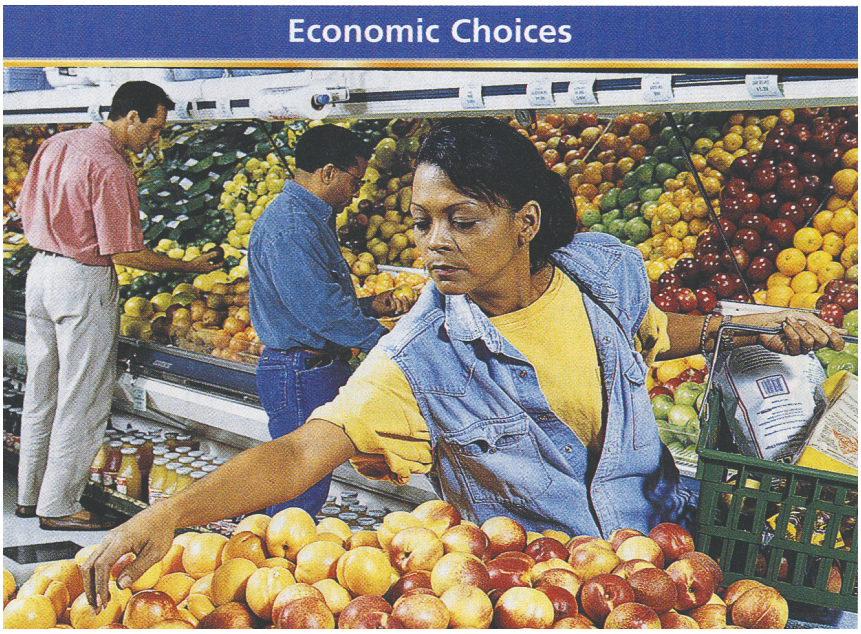


Figure 1.1 Economic choices

Economics as a field of study is in the category of social sciences because it deals with the behavior of people while making choices/decisions on the utilization of their resources. The relationship between scarce resources, unlimited wants and the making of choices is central to the study and definition of economics.

Economics is the study of how individuals and societies choose to use their scarce resources in order to satisfy their material wants as much as possible**.** Economics is a social science concerned with the efficient use of limited (scarce) resources to achieve maximum satisfaction of human material wants.

Activity 1.1
Work in your assigned group on the following question:
1. Why do we study economics? Explain.

(i) Central /Fundamental Economic Problem of all Societies

Focus Questions:

1. As consumers, what do you think are the fundamental economic problems that you face?
2. What would you like to purchase if someone from your family gives you an amount of Nakfa? Do you think that all your wants would be satisfied with the money you received?

An important characteristic of people's wants is that they always tend to get more items. Thus, human wants for material items such as food, clothing, housing, cars, television, education, etc., are unlimited both individually and collectively. However, the quantity of resources available for the production of goods and services are limited. Thus, we cannot produce everything we want in the quantities desired. The coexistence of scarce resource and unlimited human wants brings us to the fundamental question: how can a society best satisfy its wants with the scarce resources at its disposal?

All countries or societies have land, raw materials, people, and capital but their quantity and quality are still limited in relation to the unlimited wants of their people. Scarcity will always exist and cannot be eliminated in all societies; it is a universal economic problem. Scarcity of resources is the central economic problem of all societies or countries. Scarcity of resources forces all societies to make three choices (economic decisions):

- What goods and services will be produced and in what quantities?
- How the goods and services will be produced?
- For whom the goods and services will be produced?

What goods and services to produce? This refers to the fact that every society faces endless wants but is capable of producing only limited varieties and amounts of goods and services. Every society, therefore, must choose the types of goods and services that it wants to produce. For example, if the society wants more food to satisfy its wants, then the society must allocate more of its resources for the production of food. Similarly, if the society prefers to provide more health care services, it means it has to allocate more of its resources to health care.

How the goods and services are to be produced? This refers to the fact that any product can be produced in various ways with different combination of resources. That is, a society has to make a choice regarding the combination of inputs. The combination of inputs could be either labor-intensive which uses more labour and less capital, or capital-intensive which uses more capital and less of labour. The choices regarding the combination of inputs depend on the availability and the relative cost of the inputs. If labour is relatively cheaper than capital, labor-intensive method of production will be preferred to capital- intensive method of production to produce goods and services.

For whom the goods and services will be produced?

This refers to the mode of distribution of the goods and services produced. A society has to decide which members of the society will receive their share of the total goods and services produced. For example, if a society produces fewer houses compared to those who need houses, it has to decide which section of the society will get the houses: the workers, professionals or government employees?

Activity 1.2

1. Why is "what to produce" a problem in every society /economy?
2. Why is "how to produce" a problem in every society/economy?
3. Why is "for whom to produce" a problem in every society/economy?

Figure 1.2 shows the relationship between scarce resources and the making of choices by a society determined by the economic system of the society.

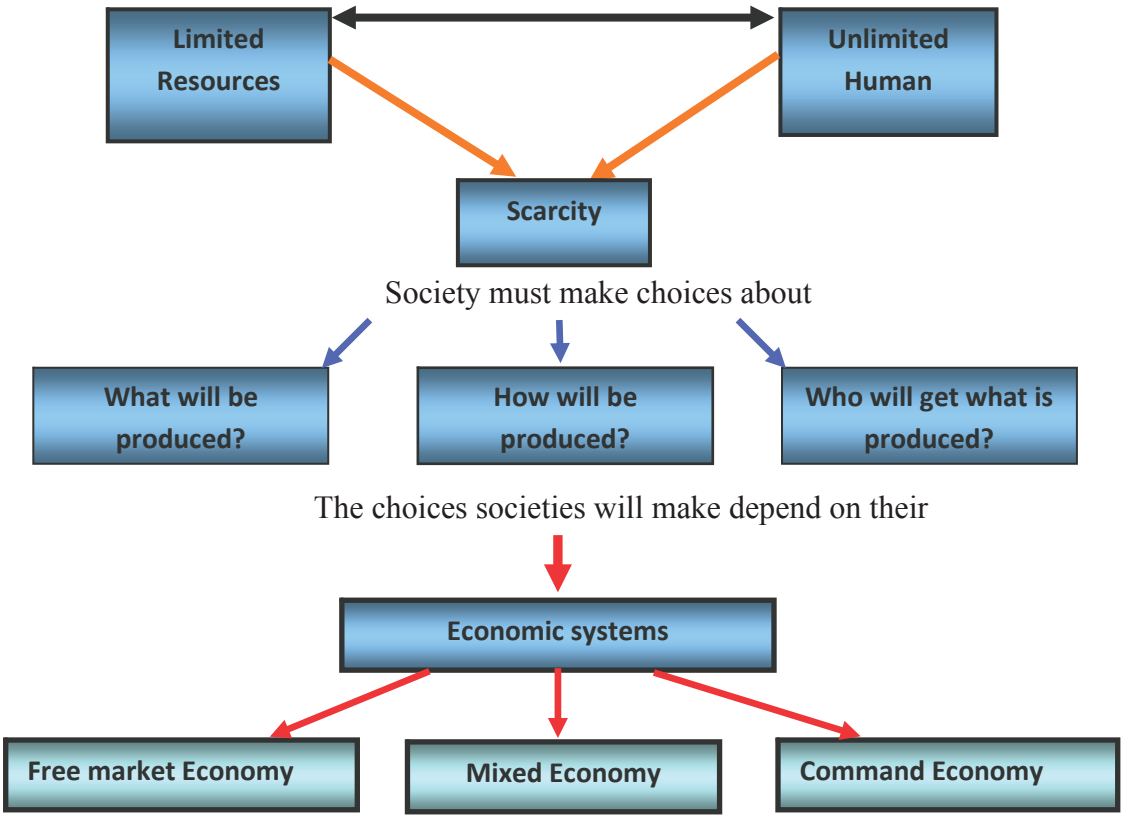


Figure 1.2 Relationships between scarcity, choices and economic systems**.**

Scarcity is thus the fundamental economic problem that forces societies to make choices and to use their resources efficiently. This is known as the "economizing problem". The economizing problem means using our resources efficiently (carefully and wisely) in order to satisfy our wants as much as possible.

(ii) Economic Systems

Focus Questions:

1. Who are the main producers of goods and services in your locality?
2. Do you think that any society can produce goods and services that meet all its wants? What are your views?
3. Why does the economic system a society chooses matter for the society?

At the centre of the improvement of mankind is his ability to develop new means of production to produce more goods and services to satisfy his growing wants. A long time ago, societies in different parts of the world were traditional. Their social and economic lives were guided by their customs and traditions. Each individual's life –economic, social and personal was largely predominated by tradition. In a traditional economic system, each participant's task and methods of production were prescribed by customs or traditions. Traditional societies tended to use the same techniques of production as their parents did and were slow adapt to new production technology. Traditional economy tended to be a subsistence economy with little or no surplus production. In a traditional economy, the production and distribution of goods was made according to long-established traditions. The standard of living of traditional societies remained low because of the low level of production and consumption. In traditional societies, their respective customs and traditions had maintained their social, economic and political stabilities; held together their members and maintained these societies over the centuries.

Traditional economic system is an economic system in which traditions and customs of the society determine how the society will use its scarce resources.

Throughout the world, there has been increasing erosion and breakdown of traditional societies mainly because of the great influences of the technological progress in production, communications and transportation systems and the expansion of international trade. These changes helped societies to develop their modern economic systems that would guide their socio-economic development. Every economic system must answer three basic economic questions: what goods and services to produce? How to produce the goods and services? For whom will the goods and services be produced? The manner in which a society makes these three basic economic decisions depends its economic system.

Economic systems are divided on the basis of two main criteria:

(i) The ownership of resources or factors of production.

(ii) The mechanisms of allocating the resources for the production of goods and services and the mode of distribution among the members of the society.

Economic system refers to the way a society allocates its scarce resources and makes the three economic decisions.

There are three main economic systems. They are: capitalist, command and mixed.

(a) Capitalist economic system/free market system

This economic system is characterized by the private ownership of resources and the use of system of a markets. The essential feature of free market system is that it is guided by the market forces of supply and demand. The free market system communicates through prices, and coordinates economic activities through markets where buyers and sellers come together. In this economic system, there is a high degree of competition among producers or sellers (see Figure 1.3).

In a free market system, each economic agent (consumer or producer) acts on his or her own self-interest. Consumers seek to maximize their satisfaction while producers seek to maximize their profits through their own decisions regarding consumption and production, respectively. When consumers express their willingness to buy a given product, its price will increase. Producers, seeing the rise in the price of the product will increase their production and supply the good in the market. For example, if the demand for shoes increases in the market, the price of shoes will be increased. Producers of shoes will soon see that the price of shoes has increased. The shoe producers will then increase their production and supply shoes to the market with the objective to earn more profit.

Capitalist economic system is an economic system where all resources are owned by individuals (privately) and the basic economic decisions on the allocation of resources and the production of goods and services are made by individual producers and buyers coordinated by the market mechanism.

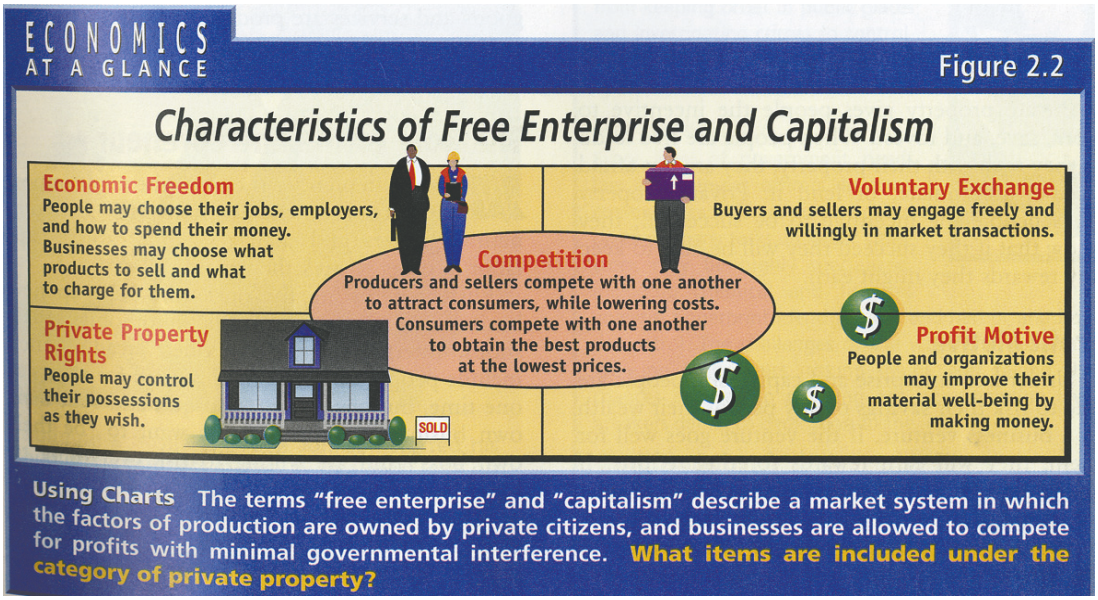


Figure 1.3 Characteristics of capitalist economy

(b) The Command Economic System

This economic system is characterized by public (government) ownership of resources. The major economic decisions concerning the use of resources, organization of production and the mix and distribution of output are determined by a central planning authority established by the government. Because the economy is coordinated by a central planning authority (government), command economy is also called centrally planned economic system.

In this economic system, the government decides how many hectares of land to cultivate for maize production, wheat production, fruits and vegetables, etc. how much to invest for shoe production, cloth production as well as for the production of capital goods; how many houses to construct; what salary to pay for the government employees. The government also determines how the goods produced will be distributed among the people. There is little competition among the producers or sellers in this economic system. In a command economy, the prices at which goods and services are sold are determined by the government and that the market forces of supply and demand have little in flue. Command economy is also described as a socialist economic system that was practiced to a greater degree in Eastern Europe and the former Soviet Union before 1990s.

Command economic system is an economic system where all resources are owned by the government (public) and the basic economic decisions on the allocation of resources and the production of goods and services are made by a central planning authority (government) rather than by individual producers or buyers.

(c) Mixed Economic System

In the real world, no economic system is based on a purely free market system or a purely centrally planned economic system. Thus, free market system and centrally planned economy are extreme economic systems. Mixed economic system falls between the two extreme economic systems. Most countries in the world have mixed economic system. This economy has the characteristics of free market system and command economy. In this economic system, resources are allocated partly by the government and partly by individuals guided by the market mechanism.

In a mixed economic system, a government participates in the economy as a buyer, producer, employer and regulator of the economy. Consumers are also free to choose the goods and services they want to consume, while producers are free to produce the goods and services with the expectation to earn more profit.

Mixed economic system is an economic system where some resources are partly owned by the government and partly by individuals (privately).In this economic system the basic economic decisions on the allocation of resources and production of goods and services are partly done by the government (planning authority) and partly by the individual producers and buyers (market mechanism).

Eritrea's economic system is mixed, where the government and the private sector play their roles in the socio-economic development of the country. The mixed economic system which Eritrea follows is an economic system which intends to satisfy the desires of the majority of Eritrean society. This has been reflected in the 1994 Macro Policy and National Charter for Eritrea. The mixed economic system ensures equitable development, encourages private investment, initiative and competition. In short, the mixed economic system Eritrea has adopted enhances economic and social justice in our country.

As indicates in the National Charter for Eritrea (1994), social justice means:

- narrowing the gap in economic opportunities and wealth between the rich and the poor to ensure equitable distribution of national wealth among all citizens;
- narrowing the development gap between rural and urban areas, between the centre and periphery and ensuring balanced and fair distribution of economic development in the whole country;
- creating economic development whose central goal is the satisfaction of people's needs;
- creating conditions which enable people to reap the fruits of their labour, improve their living standards through work, and honour work; and
- ensure public participation at community and national levels in decisions on economic affairs and enabling the oppressed and voiceless majority to have a voice.

Eritrea also believes in self-reliance in all fields: political, economic and cultural. Politically, this means following an independent line and giving priority to internal conditions; economically, relying on internal capabilities and developing internal capabilities – human, technological, managerial capabilities; and culturally, having self-confidence and the development of one's own cultural heritage. Self-reliance, however, does not mean to isolate oneself from the international community. It only means being as independent and self-confident a player as possible in the international community.

Activity 1.3

Work in your assigned group on the following questions.

1. Taking examples from our country explain why public (government owned) resources exist?
2. Under what economic system are people more motivated to produce goods and ser vices? Why?

Exercise 1

Part I: Multiple-Choice Questions

1. The study of how individuals and societies choose to use their resources to best satisfy their material wants is called_____.
    a) opportunity cost
    b) microeconomics
    c) economics
    d) business organization.
2. The fundamental choices that a society must make about the use of its resources include_____.
    a) what goods and services to produce
    b) how the goods and services are to be produced
    c) for whom are the goods and services to be produced
    d) all of the above.

3. A mixed economy may be defined as one in which resources are:
   a) allocated by individuals only to meet the needs of both consumers and producers.
   b) used partly for the production of consumer goods and partly for the production of capital goods.
   c) allocated partly by the market forces and partly by the government.
   d) able to produce goods and services which satisfy the human wants fully.
4. Which of the following is a disadvantage of a free market?
   a) wasteful competition
   b) uneven distribution of wealth
   c) production of excessive luxuries
   d) all of the above
5. One of the merits of free market is that there is
   a) strong incentive system to produce more goods and services
   b) no unsatisfied human wants
   c) no shortage of capital
   d) no social or economic problem
6. One of the disadvantages of command economy is that:
   a) all basic decisions on resource allocation are made by the government
   b) there are few incentives to produce more goods and services or innovate new technology
   c) there is a high degree of inefficiency due to the existence of large bureaucracy
   d) all of the above.
7. In a mixed economy, allocations of resources are made by:
   a) the government only
   b) by the market mechanism only
   c) both by the government and the market mechanism.
   d) individual producers only.
8. The economic system of Eritrea is
   a) command d) traditional.
   b) free market
   c) mixed

Part II: Write "True" if the statement is true or "False" if the statement is false

1. All economies must make decisions about what goods and services to produce, how to produce the goods and services and for whom to produce the goods and services.
2. The subject matter of economics is human wants.
3. A command economy primarily uses prices to coordinate the economic activities.
4. All economies tend to be mixed economies.
5. Profit is the main driving force in command economy.
6. Scarcity of resources is not a characteristic feature of a command economy.
7. When we say resources are scarce, it means that they cannot be purchased from the markets.
8. In a free market, all resources are allocated by individual producers and consumers.

Part III: Fill in the blank space with the most appropriate word or phrase.

1. All societies and individuals face_____ compared to their wants
2. _____ a social science which studies how individuals make choices about the use of resources to satisfy their wants.
3. In _____ economic decisions are guided by customs and traditions
4. The allocation of resources and coordination of economic activities in any society is done by its _____.
5. The three major economic problems of any society are _____; _____; and _____

1.1 Production of Goods and Services

Focus Question:

- What are the various goods and services available in your locality?

In order to satisfy human wants, goods and services have to be produced. Production of goods and services requires efficient use of resources (inputs). Production is the transformation of inputs into outputs by business firms. In economics, production involves the processing of raw materials into finished products such as the processing of skin into shoes and other leather products; cotton into textiles or clothes.

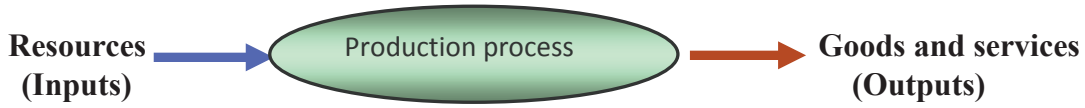


Figure 1.4 Input-output relationships

Resources used for the production of goods and services have three main characteristics:

i. They have economic value and this means that producers must pay to use them or to purchase them;
ii. Their supply is limited, implying that the goods and services produced using these resources are also limited; and
iii. They have alternative uses and that a trade-off must be made in their utilization.

The production of goods and services in a country or society takes place in three broad sectors (classes of production). The three sectors are:

i. **Primary sector (primary production) -** is the sector which involves farming, drilling of oil, mining of metallic and non-metallic minerals, quarrying and extraction of other raw materials, lumbering and fishing.
ii. **Secondary sector (industry) -** is that sector which involves the conversion of raw materials and other inputs into finished goods which have market demands. For example, iron ore can be converted into metals; cotton into clothes; skin into shoes; orange into orange juice. Secondary sector also includes industries which supply electricity and water as well as the construction industry.
iii. **Tertiary sector (service sector) -** provides various services to an economy. Activities in the tertiary sector include trade, transportation, communication and education, health care as well as financial, personal and government services.

The relative size of the different sectors in a particular country varies with the country's stage of economic development. At the early stage of economic development, the primary sector is the most important. As the economy develops, the secondary sector becomes the main economic sector. Eventually, the service sector becomes dominant as the economy matures.

1.1.1 Types of Factors of Production

Focus Question:

- Why are factors of production considered scarce in economics?

The resources used to produce goods and services are called factors of production (factor inputs) see Figure 1.5).

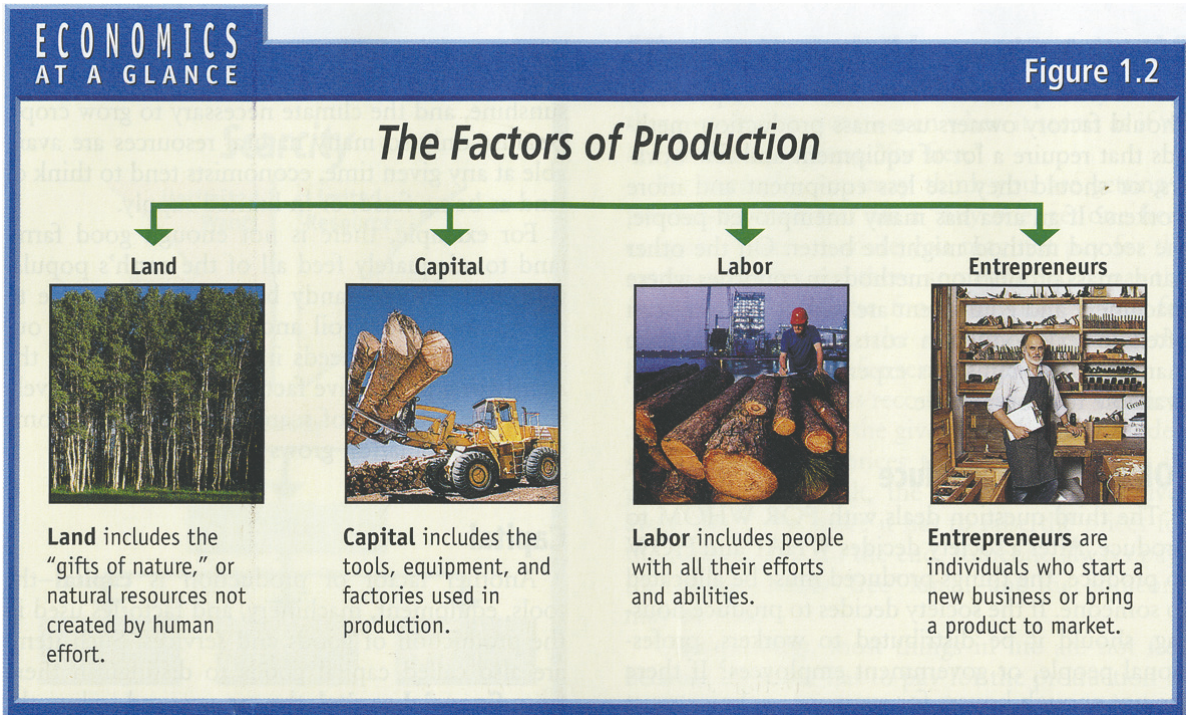


Figure 1.5 Factors of production

There are four types of factors of production. These are:

i. **Land.** In Economics, land refers to all those natural resources or "the free gift of nature". There is no cost of production. Land includes arable land, forests, minerals, water, air, sunlight, etc. which can be used for the production of goods and services. The reward (payment) for land is called rent. Land is fixed in quantity.

ii. **Labour**. Labour refers to any human effort (manual or mental), which is directed to the production of goods or services. Labour requires better equipment and efficient organization in order to be more productive. When labour is equipped with the required skill it is called **human capital**. Human capital is the economic characterization of the education and training of workers. Labour is the most active factor of production. The reward for labour is called wage/salary.

iii. **Capital**. Capital refers to those man-made physical goods used to produce other goods or services. It includes machines, tools, buildings, roads, storage, etc. The reward (payment) for capital is called interest.

iv. **Entrepreneurship.** Entrepreneurship refers to decision making and risk taking by entrepreneurs. The three factors of production (labour, land, and capital) are combined and organized by entrepreneurs in order to produce goods or services. An entrepreneur is a human resource who performs the functions of raising capital; organizing, managing the other factors of production; and making of basic business decisions. Entrepreneurs when starting new businesses such as restaurants, automobile repairs, shoe making, internet café, grocery, etc. also take risk because they may either earn profits or suffer losses/bankruptcy. The reward for entrepreneurship is called profit.

1.1.2 Types of Goods

Focus Question:

- Why do you think that some goods are more expensive (sold at higher prices) than other goods?

In Economics, a good is any item or service that satisfies material human wants. Goods are tangible objects like food, clothing, shoes, books, motor cars, etc. Services are intangible things like medical services, legal services, transportation services, financial services, etc.

There are two types of goods. These are: (i) economic goods and (ii) free goods

i. Economic goods are goods which are scarce in relation to the demand for them. Economic goods commands price because they are:

- useful (have use values) which satisfy human wants. and
- scarce in relation to the human wants.

Tractor, sickle, motor pump, warehouse, computer, shoes, clothes, food, medicine, car, ballpoint, etc. are examples of economic goods.

There are various classifications of economic goods. These are:

a) Consumer goods are goods which directly satisfy material human wants when they are consumed. Examples of consumer goods are food, shoes, clothing, jewelry, watch, and bicycle.

b) Capital/producer goods are man made goods used to produce other goods and services. Examples of capital goods are motor pump, tractor, machinery, tools, warehouse, bridge, dam, etc.

c) Necessity goods are goods which satisfy the basic human wants. Food, clothes, shelter are examples of necessity goods. They are important for our survival.

d) Luxury goods are goods which are not essential for our survival but help us to live in a luxurious life style. For example, luxury motor vehicles, specially designed and very expensive clothes, and specially designed residence houses.

e) Comfort goods are goods that increase the efficiency of our work. Examples of comfort goods include desk, electric light, heater, cooler, and vehicle.

f) Perishable goods are goods that could not be stored for a long period of time or those goods which could be spoiled after a short period of time. Milk, vegetables, fruits, meat are examples of perishable goods.

g) Durable goods are goods which normally last for a number of years. Examples include furniture, refrigerator, washing machine, cupboard, motor car, etc.

ii. Free goods are goods which are not scarce. They are useful goods which satisfy everyone's wants without any payment (or at zero prices). Free goods thus do not command prices. Fresh air, seawater, sunshine are examples of free goods.

Activity 1.4

1. Indicate whether the following goods can be categorized as necessity, luxury or comfort goods. Give explanations for your categorization

a. Food	e. Fashionable clothes
b. Water	f. Mobile telephone
c. A pair of shoes	g. Ordinary dwelling house
d. Heater	h. Electric light.

2. Write a one-page report on how your family allocates its monthly income on various consumer goods. You are expected to show the share of food, electricity, water, cloth ing, shoes, and other items bought by your family. Are the material wants of all members of the family satisfied? Explain.

3. Identify four capital goods in your locality and explain their economic benefits.

1.1.3 Production Possibilities Curve (PPC)

Focus Question:

- What do you think your opportunity costs are while studying in your classroom?

In our previous discussions, we indicated that resources which have alternative uses are scarce. For example, labour can be used for the production of brick or in the construction of roads. Similarly, capital can be used for the production of shoes or for the production of food. Thus, the choice of what goods to produce and how much to produce and the opportunity cost of making a choice that can be illustrated

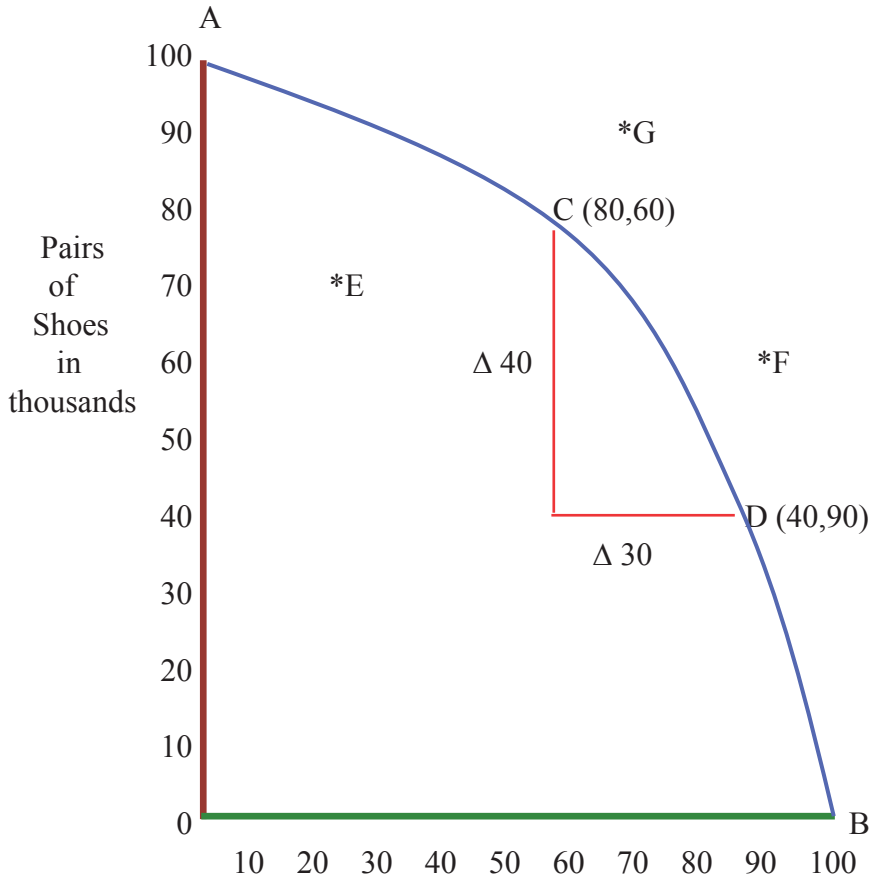
using a production possibilities curve.

Production possibilities curve/frontier shows the various combinations of quantities of two goods that a society is capable of producing at any given time with the available resources and technology.

Possibility	Shoes (in thousand pairs)	Wheat (in thousand quintals)
A	100	0
C	80	60
D	40	90
B	0	100

Table 1.1 Production possibilities schedule

Table 1.1 shows that a society (country) can produce two types of goods (shoes and wheat) with its available resources (factors of production). The production possibilities schedule is illustrated graphically in Figure 1.6.



Note that Δ (delta) means change in quantity (an increase or decrease in quantity)

The A-B production possibilities curve (see Figure 1.6) shows the limit to what a society can produce with the available resources and technology at its disposal. Any production inside the production possibilities curve is not desirable because it is considered as inefficient. For example, production at point "E" is not desirable because it indicates that a society has not fully utilized all its resources (land, labour, capital and entrepreneurship). Some of its resources are unutilized. Any production above the production possibilities

curve such as point "F" or "G" is unattainable with the technology and resources currently available to the society. Production at any point above the A-B production possibilities curve is beyond the scope of the society because of resources constraint.

All points along the A-B production possibilities curve are considered to be efficient. As shown in Figure 1.6, a society using its resources fully can produce either 100 thousand pairs of shoes only (combination "A") or 100 thousand quintals of wheat only (combination "B"). Along the A-B production possibilities curve, the society can produce various combinations of shoes and wheat depending on its choice.

Assume that the society initially chose the combination of 80 thousand pairs of shoes and 60 thousand quintals of wheat (point "C"). If the society wants to produce more of wheat, it has to move from point "C" to point "D" along the A-B production possibilities curve. At point "D", the society will produce 40 thousand pairs of shoes and 90 thousand quintals of wheat. A movement along the A-B production possibilities curve implies a trade-off between shoes and wheat. When a society moves from point "C" to point "D", it will sacrifice 40 thousand pairs of shoes to acquire 30 thousand additional quintals of wheat. The opportunity cost of one quintal of wheat is 40,000/30,000 = 1.33 pairs of shoes. The 1.33.pairs of shoes is the opportunity cost of one quintal of wheat. Opportunity cost is one of the most important concepts in economics since it captures the problem of scarcity and the making of choices. A choice always involves sacrifices or opportunity cost. As already discussed, economics is concerned with the efficient use of scarce resources, and the notion of opportunity cost is an important conceptual tool in demonstrating the efficient use of resources. Opportunity cost is the cost of something in terms of an opportunity foregone (pairs of shoes, in our example) in order to get something (wheat, in our example).

Opportunity cost is the amount of goods that must be sacrificed to obtain a unit of another good**.**

As shown in Figure 1.6, the production possibilities curve is bowed outward from the origin. This implies that the number of pairs of shoes that must be sacrificed to obtain an additional quintal of wheat will increase as the society moves from point "A" to point "B". In other words, the opportunity cost of acquiring an additional quintal of wheat increases with a movement along the production possibilities curve towards the wheat axis. Also, the opportunity cost of an additional pair of shoe will increase with the movement along the production possibilities curve towards the shoes axis. *This principle is called the law of increasing opportunity cost.* The main reason for increasing opportunity cost is that resources are not equally efficient in the production of all goods and services, i.e., they are not equally productive when used to produce alternative goods. Some resources are more productive in one use than they are in another. In our example, if more resources are withdrawn from the production of shoes to the production of wheat, the increasing opportunity cost of wheat implies that resources (labour) which are better suited for the production of shoes are shifted for the production of wheat where they are less suited.

Production possibilities curve illustrates two essential features:

(a) Scarce resources- there is a limit to the amount of goods and services a society can produce in a given time period with the available resources and technology.

(b) Opportunity cost- society can obtain additional quantities of any desired goods and services only by reducing the potential production of other goods or services.

1.1.4 Human Wants and Needs

Focus Question:

- Do you think that there can be upper limits to the human wants and needs?

The purpose of production of goods and services is to satisfy human wants and needs or to meet the demand of consumers. However, in our daily life, the concepts wants and needs are often interchangeably used. In economics, these two concepts do not imply the same meaning.

Human wants refer to the human desires for things, goods and services. Human wants as individuals or society are unlimited. All people want every thing such as food, clothing, house, shoes, car, television,

better health services, better education, etc. to improve their material wellbeing. Resources (inputs), on the other hand, are limited or scarce therefore all human wants will never be satisfied fully.

Needs refer to the necessary goods which are essential for people's survival. It includes goods such as air, water, food, clothes, shoes, shelter etc. Needs, unlike wants, are not absolutely unlimited. For example, it is possible to calculate the basic needs which have to be met if a person or household is to survive. For example, 5 kilograms of sugar may be considered enough to meet the needs of an individual consumer for a month.

1.1.5 Wealth and Welfare

Focus Question:

- How do you think an individual can accumulate wealth?

Sustained increase in the production of goods and services is the basis for the accumulation of wealth in a society. Wealth increases in the economic welfare of the members of the society by making the consumption of increased goods and services possible. Economics is also concerned with the increase in the stock of goods. both consumer and capital goods as well as with the supply of various services in adequate quantities. An increase in the production of goods and services over a longer period of time is called economic growth. It is a pre-requisite for the accumulation of wealth in a society.



Figure 1.7 Example of Wealth

Wealth is the sum of all the assets accumulated over time by a society or a country. It includes physical assets (houses, cars, power supply, roads, schools, etc.), natural assets (land, forest, water, quality of air, etc.); human capital (skilled and healthy human beings) and financial assets such as domestic savings. At the household level, wealth is the accumulation of those products that are tangible, scarce, useful and transferable from one person to another.

Welfare is the state of well-being of a society. What determines the economic welfare of a society is the amount of goods and services consumed by the individual members of a society. Also, wealth accumulated in the past such as stocks of roads, hospitals, schools, houses, etc. have a positive impact on the welfare of a society at present and in the future.

1.1.6 Approaches to the Study of Economics

Focus Question:

- Why do you think microeconomic and macroeconomic activities are interrelated in any economy?

Economics as a social science can be studied from two perspectives:

1. **Microeconomics** is a branch of economics that studies the economic behavior of individual decision-making units such as consumers and business firms. For example, studying how individual prices of goods are set in the market is the domain of microeconomics.

2. **Macroeconomics** is the branch of economics that studies the whole economy or larger part of an economy. Macroeconomics thus deals with the determination of total national income; it deals with aggregates such as total employment, aggregate consumption and investment, national savings, general price level, aggregate demand, and aggregate supply.

Summary

The basic problem of any society is how to use its available resources to meet its wants. Scarcity of resources is the basic fact of life. Available resources (factors of production) are scarce in relation to our desires for goods and services. Resources everywhere are in limited supply (scarce). All economies regardless of their stage of economic development have to answer three fundamental questions:

- What goods and services should be produced?
- How will the goods and services be produced?
- For whom will the goods and services be produced?

These questions are answered in different ways under different economic systems. Economic system refers to the way a society allocates its resources and makes the three economic decisions.

While no two economies are exactly the same, it is possible to identify three types of economic systems:

- Free market economy;
- Command economy;
- Mixed economy.

The three economic systems differ in the method of allocating the resources and ownership of the resources.

Production is the process by which factors of production (scarce resources) are changed into goods and services demanded by a society. The major factors of production are land, labour, capital and entrepreneurship. Land is considered as fixed in quantity. Society uses resources or factors of production to produce various goods and services to satisfy human wants. Scarcity necessitates the making of choices. Factors of production used to produce one product cannot be simultaneously used to produce something else. Thus, when we choose to produce something, we give up the opportunity to produce some other goods or services.

The production possibilities curve illustrates the kinds of opportunity costs an economy faces. It shows the various combinations of quantities of two goods that a society is capable of producing at any given time with all available resources and technology. Opportunity cost is the amount of a good or service that must be sacrificed to obtain a unit of another good or service**.**

Reflecting their differences in the allocation and efficiency in the use of their resources, societies have differences in the size of their wealth. Wealth is the sum of all the assets accumulated over time by a society or a country. It includes physical assets such as houses, cars, power supply, roads, schools, natural assets such as forest, water, land, quality of air, etc., human capital and financial asset such as domestic saving.

The study of economics focuses on the efficient use of limited (scarce) resources to achieve maximum satisfaction of human material wants.

Economics can be studied from two perspectives: Microeconomics- is concerned with the economic behavior of individual decision-making units such as consumers, resource owners, and business firms; Macroeconomics-is concerned with allocating the resources of an entire economy such as total employment, national income, aggregate investment, aggregate consumption, national savings, general price level, aggregate demand, and aggregate supply.

Exercise 1.1

Part I: Multiple-Choice Questions

1. The process of transforming resources into useful products that consumers' desire is called
   a) distribution. b) production.
   c) consumption. d) economics.

2. Individuals who organize production and bear the associated risks of losses are called
   a) entrepreneurs. b) consumers of goods and services.
   c) economists. d) professionals.

3. A production possibilities curve does not illustrate
   a) scarcity of resources. b) opportunity cost.
   c) attainable and unattainable points. d) monetary exchange.

4. A farmer can raise any combinations of animals within the following range:

Cows	Camels
84	12
75	15

Given the options available to the farmer, what is the opportunity cost to the farmer of raising one camel?
   a) 1 cow b) 3 cows c) 5 cows d) 7 cows

5. The amount of goods foregone to receive one more of another good is called_____.
   a) economic good b) opportunity cost
   c) production possibilities curve d) scarcity

6. Which of the following is not considered as "land"?
   a) water bodies b) forest
   c) machinery d) climate

7. Free goods_____,
   a) command price. b) have use value only.
   c) have opportunity cost. d) are provided freely to the society by a government.

Part II: Write "True" if the statement is true or "False" if the statement is false

1. A free good can also be an economic good.
2. Most people's needs exceed their wants.
3. Most products have their respective opportunity costs.
4. At any given time it is impossible for a society/nation to be inside its production possibilities curve.
5. Time has no opportunity cost.

6. Goods are items or services that satisfy human material wants.
7. Land is any naturally occurring resource which is fixed in quantity.
8. Microeconomics is the study of individual decision making units in an economy.
9. Wealth is accumulated assets over time and it can be saved for current and future generations.

Part III: Essay questions and calculations

1) Describe the production possibilities curve and its properties.
2) What is opportunity cost?
3) The following table shows the production possibilities curve of shoes and clothes in a given

Alternative combination of outputs	shoes (million pairs)	Clothes (millions meters)
A	100	0
B	80	70
C	40	90
D	0	100

a) Putting shoes on the vertical axis and clothes on the horizontal axis, plot the production possibilities curve.
b) What is the opportunity cost of clothes when the society moves from combination "B" to combination "C"?
c) What is the opportunity cost of clothes when the society moves from combination "C" to combination "D"?
d) What happens to the opportunity cost of a cloth? (Constant, decreasing or increasing?). Give reasons.

1.2 Business Organizations

Focus Questions:

1. How many of you come from families which own businesses?
2. Do you think every individual in our society can own a business? Why?

In their daily life individuals consume various goods and services. All the economic goods and the various services that we consume are produced by legally established business organisations. Business organisations sell their goods and services to buyers in the marketplace to earn profits, while buyers purchase them to satisfy their wants.

Business organization refers to any private organization which employs factors of production to produce goods and services for profit. A business organization may be commercial such as grocery; professional such as providing legal service giving; or an industrial organization such as a shoe making firm.

There are three types (forms) of business organizations. These are: Sole Proprietorship, Partnership and Corporation.

A. Sole Proprietorship (sole trader)

Sole Proprietorship is the simplest form of business. The main source of investment is the capital of the proprietor. The proprietor may work alone or may employ a few workers. However, only the owner is responsible for making all managerial decisions. The owner earns all the profits; he/she also bears all of the risks of incurring loss and debt payment obligations. Sole proprietorship has unlimited liability. Examples of sole proprietorship are individually owned hairdresser, retail shop, restaurant, glass making firm, shoe making firm, etc. (see Figure 1.8)



Figure 1.8 Sole Proprietors

A sole proprietorship *is a business firm that is owned and managed by one individual who reaps the profits and bears unlimited liability of the firm's debts*.

Advantages of sole proprietorship

i. **Ease of starting and ending the business. -**Any person can start a sole proprietorship by simply buying the needed equipment and by getting a permit or license from the government. If the owner finds that the business is not profitable he/she can simply stop and easily get out of the business.
ii. **The owner is a boss of himself/herself.** The owner is the manager and boss of himself/herself and thus has a considerable freedom in the management of his/her business.
iii. **Retention of profit.** The proprietor takes all the profit of his/her business after paying tax to the government because he/she does not have to share the profit with any one else.

Disadvantages of sole proprietorship

i. **Unlimited liability.** When one owns sole proprietorship, the business and the owner are considered as one. The owner has unlimited liability and he/she is personally liable for the debts of the firm. This means that the owner's personal assets may be legally confiscated (sold) to cover the firm's liabilities when the firm incurs huge debt.
ii. **Limited growth.** Sole proprietor depends on his/her own financial resource and managerial ability. This limits the business from growing into a large-scale enterprise.
iii. **Limited life span.** Sole proprietorship may suffer from operational discontinuity when the sole proprietor dies or becomes ill for a longer time unless it is taken over by the owner's relatives.
iv. **Longer working hours.** There is no one who shares the burden of the managerial work with the sole proprietor. Hence, he/she is forced to work longer hours compared to other employees inother forms of businesses.

B. Partnership

A partnership is a legal form of business with two or more owners. The owners formally agree to pool their financial resources and their managerial talents with the objective to share the profit earned (or loss incurred). A partnership is a common type of business organization in such areas as law, medical and accounting services.

A partnership *is a business firm with two or more owners who have unlimited liability for the firm's debts.*

Advantages of partnership

i. **Ease of starting and ending the business.** Like sole proprietorship, a partnership can also be easily established. When two or more business men/women agree to establish partnership, they can easily start it by getting a permit or license from the government.
ii. **Shared management and pooled resources.** A partnership allows greater specialization of the partners in management depending on their skill and knowledge. Partners also pool more financial capital compared to that of sole proprietorship. This mix allows the firm to be larger and more efficient than would be possible in a proprietorship.
iii. **Building trust among partners. A** partnership encourages building trust among the partners as they have equal powers and responsibilities while managing the business.

Disadvantages of partnership

I. **Unlimited liability.** Each partner is personally liable for all debts of the business, no matter who was responsible for causing those debts. A partner is liable both for his/her own mistakes and the mistakes made by his/her partners which affects the performance of the business.

II. **Disagreement among partners.** Partners may follow inconsistent and divided policies which might lead to the liquidation of the business.

III. **Easy to dissolve**. A partnership can easily be dissolved when one of the partners dies or withdraws from his/her partnership.

C. Corporation is a egal entity, distinct and separate from the individuals who own it. As a "legal entity" a corporation can acquire resources, own assets, produce and sell products, incur debts, extend credits, sue and be sued and carry functions which sole proprietorship and partnership do not perform. A corporation is established to generate more profit for the investors or owners. The stockholders of a corporation select board of directors- top management which oversees the general activities of the corporation. A corporation is managed by hired professional managers. A corporation raises capital by selling shares/stocks to the public. The shareholders/ stockholders are the owners of a corporation. A stockholder takes risk in investing his/her capital; but he/she has limited liability. The profit of a corporation is divided among the shareholders and it is called a dividend.

A corporation is *a firm that takes the form of an independent legal entity with ownership divided into shares. Each owner's liability is limited to his or her investment made in the corporation. The owners reap the profits of the corporation. But they are not personally liable for its debts*.

There are two types of corporations. These are:

a. Closed (private) corporation is one whose shares are held by a few people and are not available to the general public.
b. Open (public) corporation sells shares to the general public.

Advantages of corporation

i) **Limited liability.** A corporation has limited liability. Limited liability means that the owners of a corporation are responsible for losses only up to the amount they have invested in the corporation (what they have paid for the purchase of the corporation's stock). The owners' personal assets are not at stake if the corporation could not pay its debts.
ii) **Continuity.** Because a corporation is a separate legal entity from those who own it, the death of one or more owners does not terminate its operations. Also, if one or more owners sell their shares to other individuals, the cooperation still continues to operate.
iii) **Large size business.** A corporation can increase the size of the business by raising more capital through selling stocks or shares, and thus it has the opportunity to build a large- scale business.
iv) **Easy to employ professional employees.** A corporation can attract skilled employees by offering a better salary and other benefits compared to sole proprietorship or partnership.

Disadvantages of corporation

i) **Double taxation.** Corporate income is taxed twice. First the corporation pays tax on corporate profit (income) before it is distributed to the stockholders. Then, the stockholders pay tax on the dividends they received as part of their personal income.
ii) **Large initial cost**. A corporation requires a large capital investment to make it operational. It is more costly to start a corporation compared to sole proprietorship or partnership.
iii) **Possible conflict between management and the owners.** A corporation is managed by hired professional managers, not by the owners. Therefore, there is a likelihood that a conflict of interest on: dividend policies such as what proportion of corporate earnings after tax should be paid out as dividends; what proportion to reinvest; what proportion to use for salary increment, etc.

In addition to the three forms of business organizations, there is another form of business called a cooperative. A cooperative is formed solely to meet the needs of the members/ owners, not to generate profit for the members. A cooperative is thus established as a means for self-help and mutual aid. For instance, farmers may join together to get better prices for their products. Most cooperatives are registered under a country's cooperative Act. Cooperatives do not pay the same kind of taxes that corporations do, and thus have an advantage in the market place.

A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise. The main sources of finance of a cooperative are entrance fees, membership fees and member loans. Examples of cooperatives are marketing cooperatives, housing cooperatives, dairy farm cooperatives, producers' cooperatives, etc.

Establishment of Business in Eritrea

Eritrea encourages private investments in different ventures and in all sectors of the economy in order to speed up the development process of the country. The Investment Proclamation No.54/1994 indicates that the private sector as the lead actor, in economic activities of the country is allowed to function with no restrictions and discrimination. The government is determined to promote, encourage, safeguard, and protect investments in different ventures. As indicated in Article 210 of the Transitional Commercial Code of Eritrea, a business organization is any association arising out of a partnership. Article 211 defines a partnership as a contract whereby two or more persons who intend to join together and to cooperate undertake to bring together contributions for the purpose of carrying out activities of an economic nature and of participating in the profits of and losses arising out thereof, if any.

Activity 1.5

1. Why do individuals (groups of individuals) invest in establishing businesses in a mixed economic system? Explain.
2. What will be the consequence if a shoe-making business organization produces shoes which our society does not want to purchase? Explain.

Summary

The goods and services that we consume or use are produced by various businesses. A business organization is any organization which employs factors of production to produce goods and services that consumers are willing to purchase. A business organization may be commercial such as grocery; professional such as providing legal service; or industrial organization such as shoe making.

There are three main forms of business organizations. These are:

i. Sole proprietorship
ii. A partnership
iii. A corporation

In addition to these, there is another business called a cooperative which is established for different purposes. Cooperatives are established by a group of people to meet the common economic, social and cultural needs and aspirations of its owners.

Exercise 1.2

Part I: Multiple- Choice questions

1. A Type of business organization which has limited liability and a separation of ownership and management is called
   a) sole proprietorship.
   b) cooperative.
   c) partnership.
   d) corporation.

2. A business organization where two or more individuals share the ownership, management, and debt liability is called
   a) cooperative.
   b) proprietorship.
   c) corporation.
   d) partnership.

3. A business organization where the sole owner has unlimited liability is called
   a) cooperative.
   b) corporation.
   c) proprietorship.
   d) partnership.

4. The main objective of a cooperative is to
   a) earn more profit for its owners.
   b) support the society.
   c) support its members.
   d) accumulate capital.

5. One of the major weaknesses of sole proprietorship is that it:
   a) has limited capital.
   b) lacks of market.
   c) is unable to use modern machinery.
   d) unable to employ professionals.

6. One of the following is not the advantage of corporation.
   a) continuity
   b) large capital
   c) limited liability
   d)low profit

Part II: Write "True" if the statement is true or "False" if the statement is false:

1. Corporation is the form of business organization that has limited liability.
2. Management and ownership are separated in sole proprietorship.
3. Partnership is a business that is subjected to double taxation.
4. Partnership is a business form which is the most difficult to start.
5. Dividend is the payment the owners of share/stock receive from a company.
6. Sole proprietorship is the most profitable business organization.
7. A cooperative firm can never earn profit.

8. The source of investment is always a bank loan.
9. Partnership is a form of business that has indefinite life.
10. Service giving business organizations are always more profitable than other business organizations.

Part II: Essay questions

1. What are the differences between a cooperative and a corporation?
2. Explain the advantages and disadvantages of a partnership?
3. What does unlimited liability mean?

1.3 Transportation and Communication

Focus Questions:

1. What means of transportation do you use while coming to your school?
2. What were the various means of transportation used during the Eritrean struggle for independence?

In the present world no business can survive without modern communication and transportation systems. People in the different parts of the world are connected by a network of modern transportation and communication systems, which facilitate the movement of goods and people as well as the transfer of information. Transportation and communication facilitate trade within a country and among the different countries of the world.

1.3.1 Transportation Systems

Focus Question:

- What are the widely used means of transportation in the remote rural areas of our country?

In modem societies, it is very rare to find goods being produced in places where they are wanted or fully consumed. Often, goods are produced in some places, and they are consumed in other places. When agricultural products such as onion, grain, orange, banana, etc. are produced in remote rural areas, they have to be transported to the markets so that consumers will be able to buy them. When industrial products such as fertilizer, wheel barrows, shoes, clothing, sickles, axes, etc. are produced in urban areas, they have to be transported to the different places so that consumers will find it convenient to purchase the goods. Transportation brings goods from the place of production to the place of consumption. It also brings various raw materials needed by producers. Transportation, therefore, facilitates trade between rural and urban areas and among different countries of the world.

Similarly, modern means of transportation takes people where they want to go in a short period of time. Thus, one of the major features of modem economies is their heavy dependence on modern transportation and communication systems. Communication also has a vital role in the affairs of nations, people and business organizations because they facilitate the exchange of required information/messages. Transportation and communication system is an economic sector, which provides services by carrying people, goods and information from the places of exit to the places of destination in a certain time, condition and cost. A well developed transportation and communication systems as part of a country's infrastructure is crucial for a country's economic development.

Transportation *is the safe movement of goods (freight) and people from one place to another.*

(i) Major Functions of Transportation

a) Movement of goods and people: the various means of transportation help to transport finishedgoods and raw materials from places where they are available to the places where they are needed. Various means of transportation also help people to move from one place to another in a short period of time.

b) Price equalization: transportation makes it possible to move goods from where their prices are low because their supply exceeds their demand to places where their prices are high because their demand exceeds their supply. Eventually the prices of the goods are equalized in both places.
c) Removal of distance barrier: modern transportation can transport goods and people to distant places in a short period of time, thereby removing the distance barrier.
d) Strengthen national security (defense): during emergency such as the outbreak of war, transportation helps to transport troops and facilities very quickly, thereby strengthening the security and defense of a country.
e) Create more employment: transportation industry has the potential to provide more employment opportunities, thereby reducing the level of unemployment.
f) Facilitates the mobility of factors of production: transportation facilitates the movement of factors of production such as labour, capital and entrepreneurship, thereby encouraging investment in different parts of a country.
g) Promote national unity: transportation makes the movement of people from one place to another within their country easier, thereby creating the opportunity for them to know each other. This in turn promotes the cultural interactions and national unity by overcoming their prejudices and ignorance.
h) Transportation allows a country to trade with other countries of the world, thereby enabling it to use its comparative advantage.

(ii) Types of Transportation Systems

In economics, transportation is considered as a part of production because it **creates place utility** when goods are transported at the lowest possible cost to places where they are wanted and consumed. Transportation also creates time utility when goods or raw materials are transported to the destination when they are needed within the shortest period of time.

The purposes of transportation systems are commerce (trade), recreation or military objectives. There are three types of transportation systems. These are Land Transportation, Water Transportation and Air Transportation.

A. Land transportation is the safe movement of people and goods on land. Land transportation includes**:**

i. Road Transportation is the safe movement of goods and people on asphalted and non-asphalted roads using various kinds of vehicles, motor cycles, and bicycles. Road transportation using vehicles can transport large quantities of both solid and liquid goods for short distance within a country or between neighboring countries. Road transportation also requires large capital investment for the construction of roads and for the purchase of vehicles.

ii. Railway Transportation is the safe movement of goods and people along railways. Trains connected to locomotives that run on the rails is the means of rail transportation. Rail transportation is very expensive as it requires a large capital investment for the construction of railways and the purchase of trains.

iii. Human-powered transportation is the movement of goods from one place to another using human-muscle power. For example, a farmer may carry 25 kg of his/her wheat production from his/her village to the market for sale. By selling his/ her wheat for cash (Nakfa), the farmer can buy other goods such as clothing, shoes or kerosene needed for the household. Human-powered transportaion transport remains common in Eritrea, both in the rural and urban areas.

iv. Animal–powered transportation is the movement of goods and people from one place to another using animal energy. Humans may ride some of the animals directly, use them as pack animals for carrying goods, or harness them, alone or in teams to pull sleds or wheeled vehicles. Donkey, mule, horse and camel are used for the transportation of goods and people. Animal-

powered transportation is still extensively used in hilly, forest and desert areas of developing countries which are not accessible or difficult to reach them by modern means of transportation. Carts are generally driven by animals such as horses, camels, donkeys, buffaloes, bullocks, etc for the movement of goods or people from one place to another. Carts are a poor substitute of motor vehicles.

B. Water transportation is the safe movement of goods and people through the routes of water bodies such ocean, sea, river, lake or canal. Ships and boats are the main means of water transportation. Water transportation is the most effective mode of transportation for transporting large quantities (bulky) non-perishable goods over a long distance because it is relatively cheap. There are also ocean liners and ocean traps which transport people and cargo respectively.

i. An ocean liner is a ship designed to transport people from one seaport to another along a regular long distance.

ii. An ocean trap is a merchant vessel which is available to haul cargo of all types to all parts of the world.

C. Air transportation is the safe movement of goods and people from one place to another using air routes. Passenger and cargo planes are used in air transportation. Airplanes provide the world's fastest means of transportation. Air transportation is very expensive because it requires very large capital investment for the purchase of cargo and commercial planes, for training of pilots and technicians and for the construction of airports and installation of communication systems. It also requires large operational cost. Air transportation is convenient for the transport of perishable commodities such as vegetables and flowers which need to be transported to distant places within a short period of time or expensive commodities such as gold, and silver because they occupy small spaces but also require a high degree of safety while being transported.

D. Ropeway is a conveyance that transports freight in carriers suspended from cables and supported by series of towers. Eritrea's 71 kilometers long ropeway (cable) was constructed during the Italian colonial period. It connected the Port of Massawa with the capital city, Asmara. It had a load capacity of 720 tons per day. The Rope way was dismantled by Britain and sold for scrap during its short colonial rule replacing the Italian colonialism, following the defeat of Italy in the Second World War.

E. Pipeline transportation sends goods through a pipe, most commonly liquid such as petroleum and natural gases.

Eritrea has three modern transportation systems (road, railway and water) as well as the two traditional transportations systems (human-powered and animal-powered).

Deciding which mode of transportatation to use for transporting goods and people depends on the nature of the goods to be transported, cost of transportation and the urgency of the goods and people to reach their destinations. Thus, each means of transportation has its comparative advantages and disadvantages when compared with other means of transportation. Railway Transportation is most suitable in transporting heavy and bulky goods for long distances For short distances, Road Transportation is more appropriate. For transporting heavy and bulky goods at the cheapest cost pos sible, Water Transportation is the best. Though Air Transportation is the fastest mode of transportation, it is also the most expensive and hence it is to be used only in case of highly perishable or precious .goods where quick delivery of the goods is requird

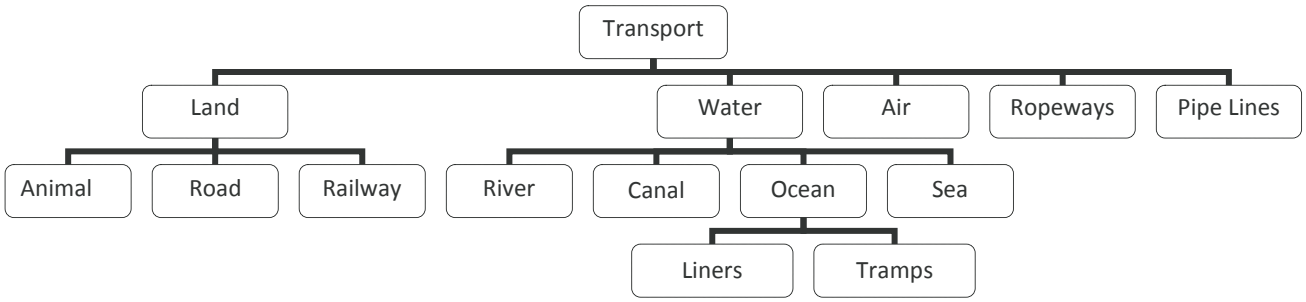


Figure 1.9 Types of transportation systems

Activity 1.6
1. Visit any transportation company in your locality and write a report on its main operations.
2. Why is the government heavily investing in the construction of rural roads in our country? Explain.
3. What are the benefits of a bicycle to our society? Explain.

1.3.2 Communication Systems

Focus Question:

- How important is communication in our daily life?

Communicating with one another is one of the most important aspects of human life. When we talk to others or write to them, communication takes place between us.

Communication is the transfer (or exchange) of any kind of information from one person or place to another person or place.

The functions of communication are to:

a) share ideas and feelings between people;
b) interact with other people, such as families and friends;
c) supply individuals or business organizations with relevant information such as provision of weather report;
d) entertain (personal entertainment);
e) facilitate the flow of information between business firms during the purchase of raw materials/inputs and sale of its outputs.
f) facilitates in the transfer of money from one country to another through banking: and
g) facilitate market information gathering by business organization.

The increasing dependency of mankind on information (exchange of information) has stimulated the growth of more communication systems in the world. Figure 1.10 shows the flow of information between message sender and message receiver.

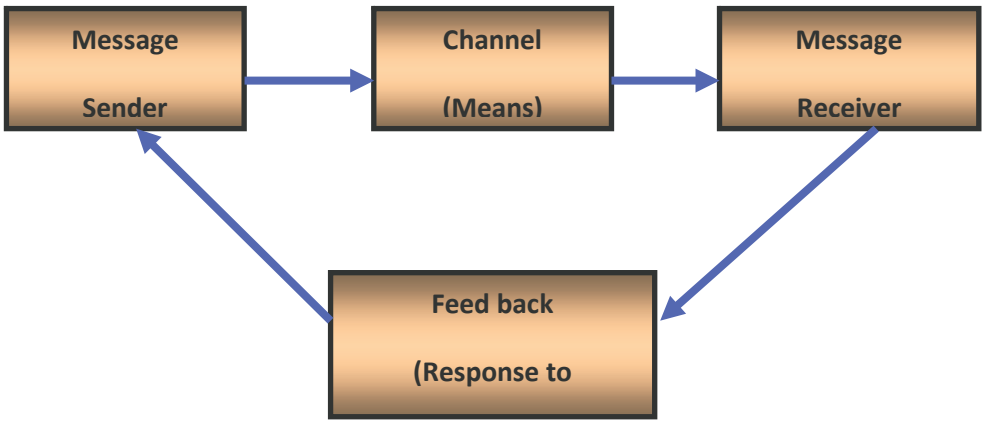


Figure 1.10 Flow of information between message sender and message receiver

- **Sender** is the person who intends to make contact with the objective of passing information and ideas to other persons.
- **Ideas** are the subject matter of communication. These might be an opinion, attitude, feelings, views or orders.
- **Channel** is the medium through which messages are sent, e.g., radio and telephone.
- **Receiver** is the person who receives the messages.
- **Feedback** is the process of ensuring that the receiver has received the message and understood in the same way as the sender.

A. Forms of communications

There are two forms of communication systems. These are:

(i) Human-based Communication

Human-based communication is the transfer of information directly from one mind to another. Human communication is dependent on the sensory organization of sight, hearing, taste, touch, and smell. The personal response (feedback) indicates that the information is received and is being processed.

(ii) Technical-based communication

This communication system depends on the use of devices or instruments to serve as extensions for the human senses. A telephone allows conversation to take place between two people hundreds of kilometers apart. There is no need to talk loudly for such exchange of information to take place. Similarly, printing and photography store visual images. They allow information to be shared many times after they are produced.

Communication system *is a combination of processes and hardware (instruments) used to accomplish the transfer of information (communication*).
Communication process *involves the production, transmission, and receipt of messages.*

B. Types of modern communication systems

There are four types of modern communication systems. These are:

(a) Visual systems,
(b) Acoustic systems,
(c) Telecommunication systems, and
(d) Data-processing systems.

i) Visual Communication Systems

A visual communication system is a combination of processes and devices to accomplish a desired result, such as the transmission of visual information from one point to another. Printing and photography

are examples of visual systems. In each example, many people can communicate at the same time. A newspaper gets the same information to many people at the same time by making a number of copies that may be distributed among many individuals. Holography, copying machines and video system are also considered visual systems.

ii) Acoustic Communication Systems

An acoustic communication system is a combination of processes and devices to accomplish a desired result, such as the transmission of acoustic information from one point to another. Telephone, telegraph and record player are examples of acoustic systems. Acoustic systems can transmit or store acoustic energy in the form of electrical pulses or magnetic energy by media such as cables, optical fibers, or disks. It is possible to make a long distance call or send a telegraph or cassette tape farther than we could shout. Information is thus transmitted by devices, usually in coded forms to the destination.

iii) Telecommunication Systems

A telecommunication system is a combination of processes, circuits and devices to accomplish a desired result, such as the transmission of information from one point to another. Radio, television, and microwave transmission of information are examples of telecommunication systems. The key to this kind of system is that the message is sent by means of electromagnetic energy through the air. There is no need for a physical carrier, such as a wire or phonograph record, as there is in acoustic systems.

iv) Data-Processing Systems

A data-processing system is a combination of processes, circuits and devices to accomplish a desired result, such as the transfer or processing of information. The computer is the best example of a data-processing system. This type of system transfers or processes information faster and more accurately than is possible by human means. The computer is also used in conjunction with the other systems to improve all areas of communication technology.

Activity 1.7

Work in your assigned group on the following questions:

1. What are the benefits of internet for modern societies? Explain.
2. How important is communication for businesses? Explain.

Summary

Transportation, as an economic sector, is the life line of modern economies. It provides services by carrying people goods and information from the place of exit to the destination in a certain time, condition and cost. The availability of good transportatio systems is critical for the efficient operation of the producing sectors of an economy- agriculture and industry. These sectors need to be supplied with the required inputs such as fertilizer and other industrial items in time to be more productive. The sectors also need effective transportation to supply their outputs to various customers or clients both nationally and internationally.

There are three modes of modern transportation systems. These are:-

- Land transportation,
- Water transportation,
- Air transportation

Communicating with one-another is one of the most important aspects of human life. In our daily life, we spend a large part of our time communicating with others both during our working time and our leisure time. The process of sharing facts, ideas, opinions, thoughts, and information through speech, writing and symbols is called communication. People communicate verbally through word, either spoken or written. Communication through the use of various parts of the human body such as waving of hands is called gestural communication.

The elements of a communication process include the sender, (a person who transmits message), a message (idea) that a sender wants to convey), a channel (the method that the sender uses to deliver message), and a receiver (the person who receives the message).

There are various ways through which we can communicate with each other. These may be called the means of communications. In face-to-face communication, we directly talk to others to pass our messages or information. Where a face-to-face communication, is not possible, we talk with the help of some other means, through which we usually convey our messages. For example, we may use letters to convey written messages; talk over telephones; send telegrams and use various other modern machines such as computers, fax machines, etc. to communicate our messages. The means to be used in our communication process depends on the purpose of communication. For example, to send an urgent message, we generally use telephone. For sending messages in which written documents are required, we can use letters, telegrams, fax, etc. Communication can also take place using other means such as radio, tape recorder, news paper, magazines, etc.

All modern communications takes place through effective communication systems. There are four types of modern communication systems. These are:-

(i) Visual communication system
(ii) Acoustic communication system
(iii) Telecommunication system and
(iv) Data-processing system.

Exercise 1.3

Part I: Multiple-Choice Questions

1. Which of the following is the process of ensuring that the receiver has received the message and understood in the same sense as the sender mean it?
   a) ideas
   b) channel
   c) feedback
   d) encoding

2. Which of the following is a modern means of transportation?
   a) road transportation
   b) railway transportation
   c) water transportation
   d) all

3. Bulky and heavy goods should be transported by_____.
   a) trains b) airplanes
   c) ships d) vehicles

4. Which of the following <u>is not</u> a modern means of transport?
   a) rail transport.
   b) road transport.
   c) air transport.
   d) animal transport.

5. The most expensive means of transportation is_____.
   a) animal transportation
   b) railway transportation
   c) road transportation
   d) air transportation

6. The cheapest means of modern transportation is_____.
   a) animal b) road
   c) water d) railway

7. What do we mean by transportation?
   a) the process of changing raw materials into finished goods.
   b) the process of exchanging information.
   c) the process of sharing goods.
   d) the movement of goods and people from one place to another.

8. Communication is _____.
   a) an exchange of information by two or more persons
   b) an exchange of goods and services by two or more people
   c) the movement of goods and services from one place to another
   d) none of the above

9. Which of the following is a form of communication?
   a) photographs.
   b) films.
   c) videos.
   d) all of the above.

10. Communication breaks down between the sender and receiver when_____.
   a) the communication is over the telephone
   b) the receiver does not understand the message
   c) the two individuals are in different places
   d) the sender and the receiver do not speak the same language
   e) none of the above.

Part II. Write "True" if the statement is true or "False" if the statement is false.

1. Wall charts posters and notice boards are visual forms of communication and may be used to impact a limited amount of information to mass audience.
2. Communication technology has reduced the cost of sending information world-wide.
3. Human powered transportatation is the movement of people and goods from one place to another using their power or the power of other humans.
4. One of the advantages of rail way transportation is that it requires a small space while transporting goods and people.
5. Ships are the fastest means of transporttation.
6. Transportation is the least user of energy in the world.
7. The internet is a computer network for the purpose of communicating messages in the form of text, voice, or images.
8. The importance of road transportation has declined worldwide.
9. Artists can communicate with large number of people without using words but through paintings.
10. Communication with the help of pictures, symbols, diagrams, books, etc. is called visual communication.

Part III: Fill in the blank space with the most appropriate word or phrase

1. The subject matter of communication contains sharing_____.
2. The feedback of any message is always directed to the_____.
3. Communication made through words either spoken or written is called_____.
4. Communication through spoken words is called_____.
5. Communication through the use of various parts of the human body such as saluting our national flag,

waving hands is termed as_____.

6. Traffic police showing a stop a sign, a teacher showing a chart of factors of production are examples of _____.
7._____ is a written form of communication delivered through the post office.

Part IV: Essay questions

1. What are the three modern transportation systems?
2. What are the functions of transportation systems?
3. What are the four types of communication systems?

Terms

Economics	Production
Factors of production	Economic goods
Free goods	Primary production
Capital goods	consumer goods
Microeconomics	Macroeconomics
Production possibilities curve	Mixed economy
Command economy	Capitalist economic system
Wealth	Sole proprietorship
Partnership	Corporation
Animal-powered	transportation human-powered transportation
Air transportation	Water transportation
Road transportation	Rail transportation
Human-based communication	Technical-based communication
Communication system	Communication process
Visual communication	Acoustic communication
Telecommunication system	Data processing systems

Review questions

Part I: Multiple-Choice Questions

1. Which of the following **is not** one of the basic economic questions that all economies must answer?
    a) what goods and services will be produced?
    b) for whom will the goods and services be produced?
    c) what is the highest opportunity cost method of producing each good?
    d) how will the goods and services be produced?

2. Which of the following is not a factor of production?
    a) human skill
    b) physical capital
    c) land
    d) production possibilities curve

3. When resources are being used wastefully,
    a) the production possibilities curve will remain unchanged
    b) the production possibilities curve will shift outward.
    c) an economy will operate inside its production possibilities curve.
    d) an economy will operate outside its production possibilities curve.

4. Which of the following is not a free good?
    a) air in the mountains
    b) sand in the desert

c) salt water in the Indian ocean
d) bread in the supermarket

5. The production possibilities curve is bowed outward because
   a) the opportunity cost of producing more of one good rises
   b) all resources are equally suited to the production of any good or service
   c) the opportunity cost of producing more of one good or services declines
   d) the opportunity cost of producing a good or service remains constant.

6. Which of the following is a characteristic feature of a free market economy?
   a) private ownership of resources
   b) prices of goods and services are determined by the government
   c) there are no businesses other than corporations
   d) most resources are public property

7. Which one of the following is not considered as capital good?
   a) city bus
   b) hammer
   c) share/stock of a company
   d) heavy duty truck

8. Which of the following forms of business organization can effectively raise capital?
   a) sole proprietorship
   b) partnership
   c) corporation
   d) cooperative

9. Which of the following is an example of a free good?
   a) international sea water
   b) public education
   c) public health
   d) public transport

10. Which means of modern transportation is widely used by the Eritrean people at present?
    a) road transportation
    b) rail way transportation
    c) sea transportation
    d) air transportation

Part II: **Write "True" if the statement is true or "False" if the statement is false.**

1. Land has no cost of production.
2. In traditional economies all human wants are fully satisfied.
3. Bells, whistles, buzzers, horns, etc. are called aural communication.
4. For most activities there is no opportunity cost.
5. The use of time involves economic choice.
6. A command economy primarily depends on market prices to coordinate the economy.
7. In a mixed economy resources are allocated by the market mechanism and by the government. .
8. Unlimited liability is one of the disadvantages of a corporation.
9. Modern transportation systems are crucial for industrial development.
10. Modern communication systems are important for the success of business organizations.

Part III: Fill in the blank spaces with the most appropriate word or phrase.

1. In _____economic decisions are made partly by the government and partly by individual producers or consumers.
2. The payments made to stockholders of a business organization is called_____
3. The dominant type of business organization in our country is _____.
4. An autonomous association of persons united voluntarily to meet their common economic social and cultural needs is _____.
5. Most bulky and heavy good are transported cost effectively by _____.
6. The fastest means of transportation is _____
7. _____was a means of transportation in Eritrea which ceased to function during British Colonialism.
8. Natural gas can be transported through_____ from the producer countries to consumer countries.
9. _____is an example of telecommunication system.
10. An example of acoustic communication systems is_____**.**
11. Because our wants exceed our ability to satisfy them_____ exists.
12. Inputs used to produce goods and services are called _____.
13. A branch of economics that studies the whole economy or national output, employment and general price level is called_____.
14. Printing and photography are examples of_____ communication system.
15. Because of resource scarcity individuals or society are forced to make_____.

Part IV: Matching. Match column "A" with Column "B" by selecting appropriate concept from column B.

Column A

1. The most active factor of production.
2. A business organization owned by more than one owner and which has unlimited liabilities.
3. Determine who owns the resources and what goods to produce, how they are produced, and for whome they are produced.
4. Widely used traditional means of transportation in rural Eritrea.
5. Central to modern business activities.
6. Decisions on the use of resources are based on customs and traditions.
7. Creates place utility.
8. Concerned with the efficient allocation of resources.
9. Tools, factories, equipment used in production.
10. A means of communication.
11. Necessitates the making of economic choices.
12. Motive for investing in new venture.
13. All resources are owned and allocated by a government.
14. Goods which command price.
15. Goods which are purchased but need further processing before it is sold to the consumer.
16. The value of the best alternative sacrificed when a choice is made.

Column B

A. Economic good
B. Communication
C. Animal transportation
D. Economic system
E. Labour
F. Partnership
G. Cooperative
H. Traditional economic system

I. Transportation and communication
J. Economics
K. Capital
L.
M. News paper
N. Scarcity of resources
O. Profit
P. Command economy
Q. Mixed economy
R. Intermediate good
S. Opportunity cost
T. Transportation

Part V. Essay questions

1. What is the subject matter of economics?
2. What are the fundamental economic problems which face all societies?
3. How are resources allocated in the three economic systems?
4. Why is transportation so important for the economic development of Eritrea? Explain.

UNIT 2

Money and Financial Institutions

Expected learning outcomes
After the completion of this unit, you are expected to:

- Explain the concept of money;
- Describe banking activities;
- Describe the different types of financial institutions;
- Explain the basic principles of insurance, and
- Describe the types of insurance.

2.1 Money

Have you ever heard people exchanging a cow with an ox? Have you ever witnessed farmers exchanging wheat for barley during summer season? The answer is obviously yes. During primitive modes of production, each community produces for its own needs. Gradually, with further development of the primitive society, division of labour started where everyone is required to concentrate on a specific production activity. For example, farmers concentrate on farming, herders concentrate on cattle raising, shoe makers concentrate on making shoes, etc. This necessitates an exchange among them in order to get what they don't produce they must offer what they do produce in the market place.

Focus Questions:

1. Why do people exchange goods and services in their day to day life?
2. Why do you think people would like to hold money?
3. How do you think money facilitates exchange among people?

Before the introduction of money, there was a system of trading known as barter.
Barter is the exchange of goods for goods without the use of money. Exchange is the process of obtaining desirable objects by offering something else in return. The existence of the primitive barter economy shows that exchange was possible without money. The functioning of a barter economy was, however, difficult and inconvenient.

Difficulties of Barter

i. **Absence of double coincidence of wants**: the first serious difficulty of barter was "the lack of a double coincidence of wants." In a barter economy, goods can only be exchanged for other goods. For example, a farmer who produces wheat needs shoes for his family. The farmer first has to find a shoemaker who needs wheat. Then, the exchange can take place. If no shoemaker was found who wants wheat, the farmer will be obliged to exchange his wheat for something else that the shoemaker requires. In other words, before the exchange of two goods can take place, there has to be a double coincidence of wants between the concerned parties.

ii. **No standard unit of measurement:** barter faced a serious shortcoming arising from the absence of any common standard unit of measurement in terms of which the values of different goods and services could be measured and expressed. In the absence of any common measure of value, the value of each commodity in the market could not be stated simply as one quantity. The numerous exchange values for the various qualities and quantities of goods made the smooth functioning of the economy very difficult. As a result, there was no scope for practicing specialization and division of labour and for gaining economies of scale in production.

iii. **Absence of divisibility:** for an item to function as the medium of exchange, it must be divisible. However, barter suffered from lack of divisibility among the various commodities used for exchange. In a barter economy if someone owns a cow and wants to exchange it with a pair of shoes, hat, exercise book etc. the exchange could be severely restricted because the cow cannot be divided into small units for the exchange to take place.

iv. **Difficulty of storage:** a barter economy also suffered from the lack of reliable method of storing wealth for future use. In a barter economy people could store their wealth for future use in the form of specific commodities. The disadvantage of this method of storing wealth was that some commodities are costly to store and the stored commodity could either deteriorate or depreciate in value over time.

A barter economy is, therefore, characterized by numerous unnecessary exchange transactions which are cumbersome and inefficient. The inefficiency of the barter economy led to the invention of money. In an economy where there is money, a double coincidence of wants between parties is no longer required. The farmer no longer has to look for a shoemaker who needs wheat. As long as a buyer can be found for the wheat, the money received in exchange for the wheat can be used to buy shoes.

What is money?

The word money is used in every conversation and it can mean many things to many people. Money is not wealth or income as observed in daily conversation. Money is one particular commodity with which we can hold wealth. People can also hold wealth in the form of a house, a motorcycle, precious items such as gold, silver, diamond etc. What distinguishes money from other commodities is that people can very easily use money for payment during transactions.

While money, income and wealth are all measured in some currency unit, they differ significantly in their meaning. Money is a stock of quantities measured at a particular point in time. People have money if they have large amounts of currency or a big bank account at a point in time. Wealth is also a stock variable. People have wealth if they have assets that can be converted into more currency than is necessary to pay their debt at a point in time. Income is a flow variable measured over a period of time. Someone earns income from work or investment.

Money is defined as anything that is generally accepted in payment for goods or services or in the payment of debts. Currency, consisting of Nakfa notes and coins, clearly fits this definition and is one type of money.

2.1.1 Functions of Money

Money has four primary functions in any economy: a medium of exchange, a unit of account, a store of value and a standard of deferred payments. Of the four functions, money as a medium of exchange is what distinguishes it from other assets such as houses, cars, land, etc.

i. Medium of exchange

Money will be accepted by all people in exchange for goods and services. This is important in eliminating barter, which requires a double coincidence of wants. Money is an asset that people are willing to accept in exchange for any good or service and with which they are willing to make payments for any good. The property that distinguishes money from all other assets is the fact that money is a universally accepted medium of exchange. This is perhaps its most important function without which the exchange of goods and services would be more complicated and difficult. The use of money as a medium of exchange promotes economic efficiency by lowering the time spent in exchanging goods and services.

ii. Measure of value (unit of account)

As we measure weight in terms of kilograms or distance in terms of kilometers, we measure the value of goods and services in terms of money. A unit of account is an agreed measure for stating the prices of goods and services. In a monetary economy, the prices of all goods and services are expressed in money terms. This function of money follows from its general acceptance as a medium of exchange. The fact that prices are all expressed in Nakfa enables us to calculate what we can afford to buy, In addition, the use of money as a measure of value enables us to obtain measures of the total value of all goods and services produced in the economy. Thus, money provides a quick and efficient method of calculating exchange ratios of goods and services.

iii. Store of value

In any society, there is a need to hold wealth in some form or another. A store of value is used to save purchasing power from the time an income is received until the time it is spent. The most common form for holding wealth or income is money, since it can be exchanged for other goods and services at a later date. This function is useful because most of us do not want to spend our income or wealth immediately upon receiving it, but rather we prefer to wait until we have the time or desire to buy goods. Thus, money is useful as a convenient store of value.

However, money is not unique as a store of value. Other assets such as land, houses, jewelry, can be used to store wealth. The advantage of using money as a store of value lies on the fact that it is usually more convenient and can be used immediately in exchange for other assets. Money has special characteristics of liquidity. Liquidity is the relative ease and speed with which an asset can be converted into cash. Money is the most liquid asset because it is the medium of exchange; it does not have to be converted into anything else in order to make purchases. Other assets cannot be converted into money so easily.

Because the value of money is fixed in terms of the price level, in time of high inflation, money loses its purchasing power and is not a good store of value. For example, during inflation when the general price level is increasing rapidly, money loses its value rapidly and people will be more unwilling to hold their wealth in the form of money. rather they want to store their assets in the form of gold, livestock, houses, etc.

iv. Standard of deferred payments

Money also serves as a standard of deferred payment. If one borrows money to buy a house now from the commercial bank of Eritrea, his/her future commitment will be agreed to pay his/her debts in Nakfa. It forms the basis for credit transaction. In modern times, undertaking businesses to a large extent is based on credit.

2.1.2 Forms of Money

The present day money (paper notes and coins) and other payment systems are only recent developments. Different forms of money have been used in different periods of time in different societies. Some of the different forms of money are:-

i) commodity money,
ii) metallic money,
iii) paper money, and
iv) cheques

i. Commodity money: as barter became very difficult to facilitate transactions, societies in different parts of the world selected commodities to serve as a medium of exchange. To overcome the problems of barter, therefore, different commodities were introduced to serve as money. Such commodities include cattle, sheep, furs, leather, fish, tobacco, tea, salt, etc. For such commodities to serve as money, they must be universally acceptable.

However, commodity money has its own limitations. The problem with commodity money is that it is very heavy and difficult to transport from place to place. Commodity money was also not divisible into small units, lacked standardization, was difficult and costly to store as wealth, was subject to fluctuations in value, lacked easy portability which a good money material must possess and was thus inconvenient for making transactions.

Moreover, commodity money has intrinsic value so that it can be used for other purposes. The term intrinsic value means that the item would have value even if it were not used as money. For example, gold can be minted and can be used for ornamental purpose. For most of human history, gold has been the most common form of commodity money.

ii. Metallic Money: the second stage in the evolution of money was metallic money. Metallic money was developed to overcome the problems of commodity money. Metallic money is broadly divided into:-

a) Standard coins, and
b) Token coins.

a) Standard Coins are also known as full bodied coins. If the value of the metallic content of the coins is equal to the face value, the coin is known as "full bodied" coin. This means, for example, the value of the metal of fifty cents coin is equal to fifty cents.

b) Token coins most coins nowadays are token coins. This means that the face value of the token money will be greater than the value of the metal content. For example, the value of the metal of twenty five cents will be less than twenty five cents. Thus, we can define token coins as money whose value is materially greater than the material out of which it is made.

Uniformity, durability and divisibility can be stated as the advantages of metallic money over commodity money. Metallic money, however, could be easily stolen. People experienced that it was unsafe to take huge amounts of metallic money with them while going to make purchases of goods and services. Furthermore, some metals were not available in adequate amount and the transportation of large amounts of metals from place to place was difficult.

iii. Paper money: the third stage in the development of money was paper money. Paper money includes pieces of paper that function as a medium of exchange. Paper money can be convertible or inconvertible money. Initially, paper money carried a guarantee that it was convertible into some quantitity of a precious metals such as gold. Paper money that is not backed by gold or other precious metals is described as inconvertible money. An inconvertible money standard is a monetary standard under which the currency cannot be converted into gold or silver by its users.

Paper money that is not convertible into gold or silver is also called **fiat money.** Fiat money is paper money and coins decreed by the government as a legal tender. Therefore, paper money is a legal tender because the law obliges everybody in society to accept it in payment of goods and services as well as in payment of debts. Fiat money is not convertible into precious metals. For example, the Eritrean currency – Nakfa has "legal tender of Eritrea" written on the paper money. In respect of the law, everyone in tsociety accepts and is willing to hold the paper money not because it has intrinsic value, but because every one expects that others will also accept it. For example, one can go to a shoe maker with 200 Nakfa and buy a pair of shoe. The shoemaker is happy to accept the money (200 Nakfa), knowing that other people will also accept the 200 Nakfa when he/she purchases goods and services in the market.

The major disadvantage of paper currency and coins are that they are easily stolen and expensive to transport in large amounts.

iv. Cheques: the final stage in the development of money is the use of bank deposits (cheques) as money. A cheques is a form of money used in payment of goods and services. A cheques is an instruction from a cheques issuer to the bank to transfer a certain amount of money from his/her bank account to the cheques holder's bank account when the check holder deposits the check in the bank. Cheques are used when banks exist in the country. cheques avoid the need to carry large amounts of currency. cheques made the payment system easier. The use of cheques reduces transferring large amounts of paper currency and coins from one place to another place. A cheques is written up to the balance in the account of the cheques holder. cheques are sometimes called demand deposits. Demand deposits are balances in bank accounts that depositors can access on demand simply by writing a cheques. Demand deposits can be withdrawn at any time in any amount on the holder's demand.

A modern economy uses various financial assets to store value. Money, however, is the most liquid of all assets. Other financial assets do not posses hundred cent liquidity which money does. These other financial assets are called quasi-money or near money. These include: bill of exchange, treasury bills, travellers' cheques, negotiable credit instruments, postal saving deposits etc. Furthermore, the development of computers and the spread of the internet now make it possible to pay bills electronically. Debit cards, credit cards, electronic money transfer are forms of money which are recent developments in the payment system.

Illustration of a* Cheques *book

Chq.No.446:Company name: ABC
Date _2/12/2009
Reason for payment : Salary

Previous Balance	2000	00
Amount Dep.	500	00
Total	2500	00
Amount of this Chq.	1000	00
Present Balance	1500	00

Cheque-**stub**

Chq.No. 446 Date: 2/12/2009

Commercial Bank of Eritrea

Pay to Ali Osman Nakfa 1000.00
One Thousand Nakfa only

Drawer's signature _____

Cheque-**bank**

Figure 2.1 Cheque book

A chequebook may be owned by individuals or organizations (private and public). The chequebook contains two parts; namely check-stub and cheque. The cheque-stub contains the data to be held by the owner, and the cheques is an instruction to transfer money from the owner's bank account to someone else's account when he/she deposits the cheque.

It is important to remember that a cheque will be valid if the amount to be withdrawn is at least less than or equal to the account balance in the cheque issuer's account in a bank. If the cheque is found to be invalid, that is, if the amount to be withdrawn is greater than the account balance, the cheque issuer will be legally responsible for the consequences that may follow.

How to Write a Cheque

Write your cheque clearly and completely. Don't leave any blank space. After you have filled out the stub in your cheque book write as follows:

a. Complete (fill) the cheque -stub first.
b. Make sure that the cheque number (chq.No) is filled.
c. Make sure that your balance covers the amount you plan to draw by writing a .
d. Write the date both on the cheque-stub and cheque-bank and it has to be the same.
e. Write the reason for paying the specified amount on the cheque-stub.
f. Write the payee's name on the bank cheque.

g. Write the amount in words as wells as in numbers on the cheque-bank.
h. Drawer's signature on the cheque-.

Activity 2.1

1. Think of an economy where there is no money. Assume also that Haile has a goat and he wants to exchange it for one quintal of wheat with Mogos.
    a. What would be the basic requirements for this transaction to take place?
    b. What problems would you expect during the transaction between Haile and Mogos?
2. How would you solve the problems of barter?
3. Does having more money mean having more wealth? Discuss.
4. There is 'legal tender' written on the Eritrean currency – Nakfa. What does it indicate?

2.1.3 Characteristics of Good Money

There are six main characteristics of good money. These are:

i) General acceptability

The essential quality of a good money material is that it would be acceptable to all without any hesitation in exchange for goods and services. It should be acceptable to anyone during the exchange of goods and services otherwise no transaction would take place.

ii) Durability

The second characteristic of good money is that it remains durable, and that the item used retains the same shape, form, and substance over an extended period of time; that is, it does not easily decompose, deteriorate, degrade, or otherwise change form.

Durability is critical for money to perform the functions of exchange and store of value. People are willing to accept an item in payment for one good because they are confident that the item (money) can be traded at a later time for some other good. An item works as a medium of exchange precisely because it stores value from one transaction to the next, and this requires durability.

Refined metals, such as gold, silver, copper, or nickel, have historically taken stage as money because they are extremely durable materials. A kilogram of gold today will be a kilogram of gold tomorrow, next week, and a thousand years to come. Organic products, such as tomatoes, ice cream, or raw meat, are seldom used as money because they are extremely perishable.

iii) Portability (Transportability)

The commodity chosen as money should be easily portable without any depreciation. It should be small in size but large in value. The item used as money should be easily moved from one location to another when such movement is needed to complete exchanges. When people go to the market to purchase a good, then they need to bring along their money. That is, money must be easily transportable.

One of the reasons why metals like gold, silver, copper, and nickel were used as money was because they were easily portable. Carrying a bag of copper coins from one place to another place was not a burden. However, these metals were replaced by paper currencies in the 20th century because paper money was lighter and easier to carry from one place to another place. For example, a 100 Nakfa note is just as easy to carry as a 1 Nakfa note. This notion has been taken a step further with paper cheque used to access chequing accounts balances. A cheque for 1 million Nakfa is just as easy to transport as a cheque for 1 Nakfa. Items that are physically heavy relative to their value in exchange, or need special handling, are not easily transportable.

iv) Divisibility

Money should be divided into small increments that can be used in exchange for goods of varying values. For an item to function as the medium of exchange, which can be used to purchase a wide range of

different goods with a wide range of different values, then it must be divisible. For an item to function as a medium of exchange, it must have increments that allow it to be traded for both large and small quantities, and everything in between.

Divisibility is one reason why metals, such as gold, silver, copper, and nickel, have been widely used as money throughout history. As pure elements, each can be divided into small units, in principle, down to the molecular level. In contrast, livestock has never become widely used as money in modern economies. Dividing a cow into increments small enough to buy gum is highly impractical. For example, the Eritrean money, both paper notes, and coins, comes in increments of one cent, sufficiently divisible to accurately match the value of virtually every good and service available in the economy. If the Eritrean money consisted exclusively of 100 Nakfa paper notes only and nothing smaller, people would have problems buying goods such as pencils, kerosene, rubber etc. These goods and many more, have values that cannot be rounded to the nearest 100 Nakfa.

v) Homogeneity

The commodity selected as money should be of a uniform quality and capable of standardization. It should be uniform which means that all notes and coins of the same amount should be standard and resembling one another. One coin or paper money should not be superior to another. For example, Nakfa notes used in Teseney are the same as Nakfa notes used in Asmara and elsewhere in the country.

vi) Hard to imitate (non-copyable)

This characteristic means that money cannot be easily duplicated. Money used should be difficult to copy otherwise it will have less value. A given item cannot function as a medium of exchange if everyone is able to "print up," or "make up" a lot of money at any time they want. Why would anyone accept money in exchange for a good, if they can make their own? Money that is easily duplicated ceases to be the medium of exchange.

Preventing the unrestricted duplication of money is a task that has long been given to governments. An economy needs a Government to regulate the total quantity of money in circulation. By controlling money duplication, governments are also able to control the total quantity in circulation, and this control is what gives money value in exchange.

2.1.4 Value of Money

The value of money and the price level

The value of money is the amount of goods and services a unit of currency, say Nakfa will buy. As we have already discussed fiat money has no intrinsic value. The price level is considered as a measure of the value of money. A rise in the price level means a lower value of money because the money people hold will buy fewer quantities of goods and services. Therefore the value of a unit of any legal tender (fiat money), say one Nakfa is inversely related to the general price level. The higher the price level, the lower the value of unit of any legal tender. Thus, there is an inverse relationship between the value of money and the general price level

Changes in the value of money

There is a reciprocal relationship between the general price level and the value of money. When money rapidly loses its value, it also rapidly loses its purchasing power. That is a given amount of money will buy lesser gods and services. Alternatively, the purchasing or buying power of money increases when we can buy more goods with a given amount of money.

We can express the inverse relationship between the general price level and the value of money mathematically. Suppose P is the general price level as measured by the consumer price index. Then, P measures the amount of Nakfa needed to buy some goods and services. Now we can turn this idea around: The quantity of goods and services that can be bought with *one Nakfa* equals $1/P$. $1/P$ is the

value of money measured in terms of goods and services. Thus, when the overall price level rises, the value of money falls.

$$\downarrow \text{Value of money} = 1/(P\uparrow)$$

Note that the downward arrow ($\downarrow$) implies a reduction in the value of money, while the upward arrow

($\uparrow$) shows an increase in the general price level in an economy.

A change in the price level has an important effect in the economy of the country. The two well known effects are inflation and deflation.

a) Inflation: the increase in the overall level of prices is called inflation. Inflation occurs when there is a general rise in prices without a corresponding increase in productivity. This means that people want more goods and services but they cannot get them because they are in short supply. As a result, people are forced to buy the goods and services they want at higher prices. Thus, inflation is a situation where too much money purchases too few good and services.

Measuring Inflation

Economists measure the inflation rate as the percentage change in the consumer price index.

A change in prices of consumer goods affects our standard of living. When prices increase, the cost of living becomes expensive and when prices decrease, the cost of living becomes cheap. A change in the prices of consumer goods is measured using a consumer price index (CPI). The CPI enables economists not only to measure the value of money but also to see whether the cost of living of the people is rising or not.

The CPI is calculated by selecting a group of commodities used by an average consumer (a consumer not too poor or not too rich). The CPI is computed by selecting a particular year as the base year. The base year is the benchmark against which other years are compared. To calculate the index, the price of the selected commodities in each year is divided by the price of the basket in the base year, and this ratio is then multiplied by 100. The resulting number is the consumer price index.

The consumer price index is also used to calculate the inflation rate**.** The inflation rate is the percentage change in the price index from the preceding period. That is, the inflation rate between two consecutive years is computed as follows:

$$\text{Inflation rate in year 2} = \frac{\text{CPI in year 2} - \text{CPI in year 1}}{\text{CPI in year 1}} \times 100$$

Example: 2008 is a base year. The consumer price index is always100 in the base year.
If the consumer price index is 175 in 2009, what is the inflation rate in 2009?

$$\text{Inflation rate in year 2} = \frac{(175 - 100)}{100} \times 100 = 75\%$$

The interpretation of the above figure is that the general price level which was 100% in 2008 increased to 175% in 2009.This means an increase in the general price of 75%. For example, a T-shirt which cost100 Nakfa in 2008, the same T-shirt costs 175 Nakfa.

Effects of inflation

Often high inflation is not desirable in an economy because it reduces the purchasing power of money. When general price rises, each unit of currency buys fewer goods and services. Thus, inflation directly reduces the living standards of a society by eroding the purchasing power of money. As a consequence, people tend to hold less money.

Inflation also penalizes people who receive fixed incomes. For example, as the general price level increases and the wage of government employees remains unchanged, the purchasing power of the wage is reduced due to inflation. Inflation also creates uncertainty about the future. This creates two kinds of costs. If there is a high degree of uncertainty about inflation, making long-term plans becomes difficult. In addition, people do not like the risk that comes with uncertainty. People are more suspicious about entering into long -term contracts. On the other hand, during periods of inflation, business organizations earn more profit by increasing the prices of their goods and services.

b) Deflation: is a persistent downward movement in the general price level over a period of time. Deflation is a decline in general price levels, often caused by a reduction in the supply of money or credit. When this happens, the available amount of currency per person falls, in effect making money scarcer; and consequently, the purchasing power of each unit of currency increases. In other words, deflation is a state in which prices fall. That is, the value of money increases in the economy. Deflation can also be brought about by direct contractions in spending, either in the form of a reduction in government spending, personal spending or investment spending. Deflation has the side effect of increasing unemployment in an economy, since the process often leads to a lower level of demand. Deflation causes a transfer of wealth from borrowers and holders of non-liquid assets, to the benefit of savers and holders of liquid assets and currency. Generally deflation is associated with falling economic activity and level of employment and the value of money saved in the past increases.

Activity 2.2

1. Why do you think that the present day paper currency and coins are used as money?
2. How could the price level affect the value of money?
3. Explain the effects of inflation in an economy?
4. Which one is good for a country: inflation or Deflation? Discuss

Summary

Before the introduction of money, there was a system of exchange called barter. Barter is defined as the exchange of goods for goods without the use of money. The functioning of a barer economy was, however, difficult and inconvenient. The problems of the barter exchange include the absence of double coincidence of wants, lack of standard measurement during transaction, lack of divisibility, difficulty of storage, etc. These problems made barter a cumbersome and inefficient means of exchange.

The problems encountered and the inefficiency observed in a barter economy led to the invention of money. Money is defined as anything that is generally accepted in payment for goods and services or in payment of debts. The introduction of money in an economy solved the problems of barter and facilitated the exchange of goods and services and made efficiency and specialization possible. Money has four basic functions in an economy: (i) as a medium of exchange, (ii) as a unit of account, (iii) as a store of value, and (iv) as a standard of deferred payments.

Different forms of money have been used in different periods of time in different societies. Commodity money was the first form to be used to facilitate transaction. In ancient societies, cattle, sheep, fur, leather, fish, tobacco, tea, salt, etc., were used as money. The next form used as money was metallic money. Metallic money includes standard coins and token coins. The third stage in the development of money was paper money. Paper money can be convertible and inconvertible money. The present day

paper money is not convertible into precious metals such as gold, silver etc. Such type of paper money is called fiat money. Fiat money is paper currency and coins decreed by the government as a legal tender. The most recent stage in the development of money is the cheque. A cheque is used in connection with a bank account. In addition, there are also commercial and electronic payment systems that facilitate the process of exchange.

The commodity that is chosen to serve as money must possess certain characteristics. Good money must be generally acceptable, durable, easily portable, divisible, homogeneous, and hard to copy. As well as the good characteristics, the value of money is also an important factor in the process of exchange. The value of money is measured in terms of the amount of goods or services a currency unit can buy. The value of money is closely related with the price level. When the general price level in the economy increases, the value of money declines and vice versa . Therefore, we can conclude that there is an inverse relationship between the general price level and the value of money.

An increase in the general price level is called inflation. When prices increase without a corresponding increase in the production of goods and services, this will have a negative impact on the living standard of the people. On the other hand, a decrease in the general price level is called deflation. Deflation is associated with falling economic activity, reduced output, and rising unemployment.

Exercise 2.1

Part I: Write "True" if the statement is true and "False" if the statement is false.

1) In a barter economy, a seller and a buyer of a good were able to easily match their wants.
2) The property that distinguishes money from all other assets is the fact that money is a universally accepted medium of exchange.
3) A primitive form of money is called commodity money.
4) Homogeneity is no longer required as a characteristic of good money.
5) Inflation is a situation where too much money purchases too many goods and services.

Part II: Fill the blank space with appropriate word or phrase

1. _____ is the exchange of goods for goods without the use of money.
2. When money serves to save purchasing power from the time an income is received until the time it is spent, this function of money is called _____.
3. Paper money that is not convertible into precious metals such as gold or silver is known as_____.
4. _____ as a characteristic of good money requires that the item used as money should not easily decompose, deteriorate and degrade.
5. A persistent decline in the general price level that leads to an increase in the value of money is called_____.

Part III: Match column "A" with the word or phrase from column "B"

Column "A"	**Column "B"**
1._____ Standard coins	A. Paper money
2._____ Difficulty of barter	B. Token coins
3._____ Bank deposit	C. Cheque
4. _____ Non-copyable	D. Absence of divisibility
5._____ Money as a measure of value of goods	E. Metallic money
	F. Store of value
	G. Durability
	H. Unit of account
	I. Hard to imitate

Part IV: Answer the following questions briefly

1. What are the basic functions of money? Which one is the most important function of money?
2. What is the difference between metallic money and paper money?
3. What is the special characteristic of money as a medium of exchange over other assets?
4. Discuss the relationship between the value of money and the price level.
5. What is inflation? How does it affect the economy?

2.2. Banks and Banking Activities

Have you ever seen people going to the bank to borrow money? Have you noticed individuals putting their money in a bank? The financial system moves the economy's scarce resources from savers (people who spend less than they earn) to borrowers (people who spend more than they earn). Savers save for various reasons—to meet unforeseen emergencies or to live comfortably during retirement age. Similarly, borrowers borrow for various reasons—to buy a house in which to live or to start a business with which to make a living. Savers supply their money to the financial system and they will get back the principal with interest at a later date. Borrowers demand money from the financial system and they will be required to pay back the principal and interest at a later date.

The financial system is made up of various financial institutions. These financial institutions coordinate the activities of savers and borrowers. Financial institutions can be grouped into two categories—financial markets and financial intermediaries.

Financial markets are the institutions through which a person who wants to save can directly supply funds to a person who wants to borrow. The two most important financial markets as the market economies are the bond market and the stock market. The bond market is a market where bonds (certificate of claims) are bought and sold where as the stock market is a market where shares are bought and sold.

Financial intermediaries are financial institutions through which savers can indirectly provide funds to borrowers. The term intermediary reflects the role of these institutions as standing between savers and borrowers. In this case, banks and other financial institutions are the most important financial intermediaries.

Focus Questions:

1. Why do people go to a bank?
2. Mention some of the reasons why a central bank retains the right to print currency?

Banking

A bank is a financial institution or intermediary that offers essential services to individuals and the society at large. In short, a bank is a place to keep money safely. Banks offer a variety of services both local and international.

Banks are the financial intermediaries with which people are most familiar. A primary function of banks is to take-in deposits from people who want to save, and to use these deposits to make loans to people who want to borrow. Banks pay depositors interest on their deposits and charge borrowers slightly higher interest on their loans. The difference between these rates of interest covers the banks' costs and brings some profit to the owners of the banks. Deposits are the amount of money put in a bank by a customer.

Besides being financial intermediaries, banks play a second important role in the economy: They facilitate purchases of goods and services by allowing people to write cheque against their deposits. In other words, banks help create a special asset (cheque) that people can use as a medium of exchange.

Activity 2.3

1. Assume that some one has money in excess of the required expenditure. Where will he/she put the money?
2. Discuss the advantages of putting money in a bank.
3. Think that you have a plan to open a small shop but you don't have enough money. What alternative sources do you have to get the money from?
4. Mention the types of financial institutions available in Eritrea.

2.2.1 Types of Banks

There are two types of banks. These are:

i) A Central bank and
ii) A Commercial bank

i) A Central Bank (National Bank)

A central bank is defined as that central monetary institution which is responsible for managing the monetary system of a country.

Functions of a Central Bank (National Bank)

The functions of a central bank are different from those of commercial banks. Firstly, a central bank is established for public service rather than for private profit. Unlike the commercial banks, its operations are not basically guided by profit motives. Secondly a central bank has a special relationship with the government of the country. Since the central bank acts as the banker to the government, the government influences its activities. Thirdly, a central bank generally does not deal directly with the public; it deals with the public only indirectly through the commercial banks.

The essential functions of a central bank (national bank) include:

a) Issue Bank Notes or Currency

Printing of money is one of the most important functions of modern central banks. A central bank is the only authorized bank by law to print money. The responsibility of printing money allows the central bank control over the money supply. Moreover, the issue of currencies by the central bank guarantees uniformity and ensures that the state can supervise and control the bank in issuing bank notes.

b) Acts as banker, agent and financial adviser to the government

Central banks in all countries act as the fiscal agent, banker, and adviser on all important financial matters to the governments of their countries. As government banker, the central bank conducts the banking accounts of government institutions. It gives short-term loans to the government. It conducts transactions on behalf of the government involving the purchases and sales of foreign currencies. The central bank also acts generally as financial adviser to the government. It manages national debt and gives advice to the government on important matters of economic policy such as printing money, whether to increase or decrease the value of the currency, foreign trade, etc.

c) Hold member banks' cash reserve

As the bankers' bank, the central bank keeps the cash reserves of commercial banks and other banks in the economy and thus acts as the custodian of the reserves of the country which support its credit and banking system. The other banks such as the commercial banks, housing banks and development and investment banks are required to keep a certain portion of their deposits with the central bank.

d) Lender of last resort

The central bank as a lender of last resort, meets directly or indirectly all demands from commercial banks and other credit institutions subject to certain terms and conditions. When commercial banks and other banks face some financial difficulty or crisis they can borrow from the central bank at a discounted interest rate.

ii) A Commercial Bank

Commercial banks play an important role in the financial system and the economy. As a key component of the financial system, commercial banks allocate funds from savers to borrowers in an efficient manner. They provide specialized financial services, which reduce the cost of obtaining information about both savings and borrowing opportunities. These financial services help to make the overall economy more efficient.

For example, if the owner of a small grocery store or a sole proprietorship wants to finance an expansion of his/her business, he/she would most likely finance the expansion with a loan from a commercial bank.

Functions of Commercial Banks

The functions of commercial banks are divided into two categories:

a) Primary functions, and
b) Other services.

a) Primary Functions:

The primary functions of a commercial bank include:

i) Accepting deposits; and
ii) Granting loans.

i) Accepting deposits

The most important activity of a commercial bank is to accept deposits from the public. People who have surplus income and savings find it convenient to deposit the extra amounts with commercial banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, the public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

Kinds of Deposit Accounts

There are two types of deposits accounts. These are:

a) Savings deposit account and
b) Current deposit account.

a) Savings Accounts

Savings are money set aside for future needs and wants. Savings account is meant for individuals who wish to deposit small amounts out of their current income.

The advantages of savings accounts are

a. It earns interest income for the depositor
b. The amount deposited in a savings account cannot be easily stolen and
c. It increases the wealth of the depositor

A savings account is a record of individuals' money kept in a bank for future use. A savings account can be opened with or without a cheque book facility. There are restrictions on the withdrawals from this account.

To open a savings account in a bank is simple. All you need to do is:-

a) Go to the bank
b) Ask the bank teller for a savings account openings forms and complete the form.
c) Make an initial deposit of 100 Nakfa or more.
d) Your bank teller will then give you a passbook. The passbook serves you as a receipt for your money. The bank also keeps the record of your deposits and withdrawals in the passbook. Your savings passbook is a valuable property and should be kept in a good place.

Your passbook may contain the following information though may differ from bank to bank

Name Abiel Tesfay Account Number 00220

Date	Deposit	Withdrawal	Interest	Balance
1/1/2003	300.00		18.00	300.00
30/12/2003				318.00
5/3/2004	300.00			618.00
10/6/2004		100.00		518.00

Figure 2.2 A sample page from a Passbook

The passbook contains all the information of the depositor. It contains the amount deposited, the interest earned; the withdrawal made on various periods of time; and the balance left at each transaction. The interest earned is calculated on an annual basis. For example, the interest rate for the above passbook is 6 cent per annum. The interest income earned is thus 18.00 Nakfa. The balance is updated when new amounts of money are deposited and withdrawn.

When an individual or a client wants to open a savings account, he/she should properly fill an application form. The Commercial bank is currently using the following application form for customers who want to open a savings account.

COMMERCIAL BANK OF ERITREA DATE _____
_____BRANCH A/C No A/C No _____

SAVINGS ACCOUNT OPENING FORM

FULL NAME_____
NATIONALITY _____
OCCUPATION _____
ADDRESS _____
TELE. _____
IDENTITY CARD OR PASSPORT No. _____
PLACE ISSUED _____DATE_____
WHERE DID YOU MAINTAIN ACCOUNTS BEFORE _____
INITIAL DEPOSIT NAKFA _____
APPLICANT (S) SIGNATURE_____
INITIAL DEPOSIT DOLLAR _____

_____ _____
OPENED BY APPROVED BY
REMARKS _____
_____
_____

Figure 2.3 A prototype of Commercial Bank application form for opening savings account

b) Current account/Chequing **accoun**t

A current account is also called a 'chequing account'. A current account is a running and active account in which the customer is allowed to deposit as much money as he/she likes. Money can also be withdrawn by the depositor at any time by checks. Businessmen generally open also be withdrawn by the depositor at any time by cheques. Businessmen generally open current accounts with banks. Current accounts do not earn any interest as the amount deposited in these accounts is repayable on demand

without any restriction. Commercial banks usually charge a small amount known as service charges on current accounts depending on the number of transactions.

Your signature is very important when cheques are used. Each new depositor is required to sign his name on a card so that the bank may verify his/her signature on all of his/her business papers that come to the bank. A copy of his/her authorized signature is called a **signature card**.

The signature card is a safeguard established by the bank to protect against forgeries. The depositor must make certain that he/she always sign the cheques exactly as his/her signature appears on the signature card filed with the bank.

Advantages of putting money in current account are:-

a) You need not keep a lot of money in your pocket, under your mattress, in a store at home or with friends and worry about losing it.
b) You can pay most of your expenses by writing cheques.
c) You can safely send a cheque through the post office.
d) In case your cheque is lost or stolen, you should inform your bank immediately.
e) It provides you updated information by preparing a statement showing exactly how much money you deposited, and how much money you withdrew during the month and the amount of service charge deducted from your account.

ii) Granting of loans

The second important function of a commercial bank is to grant loans. Such loans are given to members of the public and to the business community at a higher rate of interest than allowed by commercial banks on various deposit accounts. The rate of interest charged on loans varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the loans is the main source of a bank's income.

A loan is granted for a specific time period. Commercial banks grant short term and medium-to long-terms loans. The borrower may withdraw the entire amount in a lump sum or in installments. However, interest is charged on the full amount of the loan. Loans are generally granted against the security of certain assets which are called collateral. A loan may be repaid either in lump sum or in installments. Commercial banks lend money in the following form:

a) Demand loan, or
b) Term loan

a) Demand loan

A demand loan is repayable on demand. In other words it is repayable at short notice. The entire amount of a demand loan is disbursed at one time and the borrower has to pay interest on it. The borrower can repay the loan either in a lump sum (one time) or as agreed with the bank. Loans are normally granted by the bank against some collateral.

b) Term loans

Medium and long term loans are called ''Term loans''. Term loans are granted for more than one year and repayment of such loans is spread over a longer period of time. The repayment is generally made in suitable installments of a fixed amount. These loans are repayable over a period of 5 years and maximum up to 15 years.

A term loan is required for the purpose of setting up of new business activity, renovation, modernization, expansion/extension of existing units, purchase of plant and machinery, vehicles, land for setting up a factory, construction of factory building or purchase of other immovable assets. These loans are generally

secured against the mortgage of land, plant and machinery, building and other securities. The normal rate of interest charged for such loans is generally quite high.

b) Other Services of Commercial Banks

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These are as follows -

a) Issuing letters of credit, travellers Cheques, etc.;
b) Undertaking safe custody of valuables, important documents, and securities by providing safe deposit vaults or lockers;
c) Providing customers with facilities of foreign exchange;
d) Transferring money from one place to another; and from one branch to another branch of the bank;
e) Standing guarantee on behalf of its customers, for making payments for purchase of goods, machinery, vehicles etc.;
f) Collecting and supplying business information;
g) Issuing demand drafts and pay orders; and,
h) Providing reports on the credit worthiness of customers.

2.2.2. Banks in Eritrea

There are four kinds of banks in Eritrea. These are: Bank of Eritrea, Commercial Bank, Housing and Commerce Bank, and Eritrean Development and Investment Bank.

i. Bank of Eritrea- the Bank of Eritrea was established by the Proclamation No. 93/1997. The Bank of Eritrea functions like the Central Bank or National Bank.

General Functions of the Bank of Eritrea

- The Bank shall perform all functions required for the achievement of its objectives and for the regulation and supervision of Eritrea's financial system and such other functions as are customarily performed by central banks.

Specific Functions of the Bank of Eritrea

- Issue, manage and retire the legal tender currency in Eritrea;
- Implement measures designed to influence money supply and credit availability, interest rates and exchange rates;
- Manage and account for the foreign exchange reserves of Eritrea and issue regulations in respect to foreign exchange;
- License and supervise financial institutions in Eritrea;
- Act as lender of last resort for depository institutions in Eritrea;
- Act as banker and financial agent of and advisor to the Government on monetary and financial matters and on debt management;
- Collect and publish economic data of the financial sector and other sectors for research and policy purposes;
- Promote overall financial sector development and efficiency;
- Promote and provide facilities for money transfer, clearing and settlement systems; and
- Define the format, timing and other details of the information which should be transmitted to the bank by financial institutions.

ii. Commercial Bank

The Major Functions of the Commercial Bank of Eritrea are:

- Coordinating the country's flow of deposits and investments;
- Extending loans and credits to the public;
- Expanding banking services throughout the country; and
- Providing all sorts of international banking services.

iii. Housing and Commerce Bank

Housing and Commerce Banks are specialized institutions established with the objective of granting loans primarily for the purpose of construction of houses with the intention of solving the main problem of housing of the society. This bank also mobilizes savings of the public.

iv. Eritrean Development and Investment Bank

This bank is engaged in the promotion and development of industry, agriculture, and other key sectors. Unlike the Commercial Bank, the Eritrean Development and Investment Bank does not mobilize savings of the public; instead it provides loans for investment in different sectors of the economy.

Savings and Micro-Credit Program (SMCP)

In Eritrea, there is also a saving and micro-credit program whose major objective is to extend financial resources to poor households and small business enterprises. The ultimate goal of the establishment of the saving and micro-credit program is to help poor households improve their living standards and meet the financial needs of the small business sector through the provision of loans which otherwise could not have access to formal banking institutions. Formal banks such as the commercial bank provide loans once the borrower brings collateral as a security against default by the borrower. The saving and micro-credit program does not require high value collateral, and therefore, becomes more appropriate for poor households and small business enterprises with low capital for investment. The savings and micro-credit program encourages households and small business to save a portion of the loan for future use and makes positive contribution in the accumulation of capital. Furthermore, the program extends its loans to remote rural areas.

Activity 2.4

1. What do you think is the most important function of the central bank (national bank) in a country?
2. Mention the advantages of putting your money in a current account?
3. What are the advantages of putting your money in a savings account?
4. Distinguish between formal banks and saving and micro-credit programs?
5. Why is there a need for monetary control in any economy?

Summary

Financial markets are the institutions through which a person who wants to save directly supplies funds to a person who wants to borrow. Financial intermediaries on the other hand are financial institutions through which savers indirectly provide funds to borrowers. A bank is a financial institution or intermediary that offers a variety of services both at the local and international levels.

Generally there are two broad types of banks. These are the central (national) bank and commercial bank. The important characteristics of the central (national) bank is its discretionary or unrestricted control over the monetary system of the country. A bank is called a central bank because it occupies a central pivotal position in the monetary and banking structure of the country it operates. A central bank is defined as that central monetary institution which is responsible for managing the monetary system of the country. It also supervises, controls, and regulates the activities of the commercial banks. The functions of a central

bank vary from country to country. But there are certain functions which are commonly performed by the central bank. These functions include: (i) issuing banknotes or currency, (ii) acting as banker, agent, and financial adviser to the government, (iii) holding member banks cash reserve, and (iv) acting as a lender of last resort.

Commercial banks play an important role in the financial system and the economy at large. Commercial banks allocate funds from savers to borrowers in an efficient manner. The most important function of commercial banks is to accept deposits from the public. and to grant loans out of the money which comes to them by way of deposits to borrowers such as businessmen and entrepreneurs.

The functions of commercial banks are divided into two major categories. These are (i) primary function, and (ii) other services. Accepting deposits and granting loans are the primary functions of commercial banks. Deposits from the public can be accepted either in a savings deposit account or current deposit account. Savings are money kept for future needs and wants. Savings bank account can be opened for individuals who wish to deposit a small amount out of their income. Deposits received in savings bank accounts are subject to certain restrictions on the amount received and withdrawn. A current account is a running or active account in which the customer is allowed to deposit as much money as he/she likes. Deposits accepted in a current account are also called demand deposits and can be withdrawn any time by the depositor by means of Cheques.

The second important function of commercial banks is to grant loans. Loans are given to members of the public, the business community and entrepreneurs usually at a higher interest rate. Commercial banks grant short-term and medium-to long-term loans. Commercial banks lend money in the form of demand loans and term loans. While demand loans are repayable on demand at short notice, the repayment of term loans is spread over a longer period of time.

Commercial banks also provide other services. These services include issuing letters of credit, travellers Cheques, safe custody of valuables, important documents, transfer of money from one place to another or from one branch to another branch of the bank etc.

In Eritrea, there are four types of banks that provide various and specialized services. These banks are: (i) Bank of Eritrea, (ii) Commercial Bank of Eritrea, (iii) Housing and Commerce Bank of Eritrea, and (iv) Eritrean Development and Investment Bank.

Exercises 2.2

Part I: Write "True" if the statement is true and "False" if the statement is false.

1. Accepting deposits is an essential function of a modern commercial bank.
2. The central bank acts as the custodian of the reserves of commercial banks in a country.
3. Other services rendered by banks to the general public constitute the main functions of banks.
4. Difference of interest rates allowed to the public on deposits and charged on loans is the mains source of income for commercial banks.
5. There is time restriction on the withdrawal of deposits accepted in a current account.

Part II: Fill in the blank space with an appropriate word or phrase

1. _____ are money set aside for future needs and wants.
2. Financial institutions through which savers can indirectly provide funds to borrowers are known as _____.
3. When the loan is repayable on demand or at a short notice, the loan is known as _____ loan.
4. _____ is a financial institution that has the discretionary control on the monetary system of the country.
5. _____ and _____ are the primary functions of commercial banks.

Part III: Match column "A" with the word or phrase from column "B"

Column "A"	**Column "B"**
1. _____ Term loan	A. Current account
2. _____ Active account	B. Repayable at short notice
3. _____ Savings accounts	C. Other services of commercial banks
4. _____ Lender of last resort	D. Earns interest rate
5. _____ Issuing letter of credit	E. Repayable over a longer period of time
	F. Central bank
	G. Commercial bank

Part IV: Answer the following questions briefly.

1. Mention the types of deposits received by commercial banks.
2. How do banks earn most of their income?
3. What is the difference between demand loan and term loan?
4. Distinguish the functions of the central bank from those of the commercial bank?
5. What do depositors get when they deposit their money in a commercial bank?

2.3 Insurance

Have you ever observed people worried about risks? Have you ever seen individuals facing huge damage on their property such as cars, houses, etc? Have you noticed car owners going to the insurance corporation of Eritrea? Individuals face different types of losses or damages for different reasons. Some families will be deprived of financial support because the family head may be killed in an auto accident. Others will experience destruction of their homes and personal property because of fire, floods, earthquake or other disasters. Still others will become disabled because of heart disease, cancer, AIDS, or other diseases. Individuals face a variety of risks. Risk is related with uncertainty.

Focus Questions:

1. Can you list some of the negative risks a taxi owner or driver may face?
2. How do insurance companies work?

What is risk?

Risk is inherent in life. Everything we do involves risk. We face many risks all the time – some we know about, others not.

Risk is defined as uncertainty concerning the occurrence of a loss. Risk is the chance that you will lose something of value to you. For example, the risk of being killed in an accident is present because uncertainty is present. The risk of lung cancer from smoking is present because uncertainty is present.

Insurance is defined as a form of cooperation through which all those who are open to risks and losses pool their resources and compensate those who suffer a loss. Similarly, insurance can also be defined as the transfer of the risk of potential loss, from one entity to another, in exchange for a reasonable fee. The main duty of insurance is thus to spread the actual loss over a large number of persons and enterprises through cooperation. Insurance is only a means to compensate the losses; it cannot really eliminate or avert losses. Insurance companies are professional risk takers. For some fee they accept the risk of loss or damage to businesses and individuals.

In modern times, this cooperation is brought about by means of a contract between those who are open to risk (called the insured) and insurance companies (known as insurers) who keep a common fund. The document containing the contract is called the insurance policy.

An insurance policy is based on the law of contracts. A contract of insurance may be defined as an agreement between two parties whereby one party (the insurer) promises in exchange for a fixed sum (called premium) to pay the other party (the insured) a sum of money when a loss occur.

2.3.1 Basic Characteristics of Insurance

An insurance arrangement has certain characteristics. These include

a. Sharing of losses
b. Payment for accidental losses
c. Risk transfer and
d. Indemnification.

a. Sharing of Losses

Pooling or the sharing of losses is at the heart of insurance. Pooling is the spreading of losses incurred by the few over the entire group, so that in the process, average loss is substituted for actual loss. Thus pooling implies the sharing of losses by the entire participants.

For example, assume that 100 farmers in Gash Barka agree that if any farmer's home is damaged or destroyed by fire, the rest of the farmers cover the actual loss of the unlucky farmer. Assume also that each home is valued at 50,000 Nakfa, and on average one home is destroyed by fire each year. In the absence of insurance, the maximum loss to each farmer is 50,000 Nakfa if the home is destroyed. However, by sharing the losses, it can be spread to the entire group of farmers (100 farmers) and if one farmer has a total loss of his/her home, the maximum amount that each farmer would have to pay is only 500 Nakfa (50,000/100). In effect the pooling technique results in the substitution of an average loss of 500 Nakfa for the actual loss of 50,000 Nakfa.

b. Payment of Accidental Losses

The second characteristic of insurance is the payment of accidental losses. An accidental loss is one that is unforeseen and unexpected and occurs as a result of chance. In other words, the loss must be accidental. The law of large numbers is based on the assumption that losses are accidental and occur randomly.

c. Risk Transfer

Risk transfer is another essential element of insurance. A true insurance always involves risk transfer. Risk transfer means that the possibility of loss or no loss is transferred from the insured to the insurer. The insurer is usually in a stronger financial position to pay the loss than the insured.

d. Indemnification

A final characteristic of insurance is indemnification for losses. Indemnification means that the insured is restored to his or her approximate financial position prior to the occurrence of the loss. Thus, if your home burns in a fire, the insurance policy will restore you to your previous position.

Activity 2.5

1. Assume that you own a mini-bus. What kinds of risks do you think that your mini-bus will face during operation?
2. Discuss how insurance companies help people to share risks?
3. What is the purpose of an insurance company?

2.3.2 Legal Principles of Insurance

The insurance policy has fundamental legal principles that are reflected in insurance contracts. These principles are the legal requirements that must be met to have valid insurance contracts. The following are the legal principles of insurance: Principle of indemnity, Principle of insurable interest, Principle of subrogation, Principle of good faith, and Principle of contribution

i. Principle of indemnity

The principle of indemnity is one of the most important legal principles in the field of insurance. The principle of indemnity states that the insured should not profit from a covered loss but should be brought back to approximately the same financial position that existed before the loss. If a loss occurs, the insured should not collect more than the actual amount of loss.

The principle of indemnity has two fundamental purposes. The first purpose is to prevent the insured from making profits from the insurance contract. For example if Mussa's car is insured for 100,000 Nakfa, and a 20,000 Nakfa loss occurs because of accident, the principle of indemnity would allow him only 20,000 Nakfa. If more than the specified loss is paid, we say that the principle of indemnity is violated because Mussa is making profit from the insurance company.

The second purpose is to reduce moral hazard. If the insured is dishonest and believes that he/she can make profit from a loss, he/she may deliberately cause a loss with the intention of getting benefit from the insurance policy. Thus, if the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced.

The principle of indemnity does not apply to life insurance because it is not possible to know or calculate precisely the life of a person in terms of money.

ii. Principle of insurable interest

The principle of insurable interest is another important legal principle. According to this principle, no person can enter into a legal contract of insurance unless he/she has an insurable interest in the property or life insured. For example, you can have an insurable interest in your car since you may lose financially if your car is damaged. You can have also an insurable interest in your personal property, such as television since you may lose financially if your television is destroyed. A husband and a wife could also have an insurable interest in each other. This means, if the husband is alive the wife benefits, if he dies she suffers a monetary loss.

iii. Principle of subrogation

The principle of subrogation is that an individual should not claim compensation from two sources. Subrogation has two basic purposes. First, subrogation prevents the insured from receiving payments twice for the same loss. Secondly, subrogation is used to hold the guilty person responsible for the loss. For example, assume that Haile whose car is not insured carelessly inflicts damage of 10,000 Nakfa on Saba's car which is insured. According to the principle of subrogation Saba whose car is insured would claim compensation from the insurance company worth of 10,000 Nakfa. Once Saba is compensated by the insurance company she cannot claim compensation from Haile. The insurance company after compensating Saba could legally claim from Haile the value of the damage paid to Saba due to his carelessness.

iv. Principle of good faith

An insurance contract is based on the principle of utmost good faith. This means that a higher degree of honesty is required on both parties to an insurance contract. Each party is obliged to tell facts about the contract of insurance. For example, if you apply for life insurance, you may be asked questions concerning your age, weight, height, occupation, state of health, family history, and other relevant questions. Therefore, your answers to these questions must be true and honest. If your answers were found to be false or the insurer knew the true facts, the insurance policy may be of no value at all.

v. Principle of Contribution

Sometimes an enterprise may get its goods insured with more than one insurer. This is referred to as the principle of contribution. Let us see the following example. Suppose a co-operative has insured its store for 10,000 Nakfa. Instead of insuring with one insurance company, let us say it signs a contract of insurance

with three different companies. Thus with Company A it signs for Nakfa 5000 with B for Nakfa 4000 and with C for Nakfa 1000. The total insured becomes 10,000 Nakfa. If the store is totally destroyed the cooperative can claim Nakfa 10,000 in all. A, B, and C will compensate the co-operative proportionally that is 5000/10000 (5/10), 4000/10000 (4/10), 1000/10000 (1/10) of the value damaged respectively. A's contribution will be 5/100X10000 = 5000; B's contribution will be 4/10X10000 = 4000; C's contribution will be 1/10X10000 = 1000 Nakfa. This is how the principle works in insurance business.

vi. Principle of Limitation

According to the Transitional Commercial Code Article 674, any claim out of a contract of insurance shall be barred or disqualified after two years from the occurrence giving rise to the claim or from the day when the parties knew of the occurrence. In cases of concealment or false statement, the period of limitation shall run from the day when the insurer knew of the concealment or false statement. The periods provided in this article may not be shortened in the policy.

2.3.3 Types of Insurance

Insurance can be divided into two major categories. These are:

A. Life and health insurance, and
B. Property and liability insurance.

A. Life and health insurance

Life insurers pay death benefits to designated beneficiaries when the insured dies. The death benefits include the payments for funeral expenses, uninsured medical bills, and other expenses as a result of death. The death proceeds can also be arranged to provide periodic income payments to the deceased's dependents. In addition, life and health insurers provide individual and group health insurance plans that cover medical expenses from sickness or injury. Life and health insurance could also cover disability income during a period of disability. Finally, it also provides a means of accumulating savings for the policy holder's future use.

B. Property and liability insurance

Property and liability insurance includes the following major categories:

1. **Fire insurance**: Fire insurance covers the loss or damage to business and personal property because of fire or, lightning. Indirect loss can also be covered including the loss of profits and rents and extra expenses incurred as a result of a loss from the interruption of the business as a result of fire.
2. **Marine insurance**: Marine insurance is also called transportation insurance because it covers goods in transit against pure risks connected with transportation. Such risks may arise from heavy weather, collision, fire, loss or damage to the ship, etc. Marine insurance is divided into ocean marine and inland marine insurance. Ocean marine insurance provides protection for all types of ocean-going vessels and their cargoes. Inland marine insurance provides cover for goods being shipped. This includes imports, exports and, domestic shipment.
3. **Casualty insurance**: Casualty insurance is a broad field of insurance and covers whatever is not covered by fire, marine, and life insurance. Some of the major casualty insurances include the following:
    i. **Automobile insurance** - covers legal liability arising out of ownership or operation of an automobile and also provides physical damage insurance on the automobile, medical payment insurance, and protection against uninsured motorists. In Eritrea, third party insurance is obligatory by law.
    ii. **General liability insurance** - covers legal liability arising out of property damages or bodily injury to others. Legal liability may arise out of the ownership of business property, sales or distribution of products, manufacturing or contracting operations, and professional service.
    iii. **Burglary and theft insurance** - covers the loss of property, money etc because of burglary, robbery and other crime risks.

iv. **Workers compensation insurance -** covers workers for a job-related accident or disease. The insurance pays for medical bills, disability income benefits, and death benefits to dependents of employees whose death is job related.

Activity 2.6

1. Why is the principle of indemnity important?
2. Explain the purpose of the principle of subrogation?
3.What are the death benefits of life insurance?
4. Mussie negligently smashes Semira's car. Which type of legal principle of insurance is applicable in this case? Who will pay the loss incurred on Semira's car? Discuss.

Summary

Everything we do involves risk. Risk is the uncertainty concerning the occurrence of a loss. One way of managing risk is through insurance. Insurance is defined as a form of cooperation through which all those who are open to risk and losses pool their resources and compensate those who suffer a loss. This cooperation is brought about by means of a contract between those who are open to risk (called the insured) and insurance company (known as insurer) who mobilizes a common fund. The document containing the contract is called the insurance policy.

A typical insurance arrangement contains four characteristics. These are (i) sharing of losses, (ii) payment for accidental losses, (iii) risk transfer, and (iv) indemnification.

The insurance policy has fundamental legal principles that are reflected in insurance contracts. These legal principles are the legal requirements that must be met to have valid insurance contracts. The legal principles include: (i) principle of indemnity, (ii) principle of insurable interest, (iii) principle of subrogation, (iv) principle of good faith, (v) principle of contribution, and (vi) principle of limitation.

An insurance contract can be divided into two major categories. The first category includes life and health insurance. Life insurance pays death benefits such as payments for funeral expenses, uninsured medical bills and other expenses when the insured dies. Moreover, life and health insurance provide individual or group health insurance plan that cover medical expenses from sickness or injury. The second category of insurance is property and liability insurance. These types of insurances cover fire insurance, marine insurance, and causalty insurance.

Exercise 2.3

Part I: Write "True" if the statement is true and "False" if the statement false.

1. The document that contains the agreement between the insured and the insurer in insurance is called the insurance policy.
2. Indemnification means that the insured will be in a better financial position than prior to the occurrence of the loss.
3. The principle of subrogation supports the claim of an individual for compensation from two sources.
4. Automobile insurance covers legal liability arising out of ownership or operation of an automobile.
5. The principle of insurable interest states that a person can enter into a legal contract if he/she has an insurable interest in the property or life insured.

Part II: Fill in the blank space with an appropriate word or phrase

1. The principle of _____ requires the insured and the insurer to maintain a higher degree of honesty during an insurance contract.
2. _____ covers the loss or damage to a business or personal property because of fire.
3. The principle of _____ prevents the insured from making profits from the insurance contract.
4. The substitution of average loss for actual loss is called _____.
5. _____ is the transfer of the risk of potential loss from one entity to another in exchange for a reasonable fee.

Part III: Match column "A" with the word or phrase from column "B"

Column "A"	**Column "B"**
1. _____ Premium	A. Covers job-related accident
2. _____ Insured	B. Low of large number
3. _____ Indemnity	C. Fixed amount paid by the insured
4. _____ Workers compensation insurance	D. Someone open to risk
5. _____ Sharing losses	E. Reduces moral hazard
	F. Insurance policy
	G. Risk

Part IV: Answer the following questions briefly

1. Explain the major characteristics of an insurance policy?
2. List the major types of insurance?
3. What is an insurance premium?
4. Mention the major types of casualty insurance.
5. Why do we refer to fire insurance as a contract of indemnity? Explain by giving examples.

Key terms

Barter	Cheque
Money	Inflation
Medium of exchange	Deflation
Measure of value	Central bank
Store of value	Commercial bank
Standard deferred payments	Risk
Metallic money	Insurance
Paper money	

Review Questions

Part I – Multiple-choice

1. The direct exchange of goods with other goods without money is called _____
   a. transaction b. barter
   c. commodity money d. trade

2. Banks are _____
   a. financial institutions
   b. financial institutions which coordinate the activities of lenders and borrowers
   c. financial intermediaries
   d. all of the above

3. Risk is defined as_____
    a. uncertainty concerning the occurrence of a loss
    b. certainty concerning the occurrence of a loss
    c. the chance that some one will lose something of value
    d. a and c

4. Which of the following is a difficulty in a barter system?
    a. absence of double coincidence of wants
    b. absence of agreement between the buyers and the sellers
    c. absence of portability
    d. all of the above
5. Money is defined as anything
    a. used to measure the values of goods and services
    b. used to store wealth
    c. that is generally accepted in payment for goods and services
    d. all of the above

6. Which of the following is not the function of a central bank?
    a. managing the monetary system of the country
    b. printing money in the country
    c. accepting deposits and granting loans to the public
    d. acting as banker's bank

7. A casualty insurance that covers the physical damage for an automobile is called _____
    a. general liability insurance
    b. automobile insurance
    c. workers compensation insurance
    d. burglary and theft insurance

8. The advantage of money as a store of value over other commodities is its ____
    a. color b. liquidity c. size d. none of the above

9. Current account;
    a. can be withdrawn by depositors at any time by Checks
    b. earns interest
    c. does not require the signature of the depositor
    d. none of the above

10. Money made up of token coins is called _____
    a. paper money b. checks c. metallic money d. fiat money

11. The item used as money should not easily decompose and deteriorate. This characteristic of money is _____
    a. durability
    b. portability
    c. general acceptability
    d. divisibility

12. Which of the following characteristics of insurance involves the spread of losses incurred by the few over the entire group?
    a. pooling of losses
    b. payment for Accidental losses

c. risk transfer
d. indemnification

13. What type of relationship does exist between the value of money and the price level?
    a. proportional
    b.direct
    c.inverse
    d. all of the above

14. Loans granted for the purpose of setting up new business activity, renovation, purchase of plant and machinery
    a. demand loan
    b. term loan
    c. current account
    d. saving account

15. The Housing and Commerce Bank of Eritrea is established with the objective of granting loans primarily for _____
    a. promotion and development of industry
    b. controlling the money supply in the country
    c. construction of houses to solve the housing problem
    d. io expand the agricultural sector

16. An increase in the overall price level is called _____
    a. consumer price index (CPI)
    b. deflation
    c. cost
    d. inflation

17. When an insured is restored to his/her approximate financial position prior to the occurrence of the loss, this is _____
    a. risk transfer
    b. indemnification
    c. subrogation
    d. pooling of losses

18. Which of the following is a primary function of any commercial bank?
    a. transfer of money from one place to another place
    b. granting loans to borrowers
    c. collecting and supplying business information
    d. giving financial advice to customers

19. The principle of good faith requires_____
    a. both parties to hide facts
    b. both parties to mislead to each other
    c. higher degree of honesty on both parties
    d. none of the above

20. The financial institution which controls the supply of money is called _____
    a. commercial bank
    b. insurance company
    c. central bank/national bank
    d. housing and Commercial bank

Part II –Essay questions

1. Define barter.
2. What are the primary functions of a commercial bank?
3. Define insurance.
4. List the six legal principles of insurance?
5. When does money lose its function as a store of value?
6. How does a life insurance policy differ from other types of insurance?

PART 2



UNIT 3

Bookkeeping for a Service Business

In the previous two units, you have studied the efficient allocation of resources, business organizations, transportation and communications and the role financial institutions and money. In this unit, you will learn about bookkeeping of a service business to efficiently use businesses' scarce resources. This unit describes the bookkeeping system for various service businesses that provide variety of services such as hotels, garages, transportation services (taxi and mini-bus services), professional services like accounting, law, medical and others. The unit consists of five sub units that provide a broad knowledge and skills to students concerning the concept of bookkeeping and its functions.

Expected Learning Outcomes:
After completing this unit, you will be able to:

- Define accounting and bookkeeping.
- Explain the concept of service business and describe its financial records.
- Analyze and journalize business transactions.
- Post entries to the ledger accounts and prove the accuracy of posting by preparing trial balance.
- Prepare worksheet and financial statements.
- Close temporary accounts.
- Prepare post closing trial balance.

3.1. Starting an Accounting System for a Business

Focus Questions

1. Discuss the types of businesses operating in your area?
2. Can you name three service businesses in your area?
3. Why are you studying Accounting?

3.1.1. Introduction

An understanding of the principles of accounting is essential for anyone who is interested in a successful career in business and everyday personal life. The main purpose of accounting is to provide information concerning the financial affairs of a business.

What is Accounting?

Accounting is the art of planning how to keep financial records, summarizing, interpreting, and analyzing them to advise what should be done. ***Accounting*** is defined as *"the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of information*." This information is primarily financial-stated in money terms (Nakfa). Reliable financial information is necessary for sound management decision making.

Bookkeeping is the art of recording financial activities. A ***bookkeeper*** is a person who earns his living by recording financial activities.

Accounting includes bookkeeping but its scope goes well beyond that. Accountants analyse and interpret financial information, prepare financial statements, conduct audits, design accounting system, prepare budgets and other financial tasks. Think of bookkeeping as one slice of *'Hmbasha"* that is accounting.

Users of Accounting Information

One of the most important functions of the accounting process is to accumulate and report accounting information that shows an organization's financial position.

Owners use accounting information to determine the profitability and financial health of their business.
Bankers and suppliers appraise the financial worth of a business for loans or granting credit. They use accounting information to assess a company's ability to pay debts as they become due.
Government agencies use accounting information for the assessment of taxes.
Managers use accounting information to evaluate the performance of their business and to get timely information of the business in order to assess the company's strengths and weaknesses.
Employees use financial reports to monitor the performance of their organization as it is the source of their income. Their livelihood depends on the company's survival.

Types of Business Organizations
Based on the nature of business, organizations can be classified into three categories: service rendering, merchandising and manufacturing businesses.

1) ***Service rendering businesses***: are businesses that perform services for customers in order to earn profit. For example, people who operate service business are doctors, lawyers, engineers, accountants, hairdressers beauticians, dry cleaners, taxi-drivers and others. Moreover; banks, insurance, hospitals, theatres, garages, bus and taxi-service businesses are typical examples of service rendering businesses.
2) ***Merchandising businesses***: are businesses that purchase goods produced by others to sell to customers in order to earn profit. For example, groceries, cloth merchants, supermarkets, department stores, wholesalers, retailers and others.
3) ***Manufacturing businesses:*** are businesses that produce products to sell to their customers. For example, manufacturing factories such as textiles, footwear, breweries, tanneries, food processing plants are manufacturing businesses. Asmara Brewery, Red Sea Bottlers Coca-Cola Company, Massawa Cement Factory, Bana Tom Food Processing Plant in Alebu, Tissenima Auto Assembly in Dekemhare are some of the manufacturing businesses that we have in Eritrea.

Activity 3.1.1.
Classify each of the following businesses as either service; merchandising or manufacturing:
a) hotel; b) shoe factory; c) pharmacy; d) neighborhood shops; e) restaurants.
Furthermore, classify the businesses operating in your area into service, merchandising and manufacturing. Discuss your classification with your classmates.

Why study Accounting?

1) **Accounting is used in everyday life**. For instance, buying and selling of goods, tax payment and others. Every person, even if he/she does not plan to be an accountant or business person, will benefit from the study of accounting because it will enable him/her to keep better personal financial records that will enable him/her to spend wisely and manage his/her savings and investments.
2) **Career interest**: Studying accounting is helpful for acquiring knowledge and skills required for various positions in a business such as: accountants, financial managers, bankers, auditors, accounting clerks, payroll clerks or to work in some other accounting positions.
3) Accounting is necessary for the best management of any organization. Knowledge of accounting is essential for a person who has a service station, garage, restaurants, grocery store; factory or others. Any manager must know the cost of his/her services or products to determine their profitability.
4) Accounting is used by all business workers. Accounting has been called the '***language of business***'. Everyone engaged in a business activity uses this language.

3.1.2. Starting an Accounting System for a Service Business
Let me tell you about an Eritrean businesswoman named Dehab. She was born in 1955 and studied bookkeeping in secondary school. At that time, Eritrea was colonized by Ethiopia and the ruthless Ethiopian regime killed people and looted property and businesses in Eritrea. When Dehab finished secondary school in 1975, she joined the Eritrean Peoples' Liberation Front (E.P.L.F.), an organization

that was fighting for the liberation of Eritrea. During 1975-1991, she participated in the liberation struggle by assuming various positions. On May 24, 1991, Eritrea was liberated from Ethiopian colonization and soon afterwards it became an independent country.

Dehab was demobilized from the army in 1994. after independence; and with the assistance provided from friends and the Government; she bought a taxi and established a taxi service business. She was a hardworking person and the principles of self-reliance that she learned during the armed struggle for independence of Eritrea helped her in building a successful business. She earned a lot of money from operating the taxi business and she became famous. People talk about her success on the street and know her as Dehab *tegadalit*.

Yesterday, while I was riding on a bus, two women seated directly behind me and were discussing very loudly.
The older woman asked her friend "Do you know Dehab *tegadalit* who lives in the market area?"
Her friend replied, "Sure!"
The older woman said "she is worth a sack of money. A big sack of money. She is a millionaire. She is rich."

Her friend replied, "Dehab owns a taxi service and she is going to buy a hotel and she will of ten fly to Dubai, Delhi, Beijing and Rome for business".
When the older woman said that Dehab is worth a sack of money, it means she is possessing or having property to the value of thousands of Nakfas, a great deal of money. How do we determine what a person is worth? We determine a person's financial worth by what he/she has or by what he/she possesses.

Accounting deals with records of a person's financial worth. Let us see how a student determines his/her financial worth. Let us assume her name is Lia.
Financial worth of Lia:

Money in pocket	Nakfa	25.00
Cash in bank		100.00
Clothes		190.00
Books		250.00
Total property owned		565.00

If another student, Zeineb possesses the following: determine her financial worth:

Money in pocket …….……..	Nakfa	50.00
Cash in bank ……..		100.00
Clothes ……		1,000.00
Bicycle ……		750.00
Mobile phone ……..		3,000.00

A person's financial worth is found by adding up the value of all things that he/she owns. Zeineb owns property worth Nakfa 4,900. Own means possess, or have as property.

Suppose Lia, stated in the example above, owns all these things, but also owes to a friend Nakfa 100. How much is her financial worth? Owe means be in debt to somebody or you are liable to pay. To find the financial worth of Lia, we subtract what she owed from what she owned. If Lia owes Nakfa 100 to a friend, her financial worth is Nakfa 465 (that is, 565-100). Every person, every business can thus operate more efficiently, if they are aware of how much they are worth. Similarly, accountants determine the financial worth of businesses in the same way.

Therefore, businesses determine financial worth by using the following basic formula in accounting.
Owns = Financial worth, if there is no debt.
Owned - owed = Financial worth, if there is a debt.

Activity 3.1.2.

The following lists the property of Lia's mother and her debt

Owns		Owes	
Car	Nakfa 75,000	Electric bill	Nakfa 300
Tools	400	Money borrowed	10,000
House	500,000		
Furniture	1,000		
Clothes	300		
Money in bank	10,000		
Total	586,700		

Determine the financial worth of Lia's mother and discuss your result with your classmates.

3.1.3. Accounting Equation

In accounting, one of the basic formulas that we have is the following:
Owns = Owes + Financial worth. In accounting language, we write the same formula as:
Asset = Liabilities + Capital

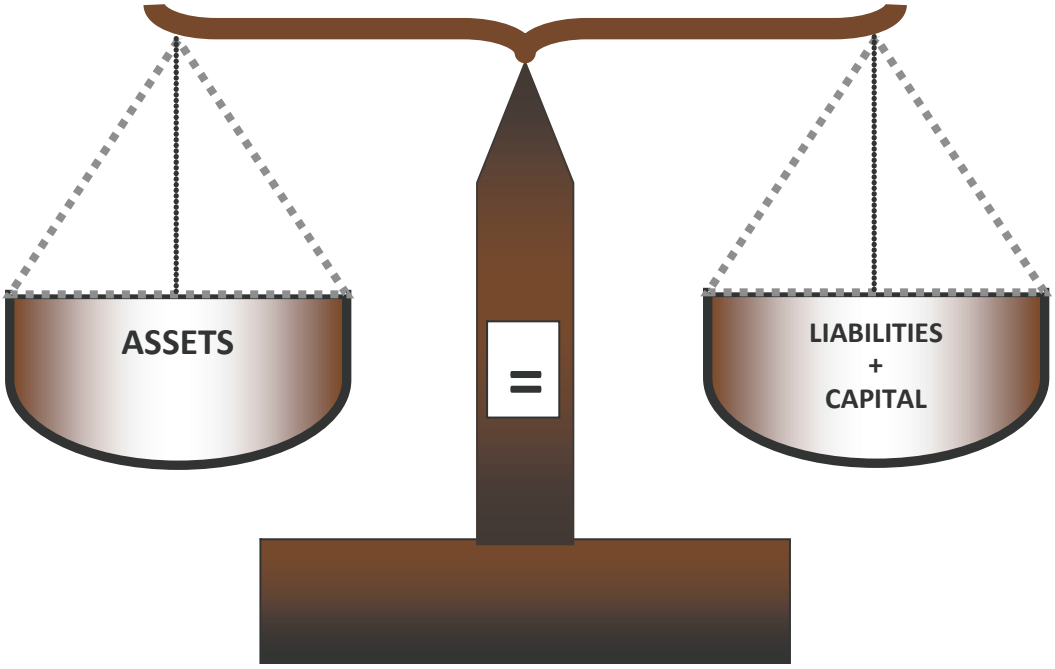


Figure 3.1 Accounting Equation (A = L + C)

Asset

It is customary to refer to the properties owned by a business enterprise as assets. Anything of value that is owned is called an ***asset***. Assets may take many forms such as land, building, furniture, equipment, cash and supplies.

Liabilities

An amount that is owed is a ***liability***. These are debts which must be paid to others. If you buy goods without paying for it at that time, it is a liability to you. Similarly, if a bank lends you money, it is a liability to you. In both cases, you must pay back the amount owed. The following are examples of liabilities:

Liabilities are grouped into: -

a) Accounts Payable: - money owed for goods bought by the business.
b) Salaries and wages payable: - employees' money not yet paid.
c) Taxes payable: - taxes not yet paid.
d) Mortgage payable: - liability arising from buying land or houses.

Capital

A business term that has the same meaning as financial worth is ***capital***. What the business is worth is called capital. It is the difference of total assets and total liabilities. An owner of a business is called ***proprietor***.

Activity 3.1.3. Practice computing the accounting equation and discuss your answers with your classmates in your group.

Asset =	Liability +	Capital
Nakfa 4,000	Nakfa 1,000	Nakfa ?
20,000	4,000	?
9,500	?	5,500
5,495	1,345	?
?	6,780	6,220
?	25,000	75,000

3.1.4. Balance Sheet

Dehab tegadalit owns a taxi service business and she has been operating this business since 1994. The name of her business is ***Dehab Taxi Services*** and provides transportation services to customers. Over the years, the business prospered and Dehab purchased three more cars and rented an office in a downtown area. Moreover, she hired taxi drivers and office secretaries to assist her in operating the business. She buys benzene for her cars from Tam Oil Eritrea. Mrs. Dehab pays monthly salaries to her employees, rent to the owner of her office, electricity, water, telephone and others.

On September 1, current year, she recalled her high school bookkeeping that stated that a successful business uses accounting information in making decisions. Therefore, she decided to start a new accounting system for her taxi service business to obtain more complete information about the operation of the business.

Mrs. Dehab listed what the taxi business owned and owed as follows:

What is owned		**What is owed**	
Cash	145,000	Accounts Payable	75,000
Supplies	65,000	Taxes Payable	25,000
Automobiles	740,000		
Furniture and fixtures	15,000		
Office Equipment	50,000		





Figure 3.2 Transportation Service

To report the financial worth of a business, an accountant prepares a statement called a ***balance sheet***. In accounting, a business form that lists (1) what is owned (2) what is owed, and (3) what a business is worth on a specific date is called a ***balance sheet***.

Mrs. Dehab prepared the gopening balance sheet of Dehab Taxi services on September 1, current year as follows:

Dehab Taxi Service
Balance Sheet
September 1, current year

STEP 1 STEP 2 STEP 3 STEP 4 STEP 5

Assets									**Liabilities and Capital**								
Cash		1	4	5	0	0	0	00	Accounts Payable			7	5	0	0	0	00
Supplies			6	5	0	0	0	00	Taxes Payable			2	5	0	0	0	00
Automobiles		7	4	0	0	0	0	00	**Total Liabilities**		1	0	0	0	0	0	00
Furniture and fixtures			1	5	0	0	0	00	**Capital**								
Office Equipment			5	0	0	0	0	00	Dehab's Capital		9	1	5	0	0	0	00
Total Assets	**1**	**0**	**1**	**5**	**0**	**0**	**0**	**00**	**Total Liabilities and Capital**	**1**	**0**	**1**	**5**	**0**	**0**	**0**	**00**

The balance sheet has two sections: 1) Heading and
2) Body.

Heading

It contains three items: 1) Name of the business: Dehab Taxi Service
2) Name of the form: Balance sheet.
3) Date of the statement: September. 1, current year.

Body:

Now let us look at the body of the balance sheet. See if you can find the part of the basic accounting equation, that is, Assets = Liabilities + capital.

> **Activity 3.1.4.**
> Determine the following amounts and discuss it with your class mates.
> What is the amount of total assets of Dehab Taxi services on the left hand side of the above balance sheet?
> When you add the liabilities and capital, what is the total amount of the right hand side?
> Are the amounts the same?

This financial statement is known as balance sheet because the two sides must always be in balance to each other. The body of a balance sheet lists assets, liabilities and capital of the business.

An entrepreneur wants to know not only what the total amount of his/her assets are, but also the specific assets he/she owns. To provide this, an accountant lists the specific assets on the left hand side under the title **"Assets"**. On the balance sheet of Dehab Taxi Services, specific assets such as cash (money kept in the office and money deposited in the bank), supplies, automobiles, furniture and fixtures and office equipment are listed on the left hand side of the balance sheet.

An entrepreneur also wants to know not only the total amount of his/her liabilities, but also the specific liabilities that he/she owes. To provide this, an accountant lists the specific liabilities of the business on the right hand side under the title ''**Liabilities"**. On the balance sheet of Dehab Taxi Services, specific liabilities such as accounts payable and taxes payable are listed on the right hand side of the balance sheet. Moreover, the proprietor's **capital** is listed on the right hand side of the balance sheet.

Steps in Preparing a Balance Sheet

1. The heading is written on the centre.
2. Prepare the asset section on the left hand side.
   a) Write the word asset in the centre.
   b) List the name and amount of each asset.
3. Prepare the liabilities section on the right hand side:
   a) Write liability in the centre.
   b) List the name and amount of each liability.
   c) Rule a single line across the amount column.
   d) Write the total liabilities.
4. Prepare the capital section on the right hand side.
   a) Write Capital at the centre.
   b) Name of the owner and the word capital.
5. Check if the balance sheet is in balance.

3.1.5. Recording the Opening Entry

From time to time the owner of a business wants to know how well his/her business is doing, that is, is he/she making a profit or a loss?. The opeening balance sheet shows the starting financial position of the business. For example, Mrs. Dehab wants to know from month to month how well her business is doing. The data on the opening balance sheet are recorded on a book of permanent record.

The Journal Entry

A book in which the records of a business are first written is called a journal. Each record in a journal is called an entry. The entry that records the data shown on a opening balance sheet is called an opening entry. Since the entries in a journal are transferred later to a second book of entry, a journal is called a

book of original entry.

3.1.6. The General Journal (Two Column Journal)

A journal may have one or more amount columns. A journal with two amount columns is commonly called a general journal. The process of recording a transaction in a journal is called journalizing. A standard general journal is presented below. Note that in a general journal, the left hand amount column is the debit and the right amount column is the credit.

General Journal Page:__

Date	Account Title	Post Ref.	Debit	Credit

Post Reference is a column reserved for writing the account number to which the data on the journal is transferred.

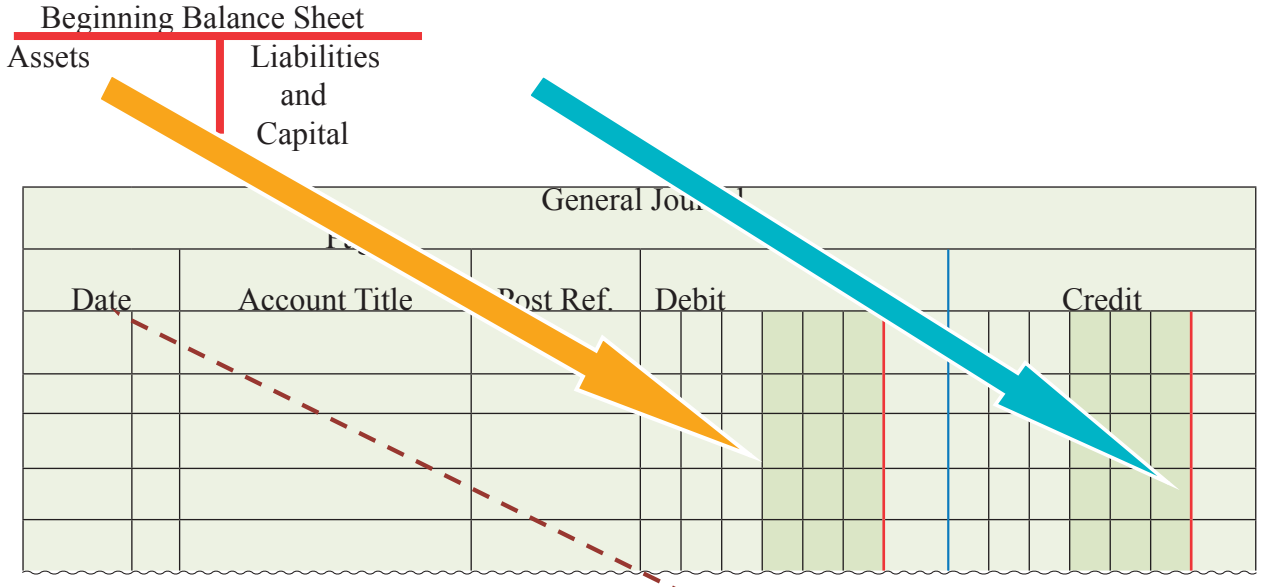
The Source Document

A business transaction is an exchange of property or service. For example selling of office equipment or selling of a chair and others. The business document prepared when a business transaction occurs is called a source document. For example cheqks, receipts, invoice and others are source documents. It is written evidence that supports the recording of an entry. Source document provides evidence or proof that a transaction has occurred. They are used as part of a process to record information into the books of original entry. They are required for audit purposes. The source document for recording an opening entry in the general journal is the beginning balance sheet.

How do we record the Opening Entry?

The amounts on the left hand side of a balance sheet are recorded on the left hand side of a two column general journal, which is called debit column.

Those on the right hand side of a balance sheet are recorded on the right hand side column of a two column general journal which is called the credit column.



Steps in Recording the Opening Entry

1) Date of the Entry:- Write the date of the opening entry in the date column as shown :

- Write the year in small figures. It is written only once on a journal.
- Write the month below the year on the first line on the first column, once in a page.
- Write the date on the first line in the 2nd column. Once for each entry

Date	
Current year Sept.	1

2) Debit Part of the Entry:-

- Write the name of each asset at the extreme left edge of the account title column.
- Write the amount of each asset in the Debit Colum

General Journal																		Page: 1
Date		Account Title	P/R	Debit							Credit							
Current year Sept.	*1*	*Cash*		*1*	*4*	*5*	*0*	*0*	*0*	*00*								
		Supplies			*6*	*5*	*0*	*0*	*0*	*00*								
		Automobiles		*7*	*4*	*0*	*0*	*0*	*0*	*00*								
		Furniture and Fixtures			*1*	*5*	*0*	*0*	*0*	*00*								
		Office Equipment			*5*	*0*	*0*	*0*	*0*	*00*								

3) Credit Part of the Entry:-

- Write the name of each liability and the name of the proprietor, followed by the word capital, in the account title column.
- Write the amount on the credit column.

General Journal																		**Page: 1**
Date		**Account Title**	**P/R**	**Debit**							**Credit**							
Current Year Sept.	*1*	*Cash*		*1*	*4*	*5*	*0*	*0*	*0*	*00*								
		Supplies			*6*	*5*	*0*	*0*	*0*	*00*								
		Automobiles		*7*	*4*	*0*	*0*	*0*	*0*	*00*								
		Furniture and Fixtures			*1*	*5*	*0*	*0*	*0*	*00*								
		Office Equipment			*5*	*0*	*0*	*0*	*0*	*00*								
		Accounts Payable										*7*	*5*	*0*	*0*	*0*	*00*	
		Taxes Payable										*2*	*5*	*0*	*0*	*0*	*00*	
		Dehab's Capital									*9*	*1*	*5*	*0*	*0*	*0*	*00*	

4) Source of the Entry:-

Write a brief explanation or indicate the source document below the last credit item. It helps for further information.

General Journal																		Page: 1
Date		Account Title	P/R	Debit							Credit							
Current year Sept.	*1*	*Cash*		*1*	*4*	*5*	*0*	*0*	*0*	*00*								
		Supplies			*6*	*5*	*0*	*0*	*0*	*00*								
		Automobiles		*7*	*4*	*0*	*0*	*0*	*0*	*00*								
		Furniture and Fixtures			*1*	*5*	*0*	*0*	*0*	*00*								
		Office Equipment			*5*	*0*	*0*	*0*	*0*	*00*								
		Accounts Payable										*7*	*5*	*0*	*0*	*0*	*00*	
		Taxes Payable										*2*	*5*	*0*	*0*	*0*	*00*	
		Dehab's Capital									*9*	*1*	*5*	*0*	*0*	*0*	*00*	
		(Sept. 1 Balance sheet)																

5) Complete the Opening Entry:

Checking Accuracy:- Accuracy is important in recording financial entry. Every journal entry must be "in balance", that is, the accountant checks if the sum of the amount in debit part equals the sum of the amount in the credit part.

Debit = Credit.

Making Corrections:- If an error is made in writing an amount, the erroneous amount should be cancelled by drawing a line through it and the correct amount should be written immediately above the cancelled amount as shown below.

75,000
Accounts Payable ~~55,000~~

3.1.7 Posting the Opening Entry

The opening entry in a journal is a complete record of the assets, liabilities, and capital at the time an accounting system is established. The accounting system, however, should show not only what a business has- assets, liabilities and capital, but also changes that occur in these items. An exchange of property or service is called ***business transaction*** (the buying and selling of goods and services, the receipt and payment of cash). For example, selling of the office equipment, selling of a chair, buying of supplies and payment of rent are business transactions.

The transactions of a business organization may cause increase or decrease in what is owned, owed or the financial worth of a business. In the process of day-to-day business operation goods and services are bought and sold. Cash is received and paid out. Debts are owed and paid. When the business makes a profit, the amount of capital (proprietorship) increases and when the business incurs a loss the amount of capital decreases. Due to this, relevant, reliable and timely information is essential for business decision making. It is necessary to keep a separate record for each item of the balance sheet to observe changes caused by business transactions. For example, we have to keep separate records for cash, supplies, equipment and others.

An accounting form, which is used to record the increases and decreases in specific assets, liabilities and owner's capital is called an ***account***. A group of accounts is called a ***ledger***. Since the information recorded in the ledger is brought from a journal, the ledger is called a ***book of secondary entry***.

Standard Form of an Account

Accounts are ruled in various ways. The following form of ruling is with three amount columns-Debit column, Credit column and Balance column.

Account Title: _____					**Account Number: _____**
Date	**Item**	**P/R**	**Debit**	**Credit**	**Balance**

The left hand side of an account is called debit side. The right hand side of an account is called credit side.

3.1.8. Chart of Accounts

The name given to an account is called the account title. The number given to an account to show its location in the ledger is called the account number. The purpose of an account number is identification and easy handling of accounts in the ledgers. The first digit indicates major classification, that is:



The second digit of each account number tells the position of the account within its division of the ledger. For example: 13 = Automobiles in the ledger of Dehab Taxi-Service business.

A list of account titles along with their numbers showing the arrangement of the accounts in the ledger is called ***chart of accounts***. The following is partial chart of accounts for Dehab Taxi Service business.

Dehab Taxi Service
Chart of Accounts

1. ASSETS		2. LIABILITIES	
Account Title	**Account Number**	**Account Title**	**Account Number**
Cash	**11**	Accounts Payable	**21**
Supplies	**12**	Taxes payable	**22**
Automobiles	**13**	**3. CAPITAL**	
Furniture and Fixtures	**14**	Dehab's Capital	**31**
Office Equipment	**15**		

Opening Accounts to form a Ledger

Writing the account title and the account number on the 1st line of a ledger account is called opening an account. Cash is the first account to be opened in the ledger of the Dehab Taxi Service business. The cash account is opened by:-

1) Writing the name of the account, that is, Cash at the upper left hand corner of the first page of the account.
2) Writing the number of the account, that is, 11 at the upper right hand corner of the first page of the account.

Account Title: Cash					Account Number: 11
Date	Item	P/R	Debit	Credit	Balance

All the rest of the accounts in the ledger are opened from the Chart of Accounts of Dehab Taxi Service as follows:

Account Title: Supplies					Account Number: 12
Date	Item	P/R	Debit	Credit	Balance

Account Title: Automobiles					Account Number: 13
Date	Item	P/R	Debit	Credit	Balance

Account Title: Furniture and Fixtures					Account Number: 14
Date	Item	P/R	Debit	Credit	Balance

Account Title: Office Equipment					Account Number: 15
Date	Item	P/R	Debit	Credit	Balance

Account Title: Accounts Payable					Account Number: 21
Date	Item	P/R	Debit	Credit	Balance

Account Title: Taxes Payable					Account Number: 22
Date	Item	P/R	Debit	Credit	Balance

Account Title: Dehab Capital					Account Number: 31
Date	Item	P/R	Debit	Credit	Balance

Posting the Opening Entry to the Ledger Accounts

Each of the amounts in the opening entry is transferred to the proper accounts in the ledger. Transferring the entries in a journal to the accounts in the ledger is called ***posting***. It sorts and summarizes the data in the journals so that all data of one kind are brought together. For example cash.

Steps in Posting the Opening Entry

- Write the date of the journal entry in the Date column of the ledger account. The same as it is written in the journal entry.
- Write the word balance in the Item column of the account.
- Write the amount in the appropriate amount column.

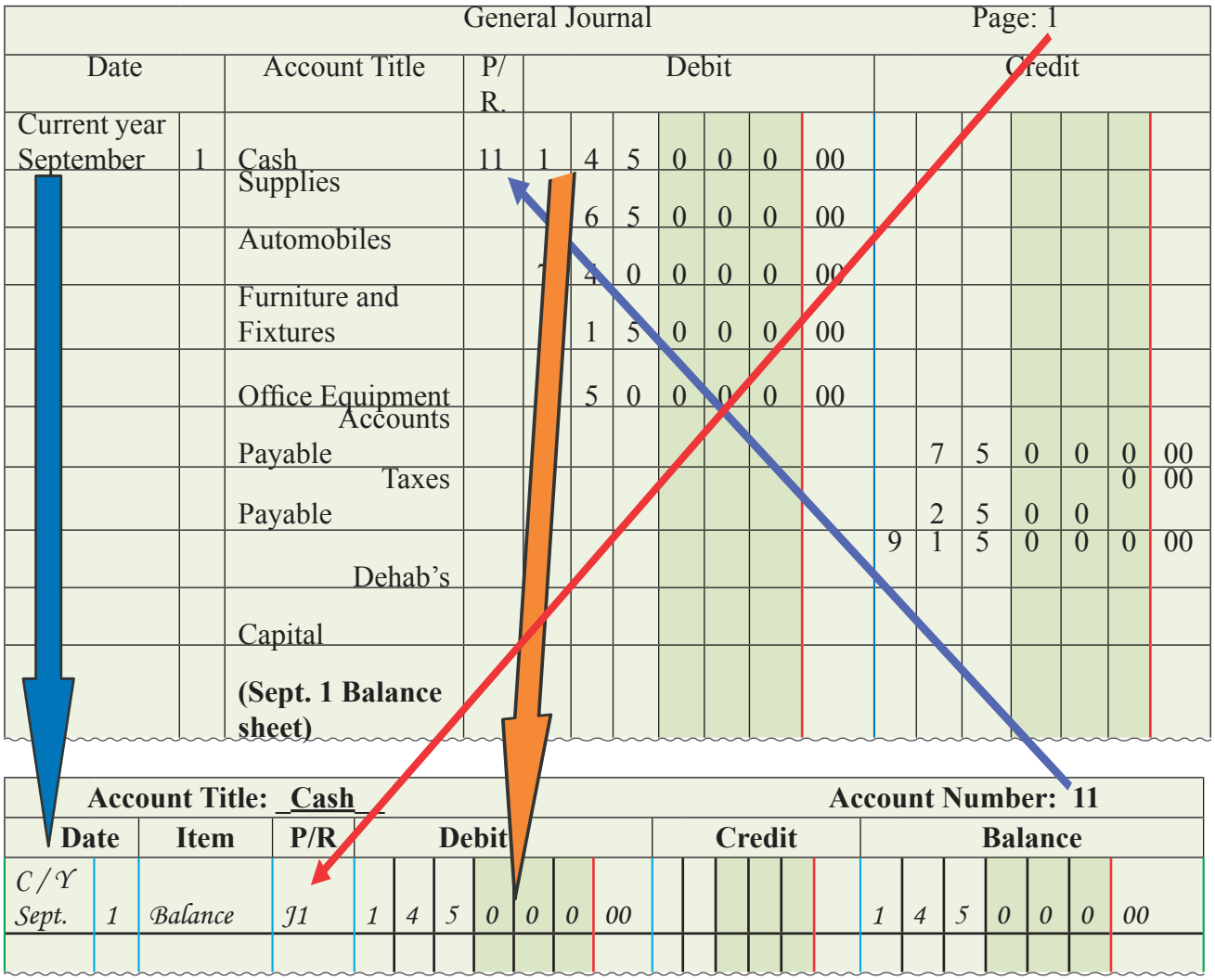
Cross-referencing

Cross-referencing between the journal and a ledger is made.

- Write page number of the journal in the Post Reference column of the account to show that this amount came from page 1 of the general journal.
- Return to the journal and write in the Post-reference column of the journal the account number of the item, the amount is posted.

Amounts on the debit side of a journal are transferred to the ***debit side*** of the account and amounts on the credit side of a journal are transferred to the ***credit side*** of the account.

The following shows the steps followed in posting the opening entry of Dehab Taxi Service journalized on general Journal Page 1:



General Journal — Page: 1

Date		Account Title	P/R.	Debit	Credit
Current year September	1	Cash	11	145,000.00	
		Supplies		6,500.00	
		Automobiles		140,000.00	
		Furniture and Fixtures		15,000.00	
		Office Equipment		50,000.00	
		Accounts Payable			75,000.00
		Taxes Payable			2,500.00
		Dehab's Capital			91,500.00
		(Sept. 1 Balance sheet)			

Account Title: _Cash_ **Account Number: 11**

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	*1*	*Balance*	*J1*	*145,000.00*		*145,000.00*

The opening entry is posted to the rest of the accounts in the ledger of Dehab Taxi Services in the same way as we have posted the Cash Account. The following shows the accounts of Dehab Taxi Service after the opening entry is posted:

Account Title: Cash **Account Number: 11**

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1	14500.00		14500.00

Account Title: _Supplies_ **Account Number 12**

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1	6500.00		6500.00

Account Title: Automobiles **Account Number: 13**

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1	74000.00		74000.00

Account Title: _Furniture and Fixtures **Account Number: 14**

Date	Item	P/R	Debit	Credit	Balance

Account Title: Office Equipment **Account Number: 15**

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1	5000.00		5000.00

Account Title: Accounts Payable **Account Number: 21**

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1		7500.00	7500.00

Account Title: Taxes Payable **Account Number: 22**

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1		2500.00	2500.00

History and Development of Accounting

Accounting enjoys a remarkable heritage. The history of accounting is as old as civilisation. The seeds of accounting were most likely first sown in Babylonia and Egypt around 4000 B.C. when recorded transactions of payment of wages and taxes would have been recorded on clay tablets. Historical evidences reveal that Egyptians used some form of accounting for their treasuries where gold and other valuables were kept. Babylonia, known as the city of commerce, used accounting for business to uncover losses taking place due to frauds and lack of efficiency. In Greece, accounting was used for apportioning the revenues received among treasuries, maintaining total receipts, total payments and a balance of government financial transactions. Romans used memorandum or daybook wherein receipts and payments were recorded and wherefrom they were posted to ledgers on a monthly basis. (700 B.C to 400 A.D). China used a sophisticated form of government accounting as early as 2000 B.C.

The book by Luca Pacioli's, an Italian monk, *Summa de Arithmetica, Geometria, Proportion at Proportionality* (Review of Arithmetic and Geometric proportions) in Venice (1494) is considered as the first book on double entry bookkeeping. A portion of this book contains facts of business and bookkeeping. In his book, he used the present day popular terms of accounting Debit (Dr.) and Credit (Cr.). These were the concepts used in Italian terminology. Debit came from the Italian *debito* which came from the Latin *debita* and *debeo* which means owed to the proprietor. Credit came from the Italian *credito* which came from the Latin '*credo*' which means trust or belief (in the proprietor or owed by the proprietor). In explaining double entry system, Pacioli wrote that 'All entries… have to be double entries, that is, if you make one creditor, you must make some debtor'. He discussed the details of memorandum, journal, ledger and specialized accounting procedures.

Summary of Starting an Accounting System

A diagram that shows the sequence of all the steps involved in a particular activity or procedure is called a ***flowchart***. The three steps taken to start an accounting system are summarized and pictorially presented below.

1. A balance sheet is prepared listing the assets, liabilities and capital of the business at the start of a new accounting system. This is called the opening balance sheet.
2. The opening balance sheet is recorded in a permanent record book-the journal.
3. The entries recorded as the opening entry in the General Journal are posted to the individual accounts in the ledger.

Dehab Taxi Service
Balance Sheet
September 1, current year

Assets		Liabilities and Capital	
Cash	14,500.00	Accounts Payable	7,500.00
Supplies	6,500.00	Taxes Payable	2,500.00
Automobiles	74,000.00	Capital	
Furniture and fixtures	15,000.00	Dehab's Capital	91,500.00
Office Equipment	5,000.00		
Total Assets	101,500.00	Total Liabilities And Capital	101,500.00

General Journal Page:__

Date		Account Title	P/ R.	Debit	Credit
C/Y Sept	1	Cash		14,500.00	
		Supplies		6,500.00	
		Automobiles		40,000.00	
		Furniture and Fixtures		15,000.00	
		Office Equipment		5,000.00	
		Accounts Payable			7,500.00
		Taxes Payable			2,500.00
		Dehab's Capital			91,500.00
		(Sept.1 Balance sheet)			

Account Title: _Cash__ **Account Number: 11**

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	14,500.00		14,500.00

Account Title: _Accounts Payable **Account Number: 21**

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1		7,500.00	7,500.00

Key Terms

Accounting	Balance sheet	Accounting equation	Account number
Bookkeeping	Journal	Business transaction	Chart of accounts
Asset	General Journal	Account	Posting
Liability	Journalizing	Ledger	Flowchart
Capital	Debit	Book of original entry	Cross referencing
Proprietor	Credit	Book of secondary entry	Post reference
Proprietorship	Source documen	Account title	Opening an account

Review Questions

1. Define accounting and bookkeeping. What is their difference?
2. Who are the users of accounting information?
3. What is an accounting equation?
4. How does a proprietor determine his/her financial worth?
5. What is a balance sheet?
6. Describe the two sections of a balance sheet.
7. Discuss the steps used in preparing a balance sheet?
8. How do we record an opening entry in a journal?
9. What is a source document? Give examples of source documents.
10. What is the purpose of writing a brief explanation or indicating the source document in journalizing the opening entry?
11. How do we correct errors found in journalizing an entry?
12. What is a business transaction?
13. What is a chart of accounts?
14. What are the steps followed in posting each account opening entry?
15. What are the three steps normally necessary to start an accounting system?

Exercises

1. Part I: Multiple Choices: Select the best answer and circle its letter.

1. The person who records the financial operations of a business in a systematic manner is known as _____.
   A) financial manager B) bookkeeper C) cashier
   D) personnel E) none of the above.

2. The process of transforming amounts from the original books to the secondary books is called _____.
   A) journalizing B) recording the opening entry C) entry
   D) posting E) none of the above.

3. The journal page number from which the entry comes to the ledger account is written in the account in the _____.
   A) item column B) post reference column C) amount column
   D) date column E) none of the above.

4. If total assets of a business have decreased by Nakfa 5,000 during a specific period of time and capital has increased by Nakfa 6,000 during the same period, the direction (increase or decrease) of the amount of change in the total liabilities of the business for that period is
   A) An increase of Nakfa 11,000. B) A decrease of Nakfa 1,000.
   C) A decrease of Nakfa 11,000. D) An increase of Nakfa 1,000.
   E) None of the above.

5. A business report which shows the financial position of a business on a particular date is called _____.
   A) Trial balance B) general ledger C) balance sheet
   D) income statement E) None of the above.
6. What is the last step to be taken, when an entry is posted?
   A) The explanation must be transferred.
   B) The account number is placed in the reference column of the account.
   C) The journal page number is placed in the reference column of the account.
   D) The account number is placed in the reference column of the journal.
   E) None of the above.
7. A group of accounts is known as a _____.
   A) Journal B) ledger C) balance sheet
   D) General journal E) All of the above.
8. In the charts of accounts, liability accounts usually begin with _____ number.
   A) 1 B) 2 C) 3 D) 4 E) 5
9. The post reference column in the journal contains
   A) dates of posting. B) journal page number. C) ledger account numbers.
   D) amount balance. E) All of the above.
10. Double lines are ruled across the amount columns on each side of the balance sheet
    A) Above the amount of the total assets.
    B) On the same line on both sides.
    C) On a different line on each side.
    D) All of the above.
    E) None of the above.

2. Matching: Complete each statement in Column II by selecting one of the terms listed in Column I and write its capital letter in the answer column.

Column I Column II	Column II	Answer
A. Account Balance	1. Writing the title of an account in the ledger for the first time is called ……	I
B. Account title	2. Transferring entries in a journal to accounts in a edger is called ……	
C. Accounts	3. The accounting forms in the ledger that are used to sort and summarize the changes caused by transactions are called:	
D. Chart of Accounts	4. The accounting term for heading of an account in the ledger is ……..	
E. Credit side	5. Getting an account ready for use is known as …	
F. Debit side	6. The left hand side of the standard form of ledger account is called the ……	
G. Items column	7. The right hand half of the standard form of led ger account is called ……	
H. Ledger	8. The difference between the two sides of an ac count is called the ……..	
I. Opening an Account	9. A list of accounts that shows the arrangement of the accounts in the ledger and the numbers as signed to each account is called a …….	
J. Post Reference	10. The column in the account that is used to record the journal page from which the entry came has the heading ……..	
K. Posting		

3.Part III: Identify each of the following items as asse

Item Answer		
1. Cash		
2. Supplies		
3. Office Furniture		
4. Office Equipment		
5. Automobiles		
6. Land		
7. Building		
8. Accounts Payable		
9. Mortgage Payable		
10. Capital		

4. Part Iv: Directions: Find the missing amount in the accounting equation for each of the businesses listed below

Name of Business	Assets	Liabilities	Capital
A	5,000.00	2,000.00	?
B	15,000.00	None	?
C	10,000.00	?	6,000.00
D	15,000.00	?	10,000.00
E	?	5,500.00	10,500.00
F	?	none	22,000.00

Problem 3.1.1
Preparing the opening balance sheet, recording the opening entry and posting.

Mohammed Attorney owns the following assets and liabilities:
Cash……Nakfa 635.00
Supplies ……. 312.00
Law Library …….. 2,250.00
Office Equipment …….. 840.00
Accounts Payable- to Legal Book Company ……...50.00
Accounts Payable- to Samuel Furniture Company ……540.00

Instructions:

1. Prepare a balance sheet for Mohammed Attorney, dated April 1 of the current year.
2. Record the opening entry on page 1 of the General Journal.
3. Open accounts in a ledger for all the account titles listed on the balance sheet, (Cash 11; Supplies 12; Law Library 13; Office Equipment 14; Accounts Payable 21; and Mohamed Capital 31)
4. Post the opening entry to the General Ledger.

Problem 3.1.2
Preparing the opening balance sheet, recording the opening entry and posting.

Delina Office Management Services owns and operates a secretarial service. The following are the assets and the liabilities of the business.

Assets		Liabilities	
	15,000.00	Payable to Mesno Equipment Company	3,000.00
Office supplies	1,500.00	Payable to Mohamed Products Inc.	4,500.00
Office Furniture	8,500.00	Payable to Selamawit Stationery company	7,000.00
Office machine	1,400.00		

Instructions:

1. Prepare a balance sheet for the Delina Office Management Services dated September 1 of the current year.
2. Record the opening entry on a General Journal page number 1.
3. Open accounts in a ledger for all the account titles listed on the balance sheet. Number the accounts as follows: Asset accounts 11 to 14. Liability accounts: accounts Payable 21 and Capital account 31.
4. Post the opening entry to General Ledger.

3.2. Analysis of Business Transactions

Focus Questions:

1. When you go shopping to the market, do you buy goods from shopkeepers?
2. How does the purchase of goods such as clothes, shoes and others affect your cash balance?
3. How does a business person know if he/she is making profit or loss?

In the previous sub-unit, we discussed how Mrs. Dehab established a modern accounting system for her business, Dehab Taxi Services. The opening entry was journalized in a General Journal and posted to each account in a ledger of Dehab Taxi Services. The opening balance sheet shows the financial position of the business a at specific date; for example; September 1, current year for Dehab Tax Services. From time to time the owner of a business wants to know how well his/her business is doing. An owner wants to know if he/she is making profit or a loss.

A business transaction is the process of buying and selling goods and services of a business. For example, the purchase of supplies such as pens, pencils and others. Business transactions change the financial position of a company by affecting one or more of the elements in the basic accounting equation. Let us see how a transaction can change the accounting equation using the example of Dehab Taxi Services.

3.2.1 Transaction Analysis

Every business transaction is recorded in a journal. However; it is first analysed to determine the accounts affected, the amount and their classification. Every business transaction can be analysed by or expressed in terms of its effect on the accounting equation.

Accountants use multi-columnar working papers called ***worksheets*** as a 'scratch pad. It can be a time saver, a helpful short cut for summarizing and making available necessary information for management decision making. A multi-columnar working paper used to show the effect of a business transaction on the accounting equation is known as ***financial transaction work sheet***. A financial transaction work sheet is presented below. Let us see how a transaction can change the accounting equation using the example of Dehab Taxi Services.

Dehab Taxi Service									
Financial Transaction Work sheet									
For the month ended September 30, current year									
Assets						**=**	**Liabilities**		**+ Capital**
	Cash	**Supplies**	**Auto-mobiles**	**Furniture & Fixture**	**Office Equip.**		**Accounts Payable**	**Taxes Payable**	**Capital**

During the month of September of the current year, Mrs. Dehab recorded the following transactions in her Dehab Taxi Service Business:

Transaction 1: Additional Investment of Capital by Owner of the Business.

On September 2, current year, Mrs. Dehab, the proprietor, deposited Nakfa 900,000 additional investment in a bank to help in the operation of her business.

In analyzing a transaction, we should answer the following questions:

1. What are the names of the accounts affected?
2. What is the classification of the accounts affected in terms of the accounting equation?
3. How is the balance of each of these accounts changed? Did the balance increase or decrease?
4. What is the amount?

Analysis:		Cash	Mrs. Dehab's Capital
1)	*Affected accounts*	Cash	Mrs. Dehab's Capital
2)	*Classification*	Asset (A)	Capital (C)
3)	*The effect*	Increase (+)	Increase (+)
4)	*Amount*	900,000	900,000

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets						=	Liabilities	+ Capital
	Cash	Supplies	Automobiles	Furniture & Fixtures	Office Equipment		Accounts Payable	Taxes Payable	Capital
Bal.	145,000	65,000	740,000	15,000	50,000		75,000	25,000	915,000
1.	900,000								900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000		75,000	25,000	1,815,000

Additional cash investment by owner increases cash and owner's capital.

Transaction 2: Purchase of an Asset for Cash

On September 5, current year, Mrs. Dehab bought office equipment for which she paid Nakfa 45,000.

Analysis: 1)	*Affected accounts*	Cash	Office Equipment
	2) *Classification*	Asset (A)	Asset (A)
	3) *The effect*	decrease (-)	Increase (+)
	4) *Amount*	45,000	45,000

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets					=	Liabilities	+	Capital
	Cash	Supplies	Auto mobiles	Furniture & Fixtures	Office Equipment	Accounts Payable	Taxes Payable	Capital
Bal.	145,000		740,000	15,000	50,000	75,000	25,000	915,000
1.	+900,000							+900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000	75,000	25,000	1,815,000
2.	-45,000				+45,000			
Bal.	1,000,000	65,000	740,000	15,000	95,000	75,000	25,000	1,815,000

Purchase of an asset by paying cash increases equipment and reduces the cash balance of the business.

Transaction 3: Purchase of an Asset on Account (Credit)

On September 10 current year, Mrs. Dehab purchased Nakfa 65,000 gasoil (supplies) From Tamoil Eritrea agreeing to pay in the near future.

Analysis: 1)	*Affected accounts*	Supplies	Accounts Payable
	2) *Classification*	Asset (A)	Liabilities (L)
	3) *The effect*	Increase (+)	Increase (+)
	4) *Amount*	65,000	65,000

Activity 3.2.1

Analyse the following transactions:

1. Mr. Samuel purchased furniture and fixtures for his business paying cash, Nakfa 5,000.
2. Mrs. Marus, the owner, made additional investment in her business, Nakfa 25,000.
3. Ms. Aziza purchased computers worth Nakfa 50,000 for her business from Sewit International Company agreeing to pay in the near future.

Discuss the result of your analysis with your classmates.

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets					=	Liabilities		+ Capital
	Cash	Supplies	Auto mobile	Furniture & Fixtures	Office Equipment	Accounts Payable	Taxes Payable	Capital
Bal.	145,000	65,000	740,000	15,000	50,000	75,000	25,000	915,000
1.	+900,000							+900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000	75,000	25,000	1,815,000
2.	-45,000				+45,000			
Bal.	1,000,000	65,000	740,000	15,000		75,000	25,000	1,815,000
3.		+65,000				+65,000		
Bal.	1,000,000	130,000	740,000	15,000	95,000	140,000	25,000	1,815,000

Purchase of an asset on credit increases supplies and increases accounts payable.

Transaction 4: Part Payment of a Liability

On September 15, Mrs. Dehab paid Nakfa 30,000 in part payment of a liability to Tamoil Eritrea.

Analysis:			
1)	*Affected accounts*	Cash	Accounts payable
2)	*Classification*	Asset (A)	liability (L)
3)	*The effect*	decrease (-)	decrease (-)
4)	*Amount*	30,000	30,000

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets					=	Liabilities + Capital		
	Cash	Supplies	Auto mobile	Furniture & Fixtures	Office Equipment	Accounts Payable	Taxes Payable	Capital
Bal.	145,000	65,000	740,000	15,000	50,000	75,000	25,000	915,000
1.	+900,000							+900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000	75,000	25,000	1,815,000
2.	-45,000				+45,000			
Bal.	1,000,000	65,000	740,000	15,000	95,000	75,000	25,000	1,815,000
3.		+65,000				+65,000		
Bal.	1,000,000	130,000	740,000	15,000	95,000	140,000	25,000	1,815,000
4.	-30,000					-30,000		
Ba l.	970,000	130,000	740,000	15,000	95,000	110,000	25,000	1,815,000

The payment of liability decreases Cash and decreases liability.

Transaction 5: Sale of an Asset for Cash

On September 20, Mrs. Dehab received cash Nakfa 5,000 from the sale of old furniture.

Analysis:			
1) *Affected accounts*	Cash	Furniture and Fixture
2) *Classification*	Asset (A)	Asset (A)
3) *The effect*	Increase (+)	decrease (-)
4) *Amount*	5,000	-5,000

Activity 3.2.2 Analyse the following transactions:

1. Mr. Saud sold old furniture and fixtures for cash, Nakfa 15,000.
2. Mrs. Fre paid Nakfa 75,000 in part payment of a liability to Red Sea Corporation.
3. Ms. Selam paid Nakfa 7,000 in full payment of a liability to Atlas Printers.

Discuss the result of your analysis with your classmates

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets						=	Liabilities	+ Capital
	Cash	Supplies	Auto mobiles	Furniture & Fixtures	Office Equipment	Accounts Payable	Taxes Payable	Capital
Bal.	145,000	65,000	740,000	15,000	50,000	75,000	25,000	915,000
1.	+900,000							+900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000	75,000	25,000	1,815,000
2.	-45,000				+45,000			
Bal.	1,000,000	65,000	740,000	15,000	95,000	75,000	25,000	1,815,000
3.		+65,000				+65,000		
Bal.	1,000,000	130,000	740,000	15,000	95,000	140,000	25,000	1,815,000
4.	-30,000					-30,000		
Bal.	970,000	130,000	740,000	15,000	95,000	110,000	25,000	1,815,000
5.	+5,000			-5,000				
Bal.	975,000	130,000	740,000	10,000	95,000	110,000	25,000	1,815,000

The sale of an old furniture increases cash and decreases furniture.

Transaction 6: Income Transaction

We will study the transactions that cause increase and decrease in the capital of a business but not directly put to the capital accounts. These are ***income*** and ***expenses***.

The increase in capital that results from the operation of a business is called ***income*** (revenue). Different kinds of businesses have different names for income such as:-

- For those who sell goods.....Sales.
- A doctor or lawyer (professionals) has income from …….. ..Fees.
- A bank has income from …….....Interest.
- An owner of building and land has income from ……. ……..Rent.
- Transportation businesses such as taxi, bus, and airplanes have income from…… Fares.

On September 30, of the current year, Mrs. Dehab gave taxi services and earned fares of Nakfa 200,000 for the month receiving the amount in cash.

Analysis:			
1)	*Affected accounts*	Cash	Fares earned
2)	*Classification*	Asset (A)	Capital (C)
3)	*The effect*	Increase (+)	Increase (+)
4)	*Amount*	200,000	200,000

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets						=	Liabilities	+ Capital
	Cash	Supplies	Auto mobiles	Furniture & Fixtures	Office Equipment	Accounts Payable	Taxes Payable	Capital
Bal.	145,000	65,000	740,000	15,000	50,000	75,000	25,000	915,000
1.	+900,000							+900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000	75,000	25,000	1,815,000
2.	-45,000				+45,000			
Bal.	1,000,000	65,000	740,000	15,000	95,000	75,000	25,000	1,815,000
3.		+65,000				+65,000		
Bal.	1,000,000	130,000	740,000	15,000	95,000	140,000	25,000	1,815,000
4.	-30,000					-30,000		
Bal.	970,000	130,000	740,000	15,000	95,000	110,000	25,000	1,815,000
5.	+5,000			-5,000				
Bal.	975,000	130,000	740,000	10,000	95,000	110,000	25,000	1,815,000
6.	+ 200,000							+200,000 (fares)
Bal.	1,175,000	130,000	740,000	10,000	95,000	110,000	25,000	2,015,000

Revenues may be received on Cash or business may make sales on account, allowing the customer to pay later (Accounts Receivable). ***Accounts receivable*** refers to amounts due from customers who purchase goods or services and agree to pay in the future, usually 30 to 60 days. If Mrs. Dehab transports customers and does not receive cash immediately, then Dehab Taxi Services has a right to expect payment from the customers in the near future. This right to receive money in the future is called an ***account receivable*** (it is an asset account).

Transaction 7: Expense Transactions

A decrease in capital that results from the operations of business is called an ***expense***. Business expenses are the costs of items or services used for producing income; for example, wages, rent, utilities, miscellaneous and others.

On September 30, current year, Mrs. Dehab paid monthly expenses of Nakfa 55,000 for wages, Nakfa 5,000 for rent, Nakfa 2,500 for utilities and Nakfa 7,500 for miscellaneous expenses.

Analysis:	1) *Affected accounts*	Cash	Wages; Rent; Utilities; and Miscellaneous
	2) *Classification*	Asset (A)	Capital (C)
	3) *The effect*	decrease (-)	decrease (-)
	4) *Amount*	70,000	55,000; 5,000; 2,500; 7,500

Dehab Taxi Service								
Financial Transaction work sheet								
For the month ended September 30, current year								
Assets					=	Liabilities	+	Capital
	Cash	Supplies	Auto mobiles	Furniture & Fixtures	Office Equipment	Accounts Payable	Taxes Payable	Capital
Bal.	145,000	65,000	740,000	15,000	50,000	75,000	25,000	915,000
1.	+900,000							+900,000
Bal.	1,045,000	65,000	740,000	15,000	50,000	75,000	25,000	1,815,000
2.	-45,000				+45,000			
Bal.	1,000,000	65,000	740,000	15,000	95,000	75,000	25,000	1,815,000
3.		+65,000				+65,000		
Bal.	1,000,000	130,000	740,000	15,000	95,000	140,000	25,000	1,815,000
4.	-30,000					-30,000		
Bal.	970,000	130,000	740,000	15,000	95,000	110,000	25,000	1,815,000
5.	+5,000			-5,000				
Bal.	975,000	130,000	740,000	10,000	95,000	110,000	25,000	1,815,000
6.	+ 200,000							+200,000 (fares)
Bal.	1,175,000	130,000	740,000	10,000	95,000	110,000	25,000	2,015,000
7.	-70,000							-55,000 wages -5,000 Rent -2,500 Utilities -7,500 Miscellaneous
Bal.	1,105,000	130,000	740,000	10,000	95,000	110,000	25,000	1,945,000

Activity 3.2.3.

1. Does the financial transaction work sheet show that the accounting equation bal ance?
2. Prepare the balance sheet of Dehab Taxi Services on September 30, current year. Discuss the result of your analysis and the balance sheet that you prepared with your classmates.

Summary

From time to time, the owner of a business wants to know how well his/her business is doing. An owner wants to know if he/she is profiting or losing money. In order to determine whether a business operation has resulted in net profit or net loss, every business transaction is recorded in a journal. Prior to journalizing, business transactions are analysed using a financial transaction work sheet to determine the transactions effect on the accounting equation and facilitate recording journal entries. In this sub-unit, we illustrated the analysis of business transactions such as: additional investment of capital by the owner of the business; purchase of an asset for cash; purchase of an asset on account; part payment of a liability; sale of an asset for cash; income transactions and expense transactions. In the following sub-unit, we will record the business transactions in a General Journal.

Key Terms

Financial Transactions work sheet	Miscellaneous expense	
Work sheet	Net loss	Income
Accounts receivable	Net income	Expense

Review Questions

1. What is a business transaction? Give three examples of business transactions.
2. How is a financial transaction work sheet prepared?
3. Discuss the steps used in analyzing a business transaction?
4. What is the difference between purchase of an asset for cash and purchase of an asset for credit?
5. What is revenue? Give three examples of income.
6. List the different names used for income by different kinds of businesses.
7. Discuss accounts receivable?
8. Define expense. Give four examples of expenses.

Exercise 3.2.1

1. Direction: Indicate the effect of each of the following transactions upon the total assets of a business by the use of the appropriate phrase: “Increases total assets”, “Decreases total assets”, or “No change in total assets”. Use the table below to give your answers.
   a. Purchase of office equipment for cash.
   b. Payment of a liability.
   c. Additional investment by proprietor.
   d. Purchase of a delivery truck for Nakfa 25,000. Paid cash Nakfa 12,000 cash at once and the balance to be paid later.
   e. Sale of machinery for cash at a price equal to its cost.
   f. Sale of machinery on credit at a price equal to its cost.

No.	“Increases total assets”	Decreases total assets”	“No change in total assets”
a.			√
b.			
c.			
d.			
e.			
f.			

Exercise 3.2.2

Using the steps used in analysing business transactions, analyse the following:

a) Nati, proprietor of Gash Farm, made additional investment of Nakfa 8,000 in his business.
b) He purchased a equipment on account Nakfa 1,200.
c) He purchased supplies for cash, Nakfa 500.
d) He sold old equipment, Nakfa 500.
e) He paid Nakfa 600 on the equipment purchased in transaction (b).

Exercise 3.2.3

Using the steps used in analysing business transactions, analyse the following transactions made by Natan:

a) He paid rent for the month, Nakfa 600.
b) He paid a utility bill, Nakfa 540.
c) He paid salaries of employees, Nakfa 1,800.
d) He paid for repairs to equipment, Nakfa 200.
e) He received cash from services, Nakfa 1,450.

Problem 3.2.1 Analysing Business Transactions.

Ato Habte is the owner and operator of Forto Restaurant. On March 1 current year, his ledger contains the following account balances: Cash Nakfa 1,000; Office Furniture Nakfa 2,400; Accounts Payable-to creditors Nakfa 500 and Habte's Capital Nakfa 2,900. The following transactions occurred during the month of March current year:

1. Ato Habte invested Nakfa 10,000 cash in his business.
2. Ato Habte bought an office desk that costs Nakfa 2,000 by paying cash.
3. Ato Habte bought an office desk costing Nakfa 2,000, and promised to pay the amount in the next month.
4. The business received a desk with a value of Nakfa 2,000 desk from the owner to be used in the business.
5. Ato Habte paid Nakfa 4,000 for rent.
6. Ato Habte received Nakfa 15,000 from sale of food.
7. Ato Habte paid Nakfa 6,000 for wages.
8. Ato Habte paid Nakfa 600 for telephone bill.
9. Ato Habte paid Nakfa 1,000 for electricity bill.
10. Ato Habte paid Nakfa 2,000 to settle the amount of money he owed to a creditor.

Instructions:

a) Prepare a financial transactions work sheet.
b) Analyze the business transaction of the month of March of Forto Restaurant and present their effect to the accounting equation using the financial transactions work sheet.

Problem 3.2.2 Analyzing Business Transactions.

Mrs. Fatima Ali is the owner and operator of Assab Swimming Pool. On January 1 current year, her ledger contains the following account balances: Cash Nakfa 1,250; Office Equipment Nakfa 700; Swimming Equipment Nakfa 1,700; Accounts Payable-Bahta Repair shop Nakfa 60 and Fatima Ali's Capital Nakfa 3,590. The following transactions occurred during the month of January current year:

On Jan. 3 of the current year, Mrs. Fatima paid cash for rent of swimming equipment Nakfa 200.
On Jan. 5 of the current year, Mrs. Fatima received cash from admission income, Nakfa 150.
On Jan. 9 of the current year, Mrs. Fatima paid cash for telephone expense, Nakfa 18.
On Jan.12 of the current year, Mrs. Fatima paid cash to Bahta Repair Shop in payment of amount owed, Nakfa 60.
On Jan. 15 of the current year, Mrs. Fatima received cash from admission income, Nakfa 130.
On Jan. 19 of the current year, Mrs. Fatima paid cash for floor repair (Miscellaneous Expense)

Nakfa 25.
On Jan. 21 of the current year, Mrs. Fatima received cash from admission income, Nakfa 195.
On Jan. 24 of the current year, Mrs. Fatima paid cash for electricity expense, Nakfa 60.
On Jan. 27 of the current year, Mrs. Fatima paid cash for newspaper advertising, Nakfa 40.
On Jan. 28 of the current year, Mrs. Fatima paid cash for new swimming equipment, Nakfa 175.
On Jan. 31 of the current year, the business received cash from Mrs. Fatima, the owner, an additional investment in the business, Nakfa 500.

Instructions:

a) Prepare a financial transactions work sheet.
b) Analyse the business transaction of the month of January of Assab Swimming Pool and present their effect to the accounting equation using the financial transactions work sheet.

Problem 3.2.3 Analyzing Business Transactions.

Semira, a dental school graduate, opened her new dental practice for business in January current year. On February 1, current year, her ledger shows the following account balances: Cash Nakfa 1,500; Accounts Receivable Nakfa 100; Dental Supplies Nakfa 300; Dental Equipment Nakfa 2,500; Accounts Payable Nakfa 2,000 and Semira's, Capital Nakfa 2,400.
During the month of February the following transactions were completed;
Feb. 1 Ms. Semira invested an additional Nakfa 3,500 of her personal funds in a bank account in the name of Semira Dental Care Service.
Feb. 2 Acquired dental equipment from Woldat Dental Equipment Company costing Nakfa 7,000, paying Nakfa 1,200 in cash and agreeing to pay the remainder Nakfa 5,800 in the future.
Feb. 3 Paid rent for the month of February, Nakfa 500.
Feb. 6 Acquired dental supplies from Hidat Medical Supplies Company on account, Nakfa 1,765.
Feb. 7 Received Nakfa 1,025 in cash from patients for dental services rendered this week.
Feb. 9 Paid Mogos Laboratories (accounts payable) for preparing dental work on a patient, Nakfa 120.
Feb. 12 Paid salaries to the dental technician and receptionists, Nakfa 750.
Feb. 15 Billed patients (accounts receivable) Nakfa 4,730 for services rendered.
Feb. 17 Paid Hidat Medical Supplies Company Nakfa 425 on account.
Feb. 20 Paid telephone expenses, Nakfa 45.
Feb. 21 Paid miscellaneous expense, Nakfa 80.
Feb. 22 Received Nakfa 2,300 from patients billed on the 15th.
Feb. 23 Acquired additional dental supplies from Hidat Medical Supplies Company on account, Nakfa 750.
Feb. 25 Paid salaries to employees, Nakfa 750.
Feb. 26 Received from patients Nakfa 3,625 in cash for services rendered.
Feb. 27 Paid Hidat Medical supplies company, Nakfa 1,250 on account.

Instructions:

a) Prepare a financial transactions work sheet.
b) Analyze the business transaction of the month of February of Semira Dental Care Services and present their effect to the accounting equation using the financial transactions work sheet.

3.3. Journalizing in General Journal and Posting

Focus Questions:

1. Many people write daily events of their life in diaries. Do you have a diary?
2. What does a daily journal like Hadas Eritrea , Eritrea Alhadisa and others tell us about?
3. How does a traffic rule improve safety on the road?

In the previous sub-unit, we analysed business transactions to know the names of accounts affected; their classification; whether the accounts have increased or decreased and the amounts. Analysis of business transactions helps in recording entries in a journal. In this sub-unit, we will record the business transaction in a journal and illustrate how it will be posted to accounts in a ledger.

3.3.1. Generally Accepted Accounting Principles (GAAP)

In accounting, we have rules that we follow in recording business transactions. These rules are known as Generally Accepted Accounting Principles (GAAP). There is a need to have some standards developed so that the financial statements can be useful to investors and creditors. Some basic accounting principles that govern the preparation of financial statements are:

The Historical Cost Principle

The historical cost principle specifies that assets acquired by a business entity are to be recorded at the price paid for them. The price the buyer pays in exchange for an asset is known as the ***historical cost***. It is called the historical cost because once recorded the cost of the asset remains unchanged.

The Objectivity Principle

Evidence of the exchange price agreed upon can be found in documents such as purchase invoices, sales invoices, property deeds, transfers of title and other similar documents. The objectivity principle requires that this exchange price the historical cost can be confirmed by any independent party by simply reviewing the information in the sales document. The objectivity principle establishes the reason for recording assets at cost.

The Business Entity Concept

Business entity concept states that for accounting purposes a business entity is considered to be separate and distinct from its owner or owners. It is necessary to record the business transaction separately to distinguish the business transactions from that of the owner's personal transactions. For example, if a ***proprietor*** owns a travel agency and a dry cleaning, the business transactions of each must be recorded, summarized and reported separately. Accounting treats each business entity as generating its own revenue, incurring its own expenses, owning its own assets and owning its debts.

3.3.2. Why do we need to journalize Business Transactions?

A journal provides an orderly record from which postings are made to accounts in the ledger. Business transactions are recorded in a journal because:-

1. ***Journalizing increases accuracy***. It is easy to recognize that debit is equal to credit. The journal facilitates the discovery of errors. Since the journal shows the debit and credit parts of an entry in one place, it is easier to locate recording errors. It also decreases the likelihood of omitting the debit part of an entry, or the credit part of an entry, or making two debits or two credits.
2. ***Journalizing provides a record of transactions in their chronological order (by order of date)***. It contains a day to day transaction in the life of a business. We can look at them easily in the future. Should it become necessary to check an entry, the entire entry can be found by referring back to the date the transaction was recorded.

3.3.3 Double-Entry Bookkeeping

Each transaction has a double effect on the accounting equation. At least two accounts are affected by each transaction. When Mrs. Dehab invested Nakfa 900,000 additional cash to her business Dehab Taxi Services, both an asset (Cash) and capital were increased by Nakfa 900,000. Each side of the equation was affected, and the equation balanced. This double effect is the basis of double-entry Bookkeeping. The recording of the debit part and the credit part of each transaction is called ***double entry bookkeeping.*** The double entry system also provides a check on the arithmetic accuracy of recorded business transactions. The fundamental rule of accounting stated that ***for every debit amount there must be equal credit amount***. Without this automatic check, locating an error would be very time consuming and costly.

3.3.4. Accounts, Increases and Decreases in the Accounts and Account Balances

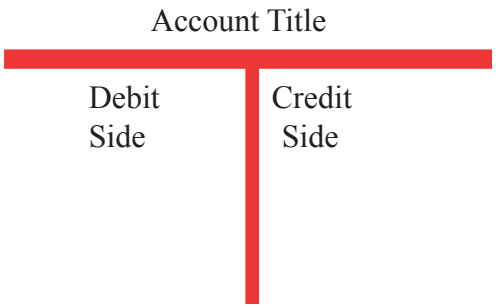
As we have discussed in sub-unit one, an account is a separate form or record used to record and summarize information related to each asset, each liability and capital. The form of account varies depending on the use. Some accounts may be bound in book form; others may be in loose-leaf binders; while others may be part of a computer system. The standard form of account is presented below:

Account Title: _____					**Account Number: _____**
Date	**Item**	**P/R**	**Debit**	**Credit**	**Balance**

Accounts are often grouped together in book form; such a grouping of accounts is called a ledger. Thus, accounts are frequently referred to as ledger accounts.

The T-Account

For learning purposes, the changes in an account balance can best be shown by using a simple form of account called ***T-account***. A skeleton form of ledger account that shows only the account title and debit and credit side of an account is called T-account. The T-account, so named because it looks like a capital letter "T", is a skeleton form of the standard form of account. The T-account provides the same basic data as the standard form of account: (1) the account title, (2) the debit side, and (3) the credit side. Because they can be drawn quickly, T accounts are useful for learning purposes, while business people use the standard form of account. The T account is illustrated below:



The left hand side of an account is called ***debit side***. To debit an account means to enter an amount on the left, or debit, side. The right hand side of an account is called ***credit side***. To credit an account means to enter an amount on the right, or credit, side.

Increases and Decreases in the Accounts.

The type of an account determines how increases and decreases are recorded. For any given account, all increases are recorded on one side and all decreases are recorded on the other side. Increases in ***assets*** are recorded in the left (the debit) side of the account. Decreases in assets are recorded in the right (the credit) side of the account.

Conversely, increases in liabilities and capital are recorded in the right (the credit) side of the account. Decreases in liabilities and capital are recorded in the left (the debit) side of the account. This pattern of recording debits and credits is based on the accounting equation, that is,

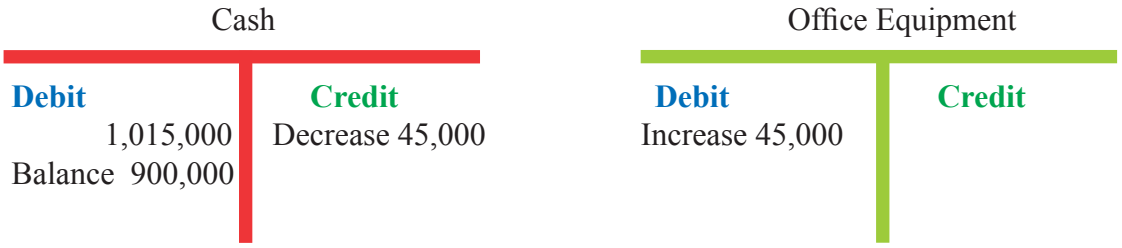
ASSETS = LIABILITIES + CAPITAL.

To illustrate this reconsider the first transaction from the preceding sub-unit of Dehab Taxi Services, that is, additional investment of capital by owner of business. On September 2, current year, Mrs. Dehab, the

proprietor, deposited Nakfa 900,000 additional investment in a bank to help the operation of her business. Which accounts of the business are affected? By what amount? On which side (debit or credit)? The answer is cash (an asset account) and capital will increase by Nakfa 900,000.



The second transaction is purchase of office equipment for cash, Nakfa 45, 000. This transaction affects two assets: Cash and Office Equipment. It decreases (credits) Cash and increases (debits) Office Equipment, as shown in the T-accounts.



Activity 3.3.1.
Continue to practice the effect of Dehab Taxi Service Transactions in T-accounts and discuss your answers with your classmates.

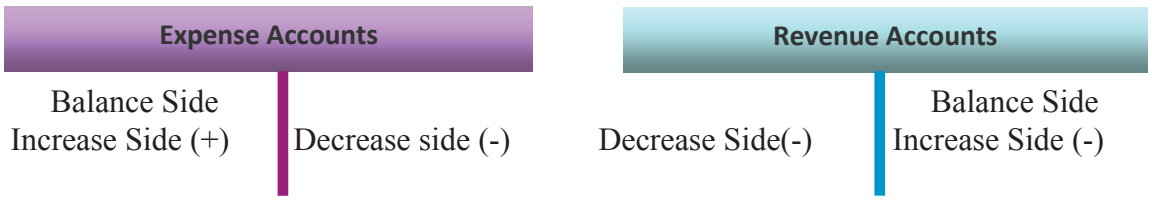
Normal Balance of Accounts

After all transactions have been entered in the appropriate accounts, each account must be totaled to determine its balance. When there is only one transaction recorded in an account, the balance is that figure. The balance is a debit or credit depending on whether the amount is on the left (debit) side or the right (credit) side of the account.

When there are many transactions in an account, the balance is not so readily apparent. In that case, the balance is found by adding first the debit column and then the credit column and subtracting the smaller amount from the larger amount. The difference between the totals of the amounts posted to the two sides of an account is called an ***account balance***. When the total of the debit amounts in an account exceeds the total of its credit amounts, the account has a ***debit balance***. When the total of the credit amounts in an account exceeds the total of its debit amounts, the account has a ***credit balance***. In other words, if the total is on the left side of the account, it is a ***debit balance***. If it is on the right side, it is a ***credit balance***.

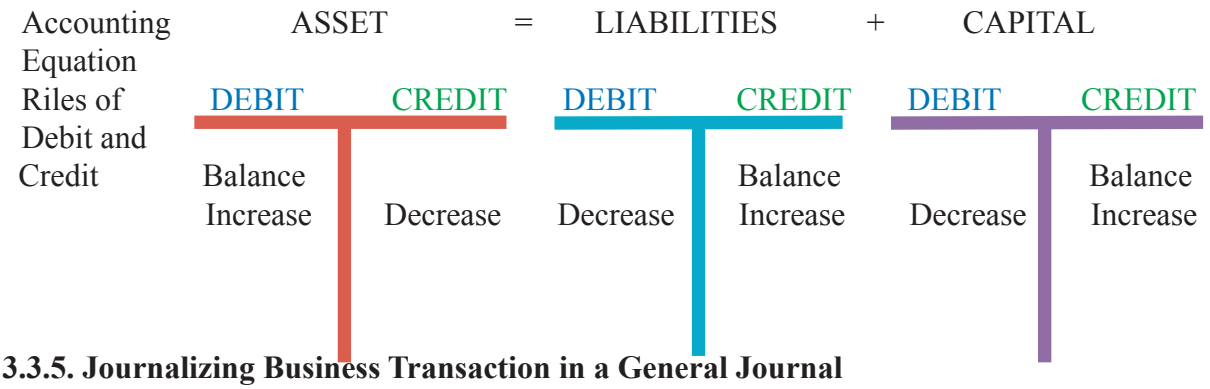
All ***asset*** accounts have ***debit*** side balance. All ***liability*** and ***capital*** accounts have ***credit*** side balance.

Revenue and expense accounts are called ***temporary accounts*** or ***nominal accounts***.
The balance sheet accounts are called ***permanent***, ***capital*** or ***real accounts***.



Debit may signify:-	Credit may signify:-
✓ Increase in assets	✓ Decrease in assets
✓ Decrease in Liabilities and Capital	✓ Increase in liabilities and capital
✓ Increase in expenses	✓ Decrease in expenses
✓ Decrease in revenue	✓ Increase in income

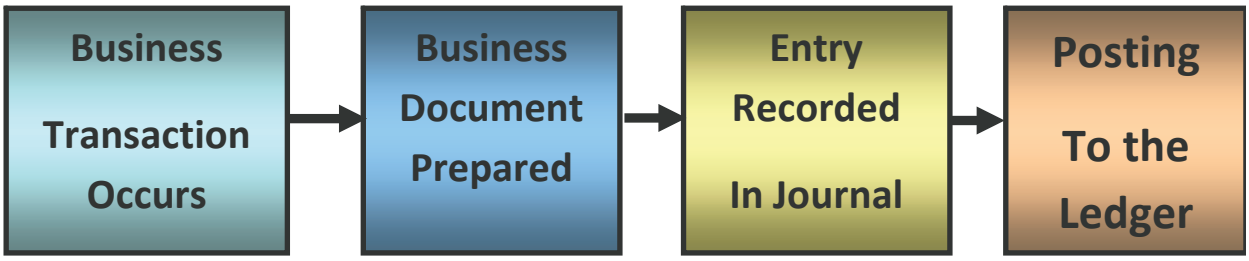
Accounting equation and rules of debit and credit.



3.3.5. Journalizing Business Transaction in a General Journal

Information about a business transaction flows from (1) business papers, source documents or other recording devices to (2) the journal entries to (3) the accounts in a ledger.

Flow of Accounting Data



When a business transaction occurs, a business document is prepared to describe the transaction in detail. For example, when Dehab Taxi Services receives cash from customers, the accountants of the business issue receipts. The receipt is prepared with carbon copies. The original is given to the customers and the carbon copy is retained. Similarly, when Dehab Taxi Services makes payments, the accountants write a cheque and fill out a cheque stub. In bookkeeping, a business paper prepared at the time of business transaction that describes the transaction is a ***source document***. The source document provides essential information for analyzing and recording the business transaction in a journal.

Although a transaction may originally be noted on a business paper, its first recording in terms of double-entry accounting occurs in the journal. The journal is the place where all transactions are initially recorded.

How to Journalize Business Transactions in General Journal

The process of transferring the information contained in a business document to the journal is known as journalizing. The simplest form of journal, often called General Journal, contains only two money columns; one for debit amounts and one for credit amounts. This kind of journal can be used for recording all the transactions of a business. To illustrate the journalizing process, we will record the transactions of Dehab Taxi Services from September.1-30, current year that we have analysed in sub-unit 3.2.

Transaction 1: Additional Investment of Capital by Owner of the Business.

On September 2, current year, Mrs. Dehab, the proprietor, deposited Nakfa 900,000 additional investment in a bank to help the operation her business.

In analyzing a transaction, we answered the following questions:

1. What are the names of the accounts affected?
2. What is the classification of the account affected in terms of the elements in the accounting equation?
3. How is the balance of each of these accounts changed? Did the balance increase or decrease?
4. What is the amount?

Analysis:	1) *Affected accounts*	Cash	Mrs. Dehab's Capital
	2) *Classification*	Asset (A)	Capital (C)
	3) *The effect*	Increase (+)	Increase (+)
	4) *Amount*	900,000	900,000

Now that we have mastered the language of debit and credit, we can rephrase the questions as follows:

1) Which account or accounts are debited?
Cash

2) Which account or accounts are to be credited?
Dehab's Capital

3) What is the amount to be debited or credited?
900,000

General Journal — Page: 2

Date		Account Title	P/ R.	Debit							Credit						
	2	*Cash*		9	0	0	0	0	0	00							
		Dehab's Capital									9	0	0	0	0	0	00
		(Receipt No.1)															

Steps used in Recording Transaction No.1:-

We follow the same steps that we have discussed in journalizing the opening balance sheet in sub-unit 3.1.5.

1) **Date of the entry**: Since the year and the month are already on the journal, we only write the date of the transaction.
2) **Debit Part of the Entry**: on the same line as the day, we write the name of the debited account on the far left and the amount of asset increase-Nakfa 900,000 is entered in the Debit column on the same line.
3) **Credit Part of the Entry**: Indented about one centimeter on the next line, we write the name of the credited account and then the amount of the increase in Dehab's Capital-Nakfa 900,000-was entered on the same line in the Credit column.
4) **Source of the entry and Brief explanation**: Indented slightly on the next line, we write source of the entry or a brief explanation of the transaction.

Transaction 2: Purchase of an Asset for Cash

On September 5, current year, Mrs. Dehab bought office equipment for which she paid Nakfa 45,000.
Issued Cheque Number 1.

Check: An order in writing, signed by the depositor, ordering the bank to pay cash from the depositor's account is called aCheque. Most businesses use Cheque to make all major cash payments.

Analysis:	1) *Affected accounts*	Cash	Office Equipment
	2) *Classification*	Asset (A)	Asset (A)
	3) *The effect*	decrease (-)	Increase (+)
	4) *Amount*	45,000	45,000

1) **Which account or accounts are debited?**
   Office Equipment
2) **Which account or accounts are to be credited?**
   Cash
3) **What is the amount to be debited or credited?**
   45,000

General Journal												Page: 2						
Date		Account Title	P/R.	Debit							Credit							
	2	Cash		9	0	0	0	0	0	00								
		Dehab's Capital									9	0	0	0	0	0	00	
		(Receipt No.1)																
	5	Office Equipment			4	5	0	0	0	00								
		Cash										4	5	0	0	0	00	
		(Cheque No.1)																

Transaction 3: Purchase of an Asset on Account (Credit)

On September 10 current year, Mrs. Dehab purchased Nakfa 65,000 of gasoline oil (supplies) from Tamoil Eritrea agreeing to pay in the near future.

Analysis:	1) *Affected accounts*	Supplies	Accounts Payable
	2) *Classification*	Asset (A)	Liabilities (L)
	3) *The effect*	Increase (+)	Increase (+)
	4) *Amount*	65,000	65,000

1) **Which account or accounts are debited?**
   Supplies
2) **Which account or accounts are to be credited?**
   Accounts Payable
3) **What is the amount to be debited or credited?**
   65,000

General Journal				Page: 2													
Date		Account Title	P/R.	Debit							Credit						
	2	*Cash*		9	0	0	0	0	0	00							
		Dehab's Capital									9	0	0	0	0	0	00
		(Receipt No.1)															
	5	*Office Equipment*			4	5	0	0	0	00							
		Cash										4	5	0	0	0	00
		(Cheque No.1)															
	10	*Supplies*			6	5	0	0	0	00							
		Accounts Payable										6	5	0	0	0	00
		(Cheque No.2)															

Activity 3.3.2.
Journalize the following transactions:
1. Mr. Samuel purchased furniture and fixtures for his business paying cash, Nakfa 5,000.
2. Mrs. Marus, an owner, made additional investment in her business, Nakfa 25,000.
3. Ms. Aziza purchased computers worth Nakfa 50,000 for her business from Sewit International Company agreeing to pay in the near future.
Discuss your journal entries with that of your classmates.

Transaction 4: Part Payment of a Liability
On September 15, Mrs. Dehab paid Nakfa 30,000 in part payment of a liability to Tamoil Eritrea.

Analysis:	1) Affected accounts	Cash	Accounts Payable
	2) Classification	Asset (A)	liability (L)
	3) The effect	Decrease (-)	Decrease (-)
	4) Amount	30,000	30,000

1) Which account or accounts are debited?
Accounts Payable
2) Which account or accounts are to be credited?
Cash
3) What is the amount to be debited or credited?
30,000

General Journal																		Page: 2
Date		Account Title	P/R	Debit							Credit							
	2	*Cash*		9	0	0	0	0	0	00								
		Dehab's Capital									9	0	0	0	0	0	00	
		(Receipt No.1)																
	5	*Office Equipment*			4	5	0	0	0	00								
		Cash										4	5	0	0	0	00	
		Cheque No.1)																
	10	*Supplies*			6	5	0	0	0	00								
		Accounts Payable										6	5	0	0	0	00	
		(Invoice No.1)																
	15	*Accounts Payable*			3	0	0	0	0	00								
		Cash										3	0	0	0	0	00	
		(ChequeNo.2)																

Transaction 5: Sale of an Asset for Cash

On September 20, Mrs. Dehab received cash Nakfa 5,000 from the sale of old furniture and fixture.

Analysis:	**1) Affected accounts**	**Cash**	**Furniture and Fixtures**
	2) Classification	**Asset (A)**	**Asset (A)**
	3) The effect	**Increase (+)**	**Decrease (-)**
	4) Amount	**5,000**	**5,000**

1) Which account or accounts are debited?
Cash

2) What account or accounts are to be credited?
Furniture and Fixtures

3) What is the amount to be debited or credited?
5,000

General Journal																		Page: 2
Date		Account Title	P/R	Debit							Credit							
	2	*Cash*		9	0	0	0	0	0	00								
		Dehab's Capital									9	0	0	0	0	0	00	
		(Receipt No.1)																
	5	*Office Equipment*			4	5	0	0	0	00								
		Cash										4	5	0	0	0	00	
		(Cheque No.1)																
	10	*Supplies*			6	5	0	0	0	00								
		Accounts Payable										6	5	0	0	0	00	
		(Invoice No.1)																
	15	*Accounts Payable*			3	0	0	0	0	00								
		Cash										3	0	0	0	0	00	
		(ChequeNo.2)																
	20	*Cash*			5	0	0	0	0	00								
		Furniture & Fixtures											5	0	0	0	00	
		(Receipt No.2)																

Activity 3.3.3 Journalize the following transactions:

1. Mr. Saud sold old furniture and fixtures for cash, Nakfa 15,000.
2. Mrs. Fre paid Nakfa 75,000 in part payment of a liability to Red Sea Corporation.
3. Ms. Selam paid Nakfa 7,000 in full payment of a liability to Atlas Printers.

Discuss your journal entries with that of your classmates.

Transaction 6: Income Transaction

On September 30, current year, Mrs. Dehab earned fares of Nakfa 200,000 for the month receiving the amount in cash.

Analysis:	1) *Affected accounts*	Cash		Fares earned
	2) *Classification*	Asset (A)		Capital (C)
	3) *The effect*	Increase (+)	I	Increase (+)
	4) *Amount*	200,000		200,000

1) **Which account or accounts are debited?**
   Cash
2) **Which account or accounts are to be credited?**
   Fares earned
3) **What is the amount to be debited or credited?**
   200,000

General Journal — Page: 2

Date		Account Title	P/ R.	Debit							Credit						
	2	Cash		9	0	0	0	0	0	00							
		Dehab's Capital									9	0	0	0	0	0	00
		(Receipt No.1)															
	5	Office Equipment			4	5	0	0	0	00							
		Cash										4	5	0	0	0	00
		(Cheque No.1)															
	10	Supplies			6	5	0	0	0	00							
		Accounts Payable										6	5	0	0	0	00
		(Invoice No.1)															
	15	Accounts Payable			3	0	0	0	0	00							
		Cash										3	0	0	0	0	00
		(ChequeNo.2)															
	20	Cash				5	0	0	0	00							
		Furniture & Fixtures											5	0	0	0	00
		(Receipt No.2)															
	30	Cash		2	0	0	0	0	0	00							
											2	0	0	0	0	0	00
		(Receipt No. 3)															

Transaction 7: Expense Transactions

On September 30, current year, Mrs. Dehab paid monthly expenses of Nakfa 55,000 for wages, Nakfa 5,000 for rent, Nakfa 2,500 for utilities and Nakfa 7,500 for miscellaneous expenses.

Analysis: 1) *Affected accounts* Cash Wages; Rent; Utilities; and Miscellaneous
2) *Classification* Asset (A) Capital (C)
3) *The effect* Decrease (-) Decrease (-)
4) *Amount* 70,000 55,000; 5,000; 2,500; 7,500

1) **Which account or accounts are debited?**
Wages Expense, Rent Expenses, Utilities Expenses and Miscellaneous Expenses

2) **Which account or accounts are to be credited?**
Cash

3) What is the amount to be debited or credited?
55,000; 5,000; 2,500; 7,500 debits to expense accounts and 70,000 credit to Cash

General Journal				Page: 2													
Date		Account Title	P/ R	Debit							Credit						
	2	Cash		9	0	0	0	0	0	00							
		Dehab's Capital									9	0	0	0	0	0	00
		(Receipt No.1)															
	5	Office Equipment			4	5	0	0	0	00							
		Cash										4	5	0	0	0	00
		(Cheque No.1)															
	10	Supplies			6	5	0	0	0	00							
		Accounts Payable										6	5	0	0	0	00
		(Invoice No.1)															
	15	Accounts Payable			3	0	0	0	0	00							
		Cash										3	0	0	0	0	00
		(Cheque No.2)															
	20	Cash				5	0	0	0	00							
		Furniture & Fixtures											5	0	0	0	00
		(Receipt No.2)															
	30	Cash		2	0	0	0	0	0	00							
		Fares Earned									2	0	0	0	0	0	00
		(Receipt No. 3)															
	30	Wages Expense			5	5	0	0	0	00							
		Rent Expense				5	0	0	0	00							
		Utilities Expense				2	5	0	0	00							
		Miscellaneous Expense				7	5	0	0	00							
		Cash										7	0	0	0	0	00
		(Cheque No. 3,4,5& 6)															
				1,315,000.00							1,3 15,000.00						

Drawings: An owner may withdraw cash or other assets for personal use. We use a separate classification called drawings to determine the total withdrawals for each period. Drawing decreases owner's equity. Mrs. Dehab did not withdraw cash or other assets from her business.

Assume that Mr. Hamid withdraws Nakfa 1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity. Both Cash and Mr. Hamid's Capital decrease Nakfa 1,300, as shown below:

Assets	=	liabilities	+	Capital
- 1,300	=			- 1,300

Observe that the effect of a cash withdrawal by the owner is the opposite of the effect of an investment by the owner. Owner's drawings are not expenses. Expenses are incurred for the purpose of earning revenue. Drawings do not generate revenue. The company excludes owner's drawings in determining net income.

Withdrawals could be debited directly to Owner's Capital to indicate a decrease in owner's equity. However, it is preferable to use a separate account, called Owner's Drawing. This separate account makes it easier to determine total withdrawals for each period. Owner's Drawing is increased by debits and decreased by credits. Normally, the drawing account will have a debit balance. The following illustration shows the rules of debit and credit for the drawing account.

Hamid's Drawing

Normal Balance Debit for increase	Credit for decrease

3.3.6. Proving the General Journal

As each page in the journal is filled with entries, the accuracy of the journalizing process should be checked. This is done by first adding all the debits in the Debit column and then adding all the credits in the Credit column. The adding of the two covlumns is known as ***footing*** the columns. If the total of the Debit column equals the total of the Credit column, the journal has been proved; that is, the debits are equal to the credits in the entries on that page.

The totals or footings are entered on the last line of each filled page of the journal and are written in smaller figures than the amounts recorded for each entry. A double line is placed under the total in each column. In the above illustration, note that the total is Nakfa 1,315,000 in both Debit and Credit columns.

3.3.7. Posting

The General journal shows a chronological record of business transaction; however, it does not sort the entries into accounts and it does not summarize the effect of transactions on accounts. For example, the General journal does not show in one place the total amount spent on supplies. Furthermore, a journal does not supply an account balance for preparing an up-to-date balance sheet.

In order to know how transactions have changed the account balances, posting from the cash journal to the accounts is necessary. Posting is the transfer of amounts from journals to the ledger. Debits in the journal are posted as debits in the ledger, and credits in the journal as credits in the ledger.

The chart of accounts of a business outlines the order of the accounts in its ledger. The chart of accounts also serves as a guide in journalizing, by showing the account titles that are to be used when recording business transactions. The following shows the chart of accounts of Dehab Taxi Services including income and expense accounts.

Dehab Taxi Service
Chart of Accounts

Account Title	Account Number	Account Title	Account Number
1. Assets		**2.** Liabilities	
Cash	11	Accounts Payable	21
Supplies	12	Taxes payable	22
Automobiles	13	**3.** Capital	
Furniture and Fixtures	14	Dehab's Capital	31
Office Equipment	15	**4.** Revenue	
		Fares Earned	41
		5. Expenses	
		Wages Expenses	51
		Rent Expenses	52
		Utilities Expense	53
		Miscellaneous Expense	54

Periodically, at the end of each day or week, the transactions recorded in the general journal since the last posting date are transferred to the accounts in the general ledger.

To illustrate the posting process, we will post the transactions of Dehab Taxi Services from September.1-30, current year that we have journalized in the previous section. Let us assume that Dehab Taxi Services accountants post transactions daily. We will illustrate how the journal entries are posted to accounts in the ledger in the following part. It is similar to the process of posting of the opening balances.

Steps in the Posting Process:-

1) Locate in the general ledger the account debited in the journal entry.
2) Record the date of the transaction in the general ledger account.
3) Record the general journal reference (J) and page number in the posting reference column of the account debited in the general ledger.
4) Enter the amount of the debit from the journal into the debit column of that particular account in the ledger.
5) Determine the balance in the account.
6) Enter the account number of the ledger account debited in the posting reference column of the journal on the line of the debit part of the transaction.
7) Repeat the steps above for the credit portion of the journal entry.

General Journal **Page: 2**

Date		Account Title	P/R.	Debit	Credit
	2	*Cash*	*11*	*900000.00*	
		Dehab's Capital	*31*		*900000.00*
		(Receipt No.1)			

Account Title: Cash Account Number: 11

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	*1*	*Balance*	*J1*	*145000.00*		*145000.00*
	2		*J2*	*900000.00*		*1,045000.00*

Account Title: _Dehab Capital Account Number: _31

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	*1*	*Balance*	*J1*		*915000.00*	*915000.00*
	2		*J2*		*900000.00*	*1,815000.00*

General Journal Page: 2

Date		Account Title	P/R.	Debit	Credit
	2	*Cash*	*11*	*900000.00*	
		Dehab's Capital	*31*		*900000.00*
		(Receipt No.1)			
	5	*Office Equipment*	*15*	*450000.00*	
		Cash	*11*		*450000.00*
		(Cheque No.1)			

Account Title: _Office Equipment Account Number: 15

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	*1*	*Balance*	*J1*	*500000.00*		*500000.00*
	5		*J2*	*450000.00*		*950000.00*

Account Title: _Cash__ Account Number: 11

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	*1*	*Balance*	*J1*	*145000.00*		*145000.00*
	2		*J2*	*900000.00*		*1,045000.00*
	5				*450000.00*	*595000.00*

General Journal Page: 2

Date		Account Title	P/ R.	Debit	Credit
	2	Cash	11	9 000.00	
		Dehab's Capital	31		9 000.00
		(Receipt No.1)			
	5	Office Equipment	15	4 500.00	
		Cash	11		4 500.00
		Cheque No.1			
	10	Supplies	12	6 500.00	
		Accounts Payable	21		6 500.00
		(Invoice No.1)			

Account Title: _Supplies_ Account Number: 12

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	1	Balance	J1	6 500.00		6 500.00
	10		J2	6 500.00		13 000.00

Account Title: _Accounts Payable Account Number: 21

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	1	Balance	J1	7 500.00		7 500.00
	10		J2	6 500.00		14 000.00

After posting is completed, the General journal and ledger of Dehab Taxi Services will be as follows:

General Journal **Page: 2**

Date		Account Title	P/R	Debit							Credit						
	2	Cash	11	9	0	0	0	0	0	00							
		Dehab's Capital	31								9	0	0	0	0	0	00
		(Receipt No.1)															
	5	Office Equipment	15		4	5	0	0	0	00							
		Cash	11									4	5	0	0	0	00
		(Cheque No.1)															
	10	Supplies	12		6	5	0	0	0	00							
		Accounts Payable	21									6	5	0	0	0	00
		(Invoice No.1)															
	15	Accounts Payable	21		3	0	0	0	0	00							
		Cash	11									3	0	0	0	0	00
		(Checque No.2)															
	20	Cash	11			5	0	0	0	00							
		Furniture & Fixtures	14										5	0	0	0	00
		(Receipt No.2)															
	30	Cash	11	2	0	0	0	0	0	00							
		Fares Earned	41								2	0	0	0	0	0	00
		(Receipt No. 3)															
	30	Wages Expense	51		5	5	0	0	0	00							
		Rent Expense	52			5	0	0	0	00							
		Utilities Expense	53			2	5	0	0	00							
		Miscellaneous Expense	54			7	5	0	0	00							
		Cash	11									7	0	0	0	0	00
		(Cheque No. 3,4,5&6)															
				1,315,000.00							1,3 15,000.00						

Account Title: Cash **Account Number: 11**

Date		Item	PR	Debit							Credit						Balance						
C/Y Sept.	1	Bal	J1	1	4	5	0	0	0	00							1	4	5	0	0	0	00
	2		J2	9	0	0	0	0	0	00							1,0	4	5	0	0	0	00
	5		J2								4	5	0	0	0		1,0	0	0	0	0	0	00
	15		J2								3	0	0	0	0		9	7	0	0	0	0	00
	20		J2			5	0	0	0	00							9	7	5	0	0	0	00
	30		J2	2	0	0	0	0	0	00							1,1	7	5	0	0	0	00
	30		J2								7	0	0	0	0		1,1	0	5	0	0	0	00

Account Title: Supplies Account Number: 12

Date		Item	P/R	Debit							Credit							Balance						
C/Y Sept.	1	Balance	J1		6	5	0	0	0	00									6	5	0	0	0	00
	10		J2		6	5	0	0	0	00								1	3	0	0	0	0	00

Account Title: Automobiles — Account Number: 13

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	7 400 00		7 400 00

Account Title: Furniture and Fixtures — Account Number: 14

Date		Item	PR	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	1 500 00		1 500 00
	20		J2		5 000 00	1 000 00

Account Title: Office Equipment — Account Number: 15

Date		Item	P/R.	Debit	Credit	Balance
Current Sept.	1	Balance	J1	5 000 00		5 000 00
	5		J2	4 500 00		9 500 00

Account Title: Accounts Payable — Account Number: 21

Date		Item	PR	Debit	Credit	Balance
C/Y Sept.	1	Bal.	J1		7 500 00	7 500 00
	10		J2		6 500 00	14 000 00
	15			3 000 00		11 000 00

Account Title: Taxes Payable — Account Number: 22

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1		2 500 00	2 500 00

Account Title: Dehab Capital — Account Number: 31

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1		9 150 000 00	9 150 000 00
	2		J2		9 000 000 00	1,8 150 000 00

Account Title: Fares Earned — Account Number: 41

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	30		J2		2 000 000 00	2 000 000 00

Account Title: Wages Expense						Account Number: 51
Date		Item	PR	Debit	Credit	Balance
C/Y Sept.	30		J2	5 5 0 0 0 00		5 5 0 0 0 00

Account Title: Rent Expenses						Account Number: 52
Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	30		J2	5 0 0 0 00		5 0 0 0 00

Account Title: Utilities Expenses						Account Number: 53
Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	30		J2	2 5 0 0 0 00		2 5 0 0 0 00

Account Title: Miscellaneous Expenses						Account Number: 54
Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	30		J2	7 5 0 0 00		7 5 0 0 00

Key Terms

Double entry bookkeeping
Temporary or nominal accounts
Permanent, or real accounts
Generally Accepted Accounting Principles (GAAP)
Cheque
Footing
Historical cost
Cheque stub
T-account
Account balance

Review Questions

1. Discuss the reasons for using a journal?
2. How is the equality of debits and credits in a General journal proved?
3. What is the source document for cash receipts used by Dehab Taxi Services?
4. What is the source document for cash payment used by Dehab Taxi Services?
5. Discuss the steps used in recording entries in a General journal?
6. Why is it necessary to post entries from a General journal to the accounts in the ledger?
7. How can one prove that an entry is posted to an account in the ledger?
8. How are accounts arranged in a ledger?
9. What is the normal balance side of an asset?
10. Which side is the decrease side of a liability account?

Exercises 3.3.1

Direction: For each of the following transaction write the name of the account to be debited and credited. Item 1 is given as an example.

No.	Transactions	Debit	Credit
1.	Paid cash for supplies.	Supplies	Cash
2.	Received cash from repairs income.		
3.	Paid cash for rent of garage for the month.		
4.	Paid cash for advertising in the "Hadas Eritrea"		
5.	Paid cash for electricity for the month.		
6.	Paid cash for telephone for the month.		
7.	Paid cash for postage stamps (Miscellaneous items).		
8.	Received cash from repairs income.		

Problem 3.3.1.

Journalize the following transactions on page 2 of a General journal:

Aug. 02. Ms. Sophia paid Nakfa 600 for rent for the month.
03. Ms. Sophia bought equipment for Nakfa 1,800 agreeing to pay later.
04. Ms. Sophia received Nakfa 525 from customers.
06. Ms. Sophia paid Nakfa 38 cash for miscellaneous expense.
10. Ms. Sophia paid Nakfa 400 to creditors on account.
13. Ms. Sophia paid her employees 'salaries Nakfa 320.
16. Ms. Sophia sold goods for Nakfa 960 for cash.
20. Ms. Sophia purchased Nakfa 350 supplies.
27. Ms. Sophia paid Nakfa 20 cash for miscellaneous expenses.
31. Ms. Sophia sold goods worth Nakfa 510.
31. Ms. Sophia withdrew Nakfa 500 cash for personal use.

Problem 3.3.2

1) The Chart of Accounts of Forto Restaurant (see Problem 3.2.1) shows the following accounts in its ledger: Cash (Account Number 11), Office Furniture (Account Number 12), Accounts Payable (Account Number 21), Habte's Capital (Account Number 31), Sales (Account Number 41), Rent Expense (Account Number 51), Wages Expense (Account Number 52) and Utilities Expense (Account Number 53). Please open these accounts in a ledger of Forto Restaurant.
2) Post the account balances of Forto Restaurant to the accounts in the ledger.
3) Journalize the transactions listed in problem 3.2.1 (previous sub-unit) in General journal page 3.
4) Post the entries on page 3 of the General journal to the ledger accounts.

Problem 3.3.3

1) The Chart of Accounts of Assab Swimming Pool (see Problem 3.2.2 in the previous sub-unit) shows the following accounts in its ledger: Cash (Account Number 11), Office Equipment (Account Number 12), Swimming Equipment (Account Number 13), Accounts Payable (Account Number 21), Fatima Ali's, Capital (Account Number 31), Admissions Income (Account Number 41), Advertising Expense (Account number 51), Rent Expense (Account Number 52), Utilities Expense (Account Number 53) and Miscellaneous Expenses (Account Number 54). Please open these accounts in a ledger of Assab Swimming Pool.
2) Post the account balances of Assab Swimming Pool to the accounts in the ledger.
3) Journalize the transactions listed in problem 3.2.2 (previous sub-unit) in General journal page 10.
4) Post the entries on page 10 of the General journal to the ledger accounts

Problem 3.3.4

1) The Chart of Accounts of Semira Dental Care Services (see Problem 3.2.3 in the previous sub-unit) shows the following accounts in its ledger: Cash (Account Number 11), Accounts Receivable (Account Number 12), Dental Supplies (Account Number 13), Dental Equipment (Account Number 14), Accounts Payable (Account Number 21), Semira's, Capital (Account Number 31), Income

(Account Number 41), Rent Expense (Account Number 51), Salary Expenses (Account Number 52) and Utilities Expenses (Account Number 53). Please open these accounts in a ledger of Semira Dental Care Services.

2) Post the account balances of Semira Dental Care Services to the accounts in the ledger.
3) Journalize the transactions listed in problem 3.2.3 (previous sub-unit) in General journal page 13.
4) Post the entries on page 13 of the General journal to the ledger accounts

3.4 Journalizing Transactions in a Cash Journal and Posting

Focus Questions

1. Why do we collect cash receipts when we buy goods in shops?
2. Discuss how a cheque is used as an instrument of cash payment?
3. What does special mean?

The General Journal can be used for recording all the transactions of a business. In the preceding sub-unit, we limited our discussion of the processing of accounting transactions to recording in a General journal and posting to a general ledger. However, for two reasons, this method would ***not be enough*** for a business having even a modest number of transactions. First, recording all transactions in the General journal would seriously limit the number of transactions that could be processed in a day, simply because only one person at a time could make entries. Second, transactions recorded in a General journal must be posted individually, resulting in a great deal of posting labour. Therefore, even small and medium sized firms use specialized journals to record frequent business transactions such as cash receipt and cash payments.

A journal that is used to record only one type of transaction is called a ***special journal***. To facilitate the recording and summarizing process, many businesses, in addition to General journal, use special journals. A special journal in which only cash transactions (cash received and cash paid) are recorded is called ***cash journal***. The cash journal has a special amount column for each account that is debited or credited frequently. For Dehab Taxi Services these accounts are cash and fares earned (income). The cash account requires two special amount columns-a cash Debit column for cash receipt and a cash credit column for cash payment. The following presents the form of cash journal used by Dehab Taxi Services. A General Debit and General Credit amount columns are used for accounts that are not debited or credited often.

Cash Journal **Page 1**

Cash Debit	General Debit	Date	Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit

3.4.1. Why do we use Special Journals such as Cash Journal?

A special journal with special amount columns has several advantages:

1. ***It saves space***: less space is needed for recording entries in a cash journal than in a two-column general journal. The entry in the general journal needs three lines, while only one line is used for the same entry in the cash journal.

2. ***It saves time for recording***: When a general journal is used additional time and labour are needed to write an account title for both parts of every transaction. In a cash journal entry, only one account is written, while the title of those frequent transactions such as cash receipt and payment are already written as a heading of a column.
3. ***It saves time for posting***: less time is needed for posting from the cash journal than from the general journal. The amounts entered in special columns of a cash journal are posted in total once, while the general Debit and General Credit columns are posted separately.

3.4.2. How to Journalize Business Transactions in Cash Journal

Assume that Dehab Taxi Services business uses a Cash journal and a General journal. To illustrate the journalizing process, we will record the transactions of Dehab Taxi Services from September.1-30, current year that we have journalized in a General journal in sub-unit 3.3 in a cash journal.

Transaction 1: Additional Investment of Capital by Owner of the Business.

On September 2, current year, Mrs. Dehab, the proprietor, deposited Nakfa 900,000 additional investment in a bank to help the operation of her business.

We ask these questions to prepare for journalizing the transactions:

1) **Which account or accounts are debited?**
   Cash
2) **Which account or accounts are to be credited?**
   Dehab's Capital
3) **What is the amount to be debited or credited?**
   900,000

The following illustrates the recording of the above transaction in the cash journal.

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		

Steps used in Recording Transaction No.1:-

We follow the same steps that we have discussed in journalizing the opening balance sheet in sub-unit 3.1.

Step 1, Date of the entry: We write the date of the transaction in the Date column. This includes, the current year, month and the day, that is, September. 2 current year.

Step 2, Debit Part of the Entry: We debit the cash account on the far left Cash debit amount column -Nakfa 900,000-on the same line. We do not write Cash under the account title because it is already recorded as a heading.

Step 3, Credit Part of the Entry: We credit Dehab's Capital-Nakfa 900,000-was entered on the same line in the General Credit column. The General Debit and General Credit columns are used for accounts for which there are no special columns. When an account is recorded in one of the General columns, the name of the account debited or credited is written in the account title credit column.

Step 4, Source of the entry and Brief explanation: Write R1 in the No. column to show that Receipt No. 1 was issued in this transaction.

Transaction 2: Purchase of an Asset for Cash

On September 5, current year, Mrs. Dehab bought office equipment for which she paid Nakfa 45,000.

1) **Which account or accounts are debited?**
Office Equipment

2) Which account or accounts are to be credited?
Cash

3) What is the amount to be debited or credited?
45,000

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00

Transaction 3: Purchase of an Asset on Account (Credit)

On September 10 current year, Mrs. Dehab purchased Nakfa 65,000 of gasoil (supplies) From Tamoil Eritrea agreeing to pay in the near future.

Transactions that do not involve the receipt or payment of cash are recorded in the general journal.

1) **Which account or accounts are debited?**
Supplies
2) **Which account or accounts are to be credited?**
Accounts Payable
3) **What is the amount to be debited or credited?**
65,000

General Journal Page: 2

Date		Account Title	P/ R	Debit							Credit						
	10	*Supplies*			6	5	0	0	0	00							
		Accounts Payable										6	5	0	0	0	00
		(Invoice No.1)															

Activity 3.4.1

Journalize the following transactions in a Cash journal and General journal:

1. Mr. Samuel purchased furniture and fixtures for his business paying cash, Nakfa 5,000.
2. Mrs. Marus, an owner, made additional investment in her business, Nakfa 25,000.
3. Ms. Aziza purchased computers worth Nakfa 50,000 for her business from Sewit International Company agreeing to pay in the near future.

Discuss your journal entries with that of your classmates.

Transaction 4: Part Payment of a Liability

On September 15, Mrs. Dehab paid Nakfa 30,000 in part payment of a liability to Tamoil Eritrea.

In other words:

1) **Which account or accounts are debited?**
Accounts Payable
2) **Which account or accounts are to be credited?**
Cash

3) **What is the amount to be debited or credited?**
300

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00
	30,000.00		15	Accounts Payable	Ck2				30,000.00

Transaction 5: Sale of an Asset for Cash

On September 20, Mrs. Dehab received cash Nakfa 5,000 from the sale of old furniture and fixture. In other words:

1) **Which account or accounts are debited?**
Cash
2) **Which account or accounts are to be credited?**
Furniture and Fixtures
3) **What is the amount to be debited or credited?**
5,000

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00
	30,000.00		15	Accounts Payable	Ck2				30,000.00
5,000.00			20	Furniture & fixtures	R2		5,000.00		

Activity 3.4.2

Journalize the following transactions in a Cash Journal:

1. Mr. Saud sold old furniture and fixtures for cash, Nakfa 15,000.
2. Mrs. Fre paid Nakfa 75,000 in part payment of a liability to Red Sea Corporation.
3. Ms. Selam paid Nakfa 7,000 in full payment of a liability to Atlas Printers.

Discuss your journal entries with that of your classmates.

Transaction 6: Income Transaction

On September 30, current year, Mrs. Dehab earned fares of Nakfa 200,000 for the month receiving the amount in cash.

Analysis:	1) *Affected accounts*	Cash	Fares earned
	2) *Classification*	Asset (A)	Capital (C)
	3) *The effect*	Increase (+)	I Increase (+)
	4) *Amount*	200,000	200,000

1) **Which account or accounts are debited?**
   Cash
2) **Which account or accounts are to be credited?**
   Fares earned
3) **What is the amount to be debited or credited?**
   200,000

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00
	30,000.00		15	Accounts Payable	Ck2				30,000.00
5,000.00			20	Furniture & fixtures	R2		5,000.00		
200,000.00			30	√				200,000.00	

To avoid repetition, a check mark (√) is placed under the account title column when there is a special column created for that account.

Transaction 7: Expense Transactions

On September 30, current year, Mrs. Dehab paid monthly expenses of Nakfa 55,000 for wages, Nakfa 5,000 for rent, Nakfa 2,500 for utilities and Nakfa 7,500 for miscellaneous expenses.

1) **Which account or accounts are debited?**
   Wages Expense, Rent Expenses, Utilities Expenses and Miscellaneous Expenses
2) **Which account or accounts are to be credited?** Cash
3) **What is the amount to be debited or credited?**
   55,000; 5,000; 2,500; 7,500 debits to expense accounts and 70,000 credit to Cash

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00
	30,000.00		15	Accounts Payable	Ck2				30,000.00
5,000.00			20	Furniture & fixtures	R2		5,000.00		
200,000.00			30					200,000.00	
	55,000.00 5,000.00 2,500.00 7,500.00		30	Wages Exp Rent Exp Utilities Expense Miscellaneous					70,000.00
1,105,000.00	**145,000.00**		**30**	**Totals**			**905,000.00**	**200,000.00**	**145,000.00**

3.4.3. Proving the Accuracy of the Cash Journal

1. **Footing and proving the cash journal**: All amount columns are added to prove the equality of debits and credits. Pencil totals written in small figures are commonly called ***footings*** and are always made at the end of the month. The footings are listed and added to prove the equality of debits and credits in the cash journal. The figures for proving the cash journal of Dehab Taxi Services is presented below:

Cash Debit Footings	Nakfa 1,105,000	General Credit Footings	Nakfa 905,000
General Debit Footings	145,000	Fares Earned	200,000
		Cash Credit Footings	145,000
	Nakfa 1,250,000		**Nakfa 1,250,000**

2. **Proving cash on hand**: Determining that the amount of cash on hand agrees with the bookkeeping records is called ***proving cash***. Cash is the money deposited in the bank plus cash on hand. Cash should always be proved when the cash journal is footed at the end of the month.
   The following calculations are made to prove cash after the cash journal of Dehab Taxi Services is footed and proved on September 30, current year.
   Beginning cash balance on September 1, current year ……. Nakfa 145,000
   Cash received during the month (footing of the Cash Debit) 1,105,000
   Total of beginning balance and cash received 1,250,000
   Subtract cash paid during the month (footing of the cash credit) ….. - 145,000
   Amount of ending cash balance on September 30, current year … 1,105,000
   The last cheque stub used in the cheque book shows a bank balance of Nakfa 1,105, 000.

3. **Ruling of the cash Journal**: After the equality of debits and credits in the cash journal is proved, a single line is drawn across all amount columns of the cash journal under the last entry. The total of the column is written in ink. The last day of the month is written in the date column on the last line with the totals. The word Total should be written in the Account title column, and a double line is drawn across all amount column.

Posting

Posting is a sorting process that transfers amounts in journals to appropriate accounts in the ledger. The debits and credits in each account can then be added and new balances determined easily and quickly. To illustrate the posting process, we will post the transactions of Dehab Taxi Services from September.1-30, current year that we have journalized in the Cash journal and General journal. We will illustrate how the journal entries in the cash journal are posted to accounts in the ledger in the following part.

Posting the Special columns of the Cash Journal

In the cash journal of Dehab Taxi Services, the Cash Debit column, the Cash Credit column, and the Fares Earned columns are special columns. The individual amounts entered in special columns are not posted separately. Only the total of a special column is posted. This saves time and labour in posting.

Cash Journal **Page 1**

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1		900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00
	30,000.00		15	Accounts Payable	Ck2				30,000.00
5,000.00			20	Furniture & fixtures	R2		5,000.00		
200,000.00			30					200,000.00	
	50,000.00 5,000.00 2,500.00 7,500.00		30	Wages Expense Rent Expense Utilities Expense Miscellaneous					70,000.00
1,105,000.00	**145,000.00**		**30**	**Totals**			**905,000.00**	**200,000.00**	**145,000.00**
(11)	(√)						(√)	(41)	(11)

Account Title: Cash Account Number: 11

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	145,000.00		145,000.00
	30		C1	1,105,000.00		1,250,000.00
	30		C1		1,450,000.00	1,100,000.00

Account Title: Fares Earned **Account Number: 41**

Date		Item	P/R.	Debit	Credit	Balance
C/Y Sept.	30		C1		200,000.00	200,000.00

Posting from General Columns

Individual amounts in General Debit and General Credit columns are posted separately to accounts named in the account title column. Each time an individual amount in a General column is posted, the number of the account to which it is posted is recorded in the Post Reference column of the journal. The total of a General column is **NOT** posted to the ledger. A check mark (√) is placed in parentheses under the total of a General column to show that the total of the column is not posted. Let us illustrate posting from General column of Dehab Taxi Services.

Dehab Taxi Services ledger after posting

After posting is completed, the Cash journal, General Journal and ledger of Dehab Taxi Services will be as follows:

Cash Journal Page 1

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1	31	900,000.00		
	45,000.00		5	Office Equipment	Ck1				45,000.00
	30,000.00		15	Accounts Payable	Ck2				30,000.00
5,000.00			20	Furniture & fixtures	R2		5,000.00		
200,000.00			30					200,000.00	
	50,000.00 5,000.00 2,500.00 7,500.00		30	Wages Expense Rent Expnse Utilities Expense Miscellaneous					70,000.00
1,105,000.00	**145,000.00**		**30**	**Totals**			**905,000.00**	**200,000.00**	**145,000.00**
(11)								(41)	(11)

Account Title: Dehab Capital Account Number: 31

Date		Item	Post/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1		9,150,000.00	9,150,000.00
	2		C1		900,000.00	1,815,000.00

Activity 3.4.3

Post the remaining cash journal General columns and the General journal entry of Dehab Taxi Service. Compare your work with that of your classmates.

Cash Journal — Page 1

Cash Debit	General Debit	Date		Account Title	No	PR	General Credit	Fares Earned Credit	Cash Credit
900,000.00		C/Y Sept	2	Dehab's Capital	R1	31	900,000.00		
	45,000.00		5	Office Equipment	Ck1	15			45,000.00
	30,000.00		15	Accounts Payable	Ck2	21			30,000.00
5,000.00			20	Furniture & fixtures	R2	14	5,000.00		
200,000.00			30	√	R3			200,000.00	
	50,000.00 5,000.00 2,500.00 7,500.00		30	Wages Exp Rent Exp Utilities Expense Miscellaneous	Ck3 Ck4 Ck5 Ck6	51 52 53 54			70,000.00
1,105,000.00	**145,000.00**		**30**	**Totals**			**905,000.00**	**200,000.00**	**145,000.00**
(11)	(√)						(√)	(41)	(11)

General Journal — Page: 2

Date		Account Title	P/ R	Debit	Credit
	10	*Supplies*	12	650000	
		Accounts Payable	21		650000
		(Invoice No.1)			

Account Title: Cash — Account Number: 11

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	140000		140000
	30		C1	1,10500		1,25000
	30		C1		145000	1,10500

Account Title: Supplies — Account Number: 12

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	650000		650000
	10		J2	650000		1300000

Account Title: Automobiles — Account Number: 13

Date		Item	P/R	Debit	Credit	Balance
C/Y Sept.	1	Balance	J1	740000		740000

Account Title: Furniture and Fixtures — Account Number: 14

Date	Item	PR	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1	150000		150000
20		C2		50000	100000

Account Title: Office Equipment — Account Number: 15

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1	50000		50000
5		C2	45000		95000

Account Title: Accounts Payable — Account Number: 21

Date	Item	P/R.	Debit	Credit	Balance
C/Y Sept. 1	Bal.	J1		75000	75000
10		J2		65000	140000
15		C2	30000		110000

Account Title: Taxes Payable — Account Number: 22

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1		25000	25000

Account Title: Dehab Capital — Account Number: 31

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 1	Balance	J1		9150000	9150000
2		C2		900000	1,8 150000

Account Title: Fares Earned — Account Number: 41

Date	Item	P/R	Debit	Credit	Balance
C/Y Sept. 30		C2		200000	200000

Account Title: Salary Expense — Account Number: 51

Date	Item	PR	Debit	Credit	Balance
C/Y Sept. 30		C2	55000		55000

Account Title: Rent Expenses Account Number: 52

Date		Item	PR	Debit	Credit	Balance
C/Y Sept.	30		C2	500.00		500.00

Account Title: Utilities Expenses Account Number: 53

Date		Item	PR	Debit	Credit	Balance
C/Y Sept.	30		C2	250.00		250.00

Account Title: Miscellaneous Expenses Account Number: 54

Date		Item	PR	Debit	Credit	Balance
C/Y Sept.	30		C2	750.00		750.00

Summary

Businesses use specialized journals to record frequent business transactions such as cash receipt and cash payments. A special journal in which only cash transactions (cash receipts and cash payments) are recorded is called a cash journal. The use of a cash journal in service business helps to save space and time in recording and posting entries. Moreover, it helps in proving the cash on hand. In addition to the cash journal businesses use a general journal to record transactions that do not affect cash (for example, the purchase of an asset when agreeing to pay in the future).

The cash journal also facilitates posting entries to the ledger accounts. The special amount columns: Cash Debit, Cash Credit and Fares Earned (Income) are posted in total, while the General columns: General Debit and General Credit are posted individually.

Key Terms

Special journal	Footing
Cash journal	Proving of cash
Chronological order	Cash on hand

Review Questions:

1. Define special journal.
2. What is a cash journal?
3. Discuss the advantages of using a cash journal in a service business?
4. Distinguish the difference between the special columns and general columns of a cash journal.
5. Illustrate the steps used in recording transactions in a cash journal?
6. What are the steps used in posting entries from a cash journal to ledger accounts?
7. Describe the process of footing accounts?

Exercises:

Exercise 3.4.1: In the following illustration of a cash journal, each column of the journal is marked with a capital letter. For each of the items given below, write the capital letter that indicates the column of the cash journal in which the amount should be recorded. Item 1 is answered as an illustration.

Cash Debit	General Debit	Date	Account Title	No	P.R	General Credit	Repairs Income	Cash Credit
A	B	C D	E	F	G	H	I	J

1. Each day's income from repairs of automobiles _____I_____
2. Each cash receipt _____
3. Each cash payment_____
4. Each increase in the balance of an asset account other than cash_____
5. Each decrease in the balance of an asset account _____
6. Each increase in the balance of a liability account _____
7. Each decrease in the balance of a liability account _____
8. Each increase in owner's capital account due to additional investment _____
9. Each increase in the balance of an expense account_____

Exercise 3.4.2:

The following are business transactions of Haweshait Accounting Firm for the month of March, current year.

March 1. Received Nakfa 3,000 cash from customers for accounting services provided (Receipt Number 1).

March 5. Bought Nakfa 200 worth of equipment from Red Sea Corporation on credit (invoice No. 45).

March 10. Paid Nakfa 100 to settle a liability owed to Red Sea Corporation (Cheque No. 5).

March 15. Bought furniture worth Nakfa 1,000 from Barka wood work on credit (Invoice No. 50).

March 20. Received Nakfa 2,500 cash from customers for accounting services provided (Receipt No. 2).

March 27. Paid Nakfa 100 to settle a liability owed to Red Sea Corporation (Cheque Number 6).

March 30. Bought a new typewriter worth Nakfa 1,500 from Sewit International on credit (Invoice No. 67).

Instructions: Journalize the transactions on a cash journal (page 6) and general journal (page 9).

Problem 3.4.1

1) The Chart of Accounts of Forto Restaurant (see Problem 3.2.1) shows the following accounts in its ledger: Cash (Account Number 11), Office Furniture (Account Number 12), Accounts Payable (Account Number 21), Habte's Capital (Account Number 31), Sales (Account Number 41), Rent Expense (Account Number 51), Wages Expense (Account Number 52) and Utilities Expense (Account Number 53). Please open these accounts in a ledger of Forto Restaurant.
2) Post the account balances of Forto Restaurant to the accounts in the ledger.
3) Journalize the transactions listed in problem 3.2.1 in Cash journal page 1 and General journal page 1.
4) Post the entries on page 1 of the Cash journal to the ledger accounts.
5) Post the entries on page 1 of the General journal to the ledger accounts.

Problem 3.4.2

1) The Chart of Accounts of Assab Swimming Pool (see Problem 3.2.2) shows the following accounts in its ledger: Cash (Account Number 11), Office Equipment (Account Number 12), Swimming Equipment (Account Number 13), Accounts Payable (Account Number 21), Fatima Ali's, Capital (Account Number 31), Admissions Income (Account Number 41), Advertising Expense (Account number 51), Rent Expense (Account Number 52), Utilities Expense (Account Number 53) and Miscellaneous

Expenses (Account Number 54). Please open these accounts in a ledger of Assab Swimming Pool.
2) Post the account balances of Assab Swimming Pool to the accounts in the ledger.
3) Journalize the transactions listed in problem 3.2.2 in Cash journal page 5 and General journal page 15.
4) Post the entries on page 5 of the Cash journal to the ledger accounts.
5) Post the entries on page 15 of the General journal to the ledger accounts

Problem 3.4.3

1) The Chart of Accounts of Semira Dental Care Services (see Problem 3.2.3) shows the following accounts in its ledger: Cash (Account Number 11), Accounts Receivable (Account Number 12), Dental Supplies (Account Number 13), Dental Equipment (Account Number 14), Accounts Payable (Account Number 21), Semira's, Capital (Account Number 31), Income (Account Number 41), Rent Expense (Account Number 51), Salary Expenses (Account Number 52) and Utilities Expenses (Account Number 53). Please open these accounts in a ledger of Semira Dental Care Services.
2) Post the account balances of Semira Dental Care Services to the accounts in the ledger.
3) Journalize the transactions listed in problem 3.2.3 in Cash journal, page 4 and General journal, page 3.
4) Post the entries on page 4 of the Cash journal to the ledger accounts.
5) Post the entries on page 3 of the General journal to the ledger accounts

Problem 3.4.4 Journalizing and posting the transactions of an attorney

Mr. Nur Salih a lawyer has opened a law firm, Nur Salih Attorney. The Charts of Accounts of the law firm is presented below:

Nur Salih Attorney
Charts of Accounts

1) Assets	Account Number	4) Revenue	Account Number
Cash	11	Fees Revenue	41
Automobile	12		
Office Furniture	13	**5) Expenses**	
Professional Library	14	Automobile Repairs Expense	51
		Miscellaneous Expenses	52
2) Liabilities		Rent Expense	53
Accounts Payable	21	Salary Expense	54
3) Capital			
Nur Salih Capital	31		

The Nur Salih Attorney ledger accounts have the following balances on October 1 of the current year: Cash Nakfa 14,313; Automobiles Nakfa 3,800; Office Furniture Nakfa 1,450; Professional Library Nakfa 645; Accounts Payable 1,324; and Nur Salih Capital Nakfa 18,884. The rest of the accounts did not have a balance.

During October of the current year, the following transactions occurred:
Oct. 1. Paid cash for October rent 350.
2. Received cash for legal services Nakfa 500.
3. Paid cash for the purchase of office furniture Nakfa 145.
4. Received cash for sale of old office chair Nakfa 10.
9. Received cash for legal services Nakfa 850.
10. Paid cash to settle a liability to Red Star Company Nakfa 185.
15. Paid cash for salary expense Nakfa 200.
15. Paid cash for automobile expense Nakfa 250.

17. Paid cash for taking a client to dinner Nakfa 250.
18. Paid cash for automobile repairs Nakfa 450.
24. Received cash for legal services Nakfa 900.
25. Paid cash to settle a liability to Odeon Garage on account Nakfa 250.
26. Received cash for sale of old office furniture Nakfa 20.
26. Received for legal services, Nakfa 1,250.
29. Received cash for legal services, Nakfa 800.
30. Paid cash for telephone bill, Nakfa 160.
31. Paid cash for electric bill, Nakfa 350.
31. Paid cash for salary expense, Nakfa 200.

Instructions:

1. Open accounts in the ledger of Nur Salih Attorney.
2. Post the account balances on the appropriate sides of the proper accounts in the ledger. Write the word balance in the item column and place a check mark in the post reference column.
3. Record the cash balance as a memorandum entry. Use page 10 of a cash journal.
4. Journalize the transactions for October on a cash journal page 10. The revenue column should be headed as Fees Income Credit. Number all Cheque beginning with Cheque 216. Number all receipts beginning with R60.
5. Post the individual amounts in the general debit and general credit columns to the accounts in the ledger.
6. Foot each amount column with small pencil figures.
7. Prove the equality of debits and credits in your cash journal.
8. Prove cash. The last Cheque stub shows a bank balance at the end of the month of Nakfa 13, 593.50.
9. Total and rule the cash journal.
10. Post the totals of the three special columns. Place a check mark under the general debit and general credit column to indicate these totals are not to be posted.

3.5. The Trial Balance and the Work Sheet

Focus Questions:

1. What is a balance?
2. How is a balance used to compare items?
3. What does the term adjustment mean?

In double entry bookkeeping, the debit amount must equal the credit amount for each business transaction recorded in the journal. This double entry system makes it easy for checking the accuracy of the entries in a journal and postings to accounts. When entries are posted in accounts, usually accountants make a preliminary check of the accuracy to check if the total of debit entries is equal to that of all credit entries by using a ***trial balance***.

3.5.1. The Trial Balance

The proof of the equality of the debits and credits in the ledger is called trial balance. A trial balance is a list of the ledger accounts at a specific date, showing their balances, and the total of the debit and credit amount columns. The following illustration shows the trial balance of Dehab Taxi Services on September 30, current year.

Dehab Taxi Service
Trial Balance
September 30, current year

Account Title	Debit		Credit	
Cash	1,105,000	00		
Supplies	130,000	00		
Automobiles	740,000	00		
Furniture and Fixtures	10,000	00		
Office Equipment	95,000	00		
Accounts Payable			110,000	00
Taxes Payable			25,000	00
Dehab's Capital			1,815,000	00
Dehab's Drawing	0	00		
Fares Earned			200,000	00
Salary Expense	55,000	00		
Rent Expense	5,000	00		
Utility expense	2,500	00		
Miscellaneous Expense	7,500	00		
Total	2,150,000	00	2,150,000	00

Fiscal Period

A business analyses its financial condition and prepares financial statements at regular intervals. The length of time for which an analysis of business operations is made is called a ***fiscal period (accounting period).*** Fiscal periods may consist of a month, a quarter of a year, a half year, or a year. An accounting period of twelve consecutive months is called a ***fiscal year***. A fiscal year usually begins with the first day of a month and ends twelve months later on the last day of a month. Most businesses in Eritrea use the ***calendar year*** (January 1 to December 31) as their accounting period. Some do not. Customarily, a trial balance is prepared at the end of a fiscal period (an accounting period).

To prepare a trial balance, the accounts are listed in the order in which they appear in the ledger, that is, assets, liabilities, capital, revenues, and expenses. The primary purpose of a trial balance is to prove (Cheque) that debits equal the credits after posting. In addition, it is useful in the preparation of financial statements. A trial balance helps to uncover the errors committed in journalizing and posting.

Preparing a trial balance involves the following steps:

1. Identify each account balance from the ledger.
2. List each account and its balance. Debit balances are entered in the debit (left) column and credit balances in the credit (right) column. If an account has a zero balance, it can be listed in the trial balance with a zero in the column for its normal balance.
3. Compute the total of both debit and credit balances.
4. Verify total debit balances equal total credit balances. Note that account numbers are sometimes shown to the left of the account titles in the trial balance.

The trial balance proves the equality of debits and credits of the ledger. The trial balance provides proof that the general ledger is in balance. This means that the accountant can be sure of three things:

1. For each transaction, the debits and credits were recorded in equal amounts.
2. The balance (debit balances and credit balances) for each account was calculated correctly.
3. The balance of the various debit and credit accounts have been correctly added together to arrive at the total equality of the debits and credits.

Errors that can be discovered by preparing a trial balance

1) **Errors in preparing the trial balance** such as:
   - Transferring incorrectly the amount in the account balance to the trial balance.
   - Incorrectly recording debits as credit or credits as debit.
   - Incorrectly totaling the debit or credit column.
2) **Account balance errors**: errors can occur in calculating the balance of a specific account. For example, misplacing a debit balance in the credit column of the account or credit balance in the debit column of the account.
3) **Transaction errors**: When a transaction is recorded, an error can occur through recording an incorrect amount. For example, to record a debit entry as credit or a credit entry as debit. Another example is to record only one portion of a transaction.

Errors in a trial balance generally result from mathematical mistakes, incorrect postings, or simply transcribing data incorrectly. What do you do if you are faced with a trial balance that does not balance? First determine the amount of the difference between the two columns of the trial balance. After this amount is known, the following steps are often helpful:

1. If the error is Nakfa 1, Nakfa 10, Nakfa 100, or Nakfa 1,000, re-add the trial balance columns and recomputed the account balances.
2. If the error is divisible by 2, scan the trial balance to see whether a balance equal to half the error has been entered in the wrong column.
3. If the error is divisible by 9, retrace the account balances on the trial balance to see whether they are incorrectly copied from the ledger. For example, if a balance was Nakfa 12 and it was listed as Nakfa 21, a Nakfa 9 error has been made. Reversing the order of numbers is called a ***transposition error.***
4. If the error is not divisible by 2 or 9, check the ledger to see whether an account balance in the amount of the error has been omitted from the trial balance, and check the journal to see whether a posting of that amount has been omitted.

One cannot assume that because the trial balance balances, the accounts are correct. It is possible to have errors in the accounts and still have all the debits equal all the credits. The equality of the two totals in the trial balance does not necessarily mean that the accounting process is error-free.

Some of the ***errors that cannot be detected by preparing a trial balance*** are the following:

1) If an incorrect amount is recorded as both a debit and a credit to the proper side of the accounts, the trial balance will balance even though the totals will not be correct.
2) If either an entire transaction is omitted or a transaction is recorded twice, the trial balance would be incorrect even though it would still balance.
3) If correct amounts are recorded to incorrect accounts of the same type, for example, a debit to Cash (asset) is recorded as a debit to Accounts Receivable (asset), the trial balance would be in error but it would still balance.

It is important to review the trial balance to ensure its accuracy and balance.

Activity 3.5.1

Using the following data of Zebib Company, prepare a trial balance as of August 31, 2007.

Account Title	Amount in Nakfa
Zebib, Capital	8,000.00
Zebib's Drawing	650.00
Salaries Expense	450.00
Repairs Expense	150.00
Lodging Fees Earned	2,700.00
Linen Supplies	2,350.00
Accounts Payable	2,450.00
Office Equipment	4,800.00
Accounts Receivable	150.00
Cash	2,800.00
Prepaid Rent	1,800.00

Discuss your trial balance with that of your classmates.

3.5.2. The Work Sheet

The owner of a business needs information as to how well his/her business is doing. At regular intervals, the owner needs information as to whether his/her transactions have resulted in a profit or loss. A trial balance summarizes the information in the ledger accounts, but it does not indicate the amount of the profit or loss. Accountants use draft of financial statements prepared on accounting papers with a number of amount columns called working papers. A working paper in which the financial condition of a business is conveniently summarized is called a ***worksheet***.

A work sheet is a multiple column form that assembles the relationships among the trial balance, proposed adjusting entries and financial statements in one centre. It is defined as a columnar sheet of paper on which accountants list the general ledger accounts before making adjustments and preparing the income statement and balance sheet. It is **only a working tool** and not a permanent accounting record. Accountants generally apply it to minimize the chance of errors in adjusting accounts and to prepare the financial statements at the end of the period. It is usually prepared in pencil. The use of a worksheet is optional.

Purposes of using a Worksheet

Worksheets make it possible to provide the financial statements to management, owners and other interested parties at an earlier date. The worksheet helps the accountants to accomplish the following:

1. It organizes the process of preparing the financial statements
2. It reduces the possibility of introducing errors in that process.
3. It aids in discovering the errors that do occur.
4. It provides periodic statements without the formal adjusting and closing process.

Eight Column Worksheet

We will use the September 30 trial balance of Dehab Taxi Services to illustrate how to prepare a worksheet. Dehab Taxi Services use an eight column worksheet. On the ***heading*** we list the name of the business, (Dehab Taxi Services); name of the form, (worksheet); and the fiscal period, (for the month ended September 30, current year). An ***account title column*** contains a list of the ledgers accounts. The eight columns on Dehab Taxi Service worksheet are composed of pairs of debit and credit of Trial Balance, Adjustments, Income Statement and Balance Sheet. The following illustrates the eight column worksheet format used by Dehab Taxi Services.

Dehab Taxi Service
Worksheet
For the Month Ended September 30, current year

Account Title	Trial Balance		Adjustments		Income Statement		Balance Sheet	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*

Steps in preparing a Worksheet

1. **Prepare a Trial Balance on the Worksheet**

   Trial balance tests the accuracy of debits and credits. The trial balance is used to sort the general ledger account balances in the proper Trial Balance Debit and Credit columns. Enter all ledger accounts in the account titles space. Enter debit and credit amounts from the ledger in the trial balance columns. The illustration worksheet presented in the following pages shows the worksheet trial balance for Dehab Taxi Services, which is the same as the one prepared in the previous section.

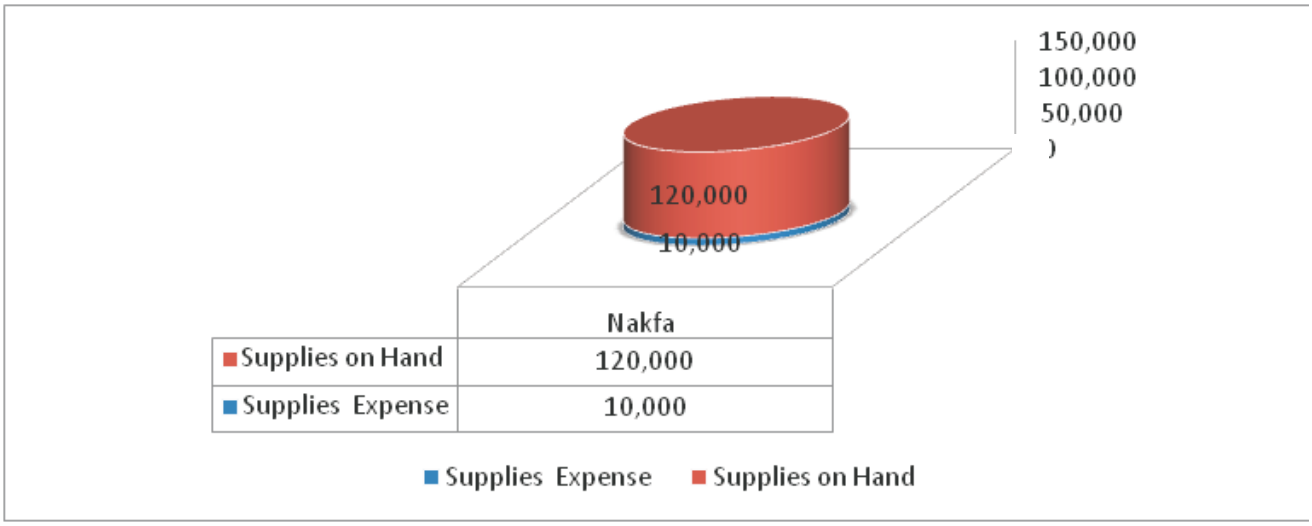
2. **Prepare the Adjustments**

   Certain accounts in the general ledger need to be adjusted so that they will reflect the condition of the business at the end of the fiscal period. ***Adjustments*** are changes that are recorded in accounts at the end of a fiscal period so that accounts will be brought up to date. A journal entry to record adjustment is called ***adjusting entry***. In order for revenues to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred, businesses make adjusting entries. Adjusting entries are required every time a business prepares financial statements. The business analyses each account in the trial balance to determine whether it is complete and up to date for financial statement purposes. Every adjusting entry will include one income statement account and one balance sheet account. Analysis of the ledger accounts of Dehab Taxi Services shows that Supplies, Automobiles, Furniture and Fixtures and Office Equipment need to be updated by adjustments.

i. **Adjusting Supplies**: The purchase of supplies, such as paper, envelopes, fuel and others result in an increase (a debit) to an asset account. During the accounting period, the company uses supplies. Rather than recording supplies expense as the supplies are used, businesses recognize supplies expense at the end of the accounting period. At the end of the accounting period the accountants of the business count the remaining supplies. The difference between the balance in the supplies (asset) account and the actual costs of supplies on hand represent the supplies used (an expense) for the period.

   Recall that Dehab Taxi Services has been buying fuel supplies from Tamoil Eritrea and the trial balance of the business shows a debit balance of Nakfa 130,000 (asset). Fuel supplies purchased during the period are used in the process of delivering services (taxi services). At the end of the period we have to calculate and record the expense of supplies used so that our income statement reflects the correct amount of expense and net income. When the accountants of Dehab Taxi services counted the fuel supplies that are still on hand at the close of business on September 30 current year the fuel at hand was worth Nakfa 120, 000. Thus, the cost of supplies used is Nakfa 10,000.

Supplies balance of the account – supplies on hand = supplies expense
130,000 – 120,000 = 10,000



To correct the supplies account of Dehab Taxi Services, the following adjusting entry is required:

General Journal															Page:_2_	
Date		Description	P/R	Debit						Credit						
C/Y		Adjusting Entries														
Sept	30	Supplies Expense		1	0	0	0	0	00							
		Supplies								1	0	0	0	0	00	

The use of supplies decreases an asset (Supplies account) on the left hand side and decreases the capital on the right hand side of the accounting equation.

After the adjusting entry is posted, the accounts, in T account form, appear as follows:\

Supplies			
Sept.1 Balance	65,000		
Sept. 10	65,000	Sept. 30	10,000
Sept. 30 Balance	120,000		

Supplies Expense	
Sept.30	10,000

The asset account Supplies now shows a balance of Nakfa 120,000, which is equal to the cost of supplies on hand at the statement date. In addition, Supplies Expense shows a balance of Nakfa 10,000, which equals the cost supplies used (expense) in September. If Dehab Taxi Services does not make the adjusting entry, September expenses will be understated and net income overstated by Nakfa 10,000. Moreover, both assets and capital will be overstated by Nakfa 10,000 on the September 30 balance sheet.

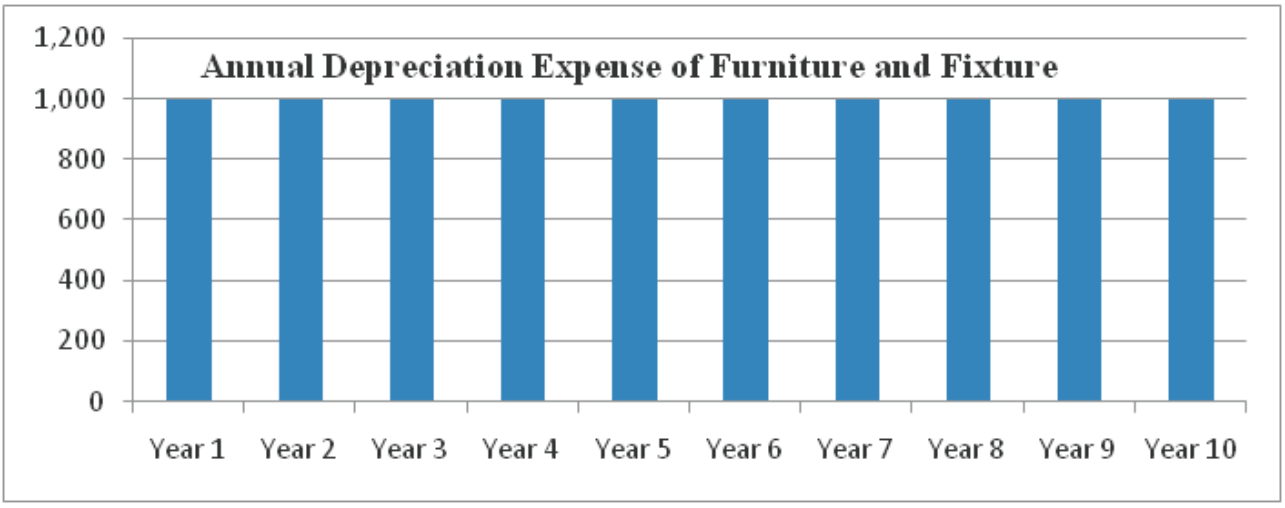
Activity 3.5.2:
Bell Print Shop has Nakfa 750 supplies on August 31, current year on the Trial balance column, but inventory of supplies on August 31, current year is determined by counting to be Nakfa 230. Determine the supplies expenses of the month and journalize the adjusting entry in a general journal, page 3.
Discuss your journal entries with that of your classmates.

ii. Adjusting Fixed Assets: A business typically owns a variety of assets that can be used for many years such as buildings, equipment, furniture and fixture, vehicles and others. These assets that are

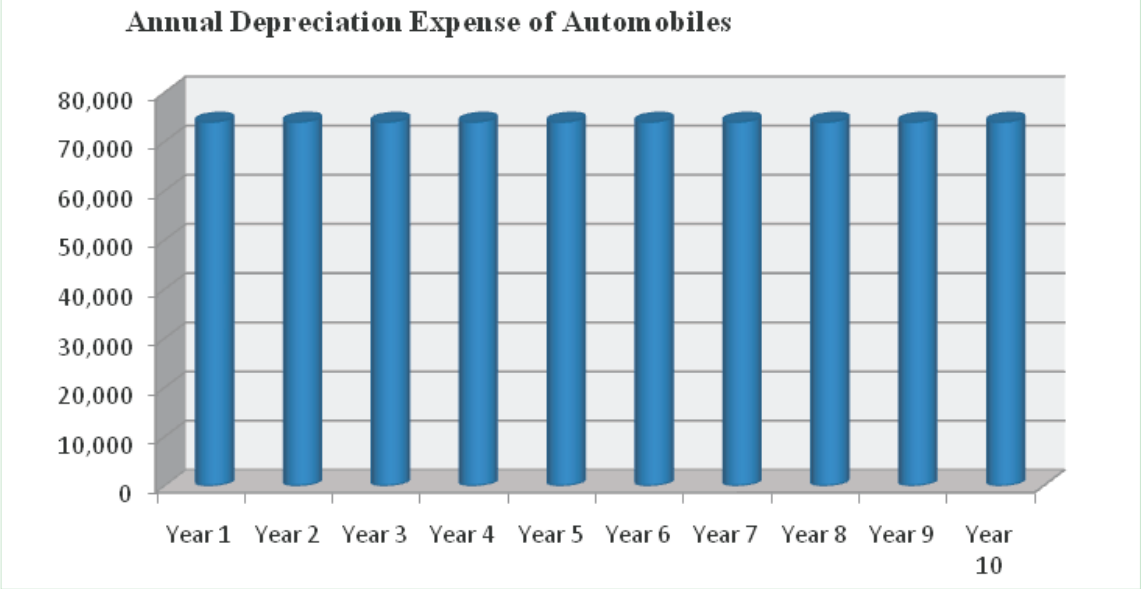
used in a business for more than one year are called ***fixed assets***. All fixed assets are recorded as an asset, rather than an expense, in the year they were acquired, as a result of the historical cost principle. However, companies then report a portion of the cost of fixed assets as an expense during each period of service years. This is called depreciation. ***Depreciation*** is the process of allocating the cost of an asset to expense over its useful service years in a rational and systematic manner. Companies need to make periodic adjusting entries for depreciation, just as they do for supplies. These entries recognize the cost that has been used (an expense) during the period and report unused (an asset) at the end of the period.

A common procedure in computing depreciation expense is to divide the cost of the asset by the service years. For example, Dehab Taxi Services owns fixed assets such as Automobiles, Furniture and fixtures and Office Equipment. The computation of depreciation expenses and adjusting entries is presented as follow:

The cost of Furniture and Fixtures of Dehab Taxi Services is Nakfa 10,000 and useful service years are expected to be 10 years. The annual depreciation is computed by dividing the cost of the asset (Nakfa 10,000) by the service years (10 years). Thus, annual depreciation is Nakfa 1,200 per year or Nakfa 83 per month.

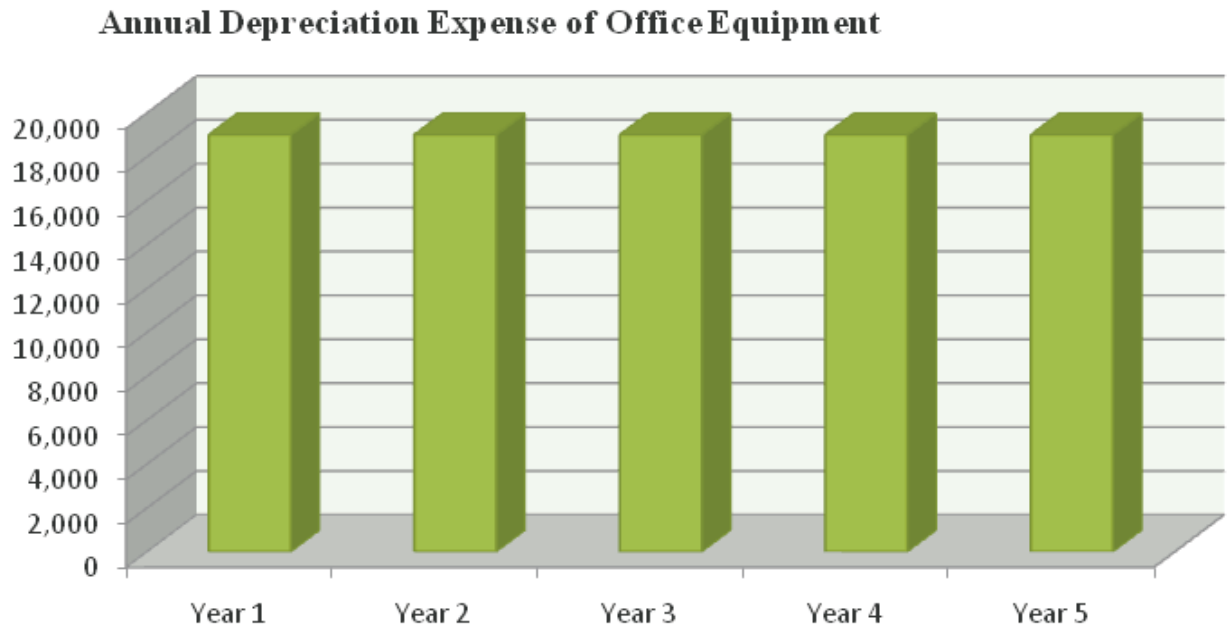


The cost of Automobiles of Dehab Taxi Services is Nakfa 740,000 and useful service years are expected to be 10 years. The annual depreciation is computed by dividing the cost of the asset (Nakfa 740,000) by the service years (10 years). Thus, annual depreciation is Nakfa 74,000 per year or Nakfa 6,167 per month.



Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
6,167	6,167	6,167	6,167	6,167	6,167	6,167	6,167	6,167	6,167	6,167	6,167	74,000

The cost of Office Equipment of Dehab Taxi Services is Nakfa 95,000 and useful service years are expected to be 5 years. The annual depreciation is computed by dividing the cost of the asset (Nakfa 95,000) by the service years (5 years). Thus, annual depreciation is Nakfa 19,000 per year or Nakfa 1,583 per month.



Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
1,583	1,583	1,583	1,583	1,583	1,583	1,583	1,583	1,583	1,583	1,583	1,583	19,000

Thus, Dehab Taxi Services makes the following adjusting entry to record depreciation for September

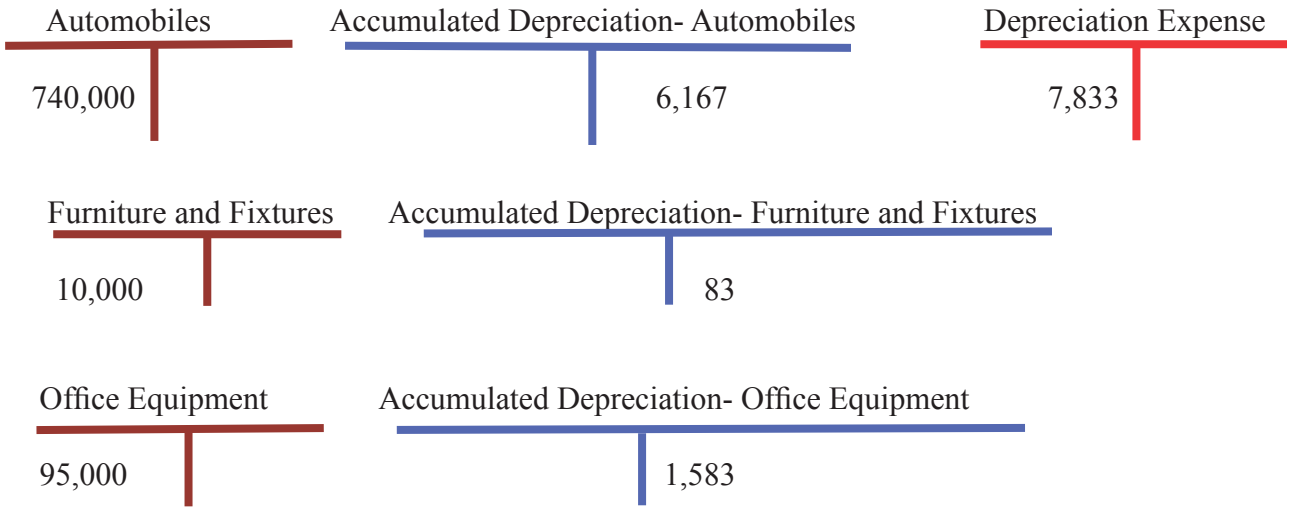
General Journal **Page: 2**

Date		Description	PR	Debit						Credit					
C/Y		Adjusting Entries													
Sep	30	Supplies Expense		1	0	0	0	0	00						
		Supplies								1	0	0	0	0	00
	30	Depreciation Expenses			7	8	3	3	00						
		Accumulated depreciation-Automobiles									6	1	6	7	00
		Accumulated depreciation-Furniture & Fixtures											8	3	00
		Accumulated depreciation-Office Equipment									1	5	8	3	00

In order to disclose the original cost of the plant assets, the depreciation amount is credited to ***accumulated depreciation*** account rather than to the asset account itself. Accumulated depreciation is a ***contra***

asset account. This means, it is offset against an asset account on the balance sheet. This accumulated depreciation account appears just after the account it offsets on the balance sheet. Its normal balance is a credit.

After the adjusting entry is posted, the accounts show:



In the balance sheet of Dehab Taxi Services, the accumulated depreciation is deducted from its related asset account as follows:

Automobiles	Nakfa 74,000	
Less: Accumulated Depreciation Expense-Automobiles	6,167	Nakfa 67,833
Furniture and Fixtures	Nakfa 10,000	
Less: Accumulated Depreciation Expense-Automobiles	83	Nakfa 9,917
Office Equipment	Nakfa 95,000	
Less: Accumulated Depreciation Expense-Automobiles	1,583	Nakfa 93,417

The illustration of the adjustment of supplies and depreciation on a worksheet is presented on the following page.

3. <u>Extend balances to the Income Statement and Balance Sheet Columns</u>

Assets and owners drawing ……..……. Debit column of Balance Sheet
Liabilities, capital and accumulated depreciation …… Credit column of Balance Sheet
Revenues ……..…..... Credit column of Income Statement
Expenses ……..…… Debit column of Income Statement

4. <u>Completing the Worksheet</u> – This involves the following:

i. Rule and total the Income Statement and Balance Sheet columns.
ii. Calculate the difference between the Income Statement debit and credit columns. Also compute the difference between Balance Sheet debit and credit columns.
iii. Total and rule the columns.

If the Income Statement credit column is greater than the Income Statement debit column, a net income is generated. If the Income Statement debit column is greater than the Income Statement credit column, then there may be a net loss. Again, the difference between the Income Statement columns and Balance Sheet columns must be equal.

Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
83	83	83	83	83	83	83	83	83	83	83	83	1,000

Dehab Taxi Service
Worksheet
For the Month Ended September 30, current year

Account Title	Trial Balance		Adjustments		Income Statement		Balance Sheet	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	1,105,000						1,105,000	
Supplies	130,000			10,000			120,000	
Automobiles	740,000						740,000	
Furniture &Fixtures	10,000						10,000	
Office Equipment	95,000						95,000	
Accounts Payable		110,000						110,000
Taxes Payable		25,000						25,000
Dehab's Capital		1,815,000						1,815,000
Dehab's Drawing								
Fares Earned		200,000				200,000		
Salary Expense	55,000				55,000			
Rent Expense	5,000				5,000			
Utility Expense	2,500				2,500			
Miscellaneous Exp.	7,500				7,500			
Total	2,150,000	2,150,000						
Supplies Expense			10,000		10,000			
Depreciation Exp			7,833		7,833			
Acc Dep- Automobile				6,167				6,167
Acc Dep- Furniture				83				83
Acc Dep- Office Equip				1,583				1,583
Total			**17,833**	**17,833**	**87,833**	**200,000**	**2,070,000**	**1,957,833**
Net Income					112,167			112,167
					200,000	**200,000**	**2,070,000**	**2,070,000**

Keep in mind that the sole purpose of the worksheet is to help you prepare the financial statement. If the worksheet didn't serve this purpose, we wouldn't use it. Once the worksheet is completed and checked, it is easy to prepare the financial statements. First prepare the income statement then you can prepare the statement of capital (owner's equity) and balance sheet respectively.

Box 3.5.1: Commercial Law is the Base for Keeping Accounts and Preparing Financial Statements.

Many countries use law-based accounting system. In Eritrea, the Provisional Commercial code of Eritrea serves as a base for keeping accounts and preparing financial statements. For instance:

Article 63 (1): Any person or business organization carrying on trade shall keep such books and accounts as are required in accordance with business practice and regulations, having regard to the nature and importance of the trade carried on.

Article 66 (1): Every trader shall keep a journal where he/she shall make daily entries of all his/her dealings regardless of the nature of such dealings or manner in which they were carried out.

(2) He/she may at least once a month balance the proceeds of such dealings and shall in such a case preserve all documents necessary for checking these dealings day by day.

Article 67 (1): When beginning to carry on his/her trade, every trader shall prepare an inventory and a balance sheet.

(2) A trader shall also, at the end of each financial year, prepare an inventory of his her assets and liabilities and balance his accounts for the purpose of preparing the final balance sheet and the profit and loss account. The balance sheet and the profit and loss account shall be entered in special books.

Article 69: All books and accounting documents shall be preserved for ten years from thedate of the last entry in such books or from the date of such documents.

Article 74 (1): The balance sheet shall show, as assets, all the debit balances and as liabilities, all the credit balances.

Article 80 (1): The capital is the original value of the elements put at the disposal of the undertaking by the owner by way of contributions in cash or in kind.

Article 83: The adjustments accounts are intended to correct debts and amounts owing not written in ordinary accounts so that only those effective debts and monies owing appear at any particular financial year.

Summary

A trial balance is a list of accounts and their balances at a point in time. It is the proof of the equality of the debits and the credits in the ledger. It is useful in the preparation of financial statements. The equality of the two totals in the trial balance does not necessarily mean that the accounting process has been error-free. It is possible to have errors in the accounts and still have all the debits equal all the credits.

A worksheet is a multiple column form that assembles the relationships among the trial balance, proposed adjusting entries and financial statements. Once the worksheet is completed and checked, it is easy to prepare the financial statements. First prepare the income statement and then you can prepare the statement of capital (owner's equity) and balance sheet respectively. A journal entry to record adjustments is called an adjusting entry.

Key Terms

Trial balance	Adjustments	Worksheet
Owner's Equity	Fiscal period	Fixed assets
Transposition error	Accounting period	Depreciation
Adjusting entry	Fiscal year	
Calendar year	Accumulated depreciation	

Review Questions

1. Define trial balance, and discuss its purpose?
2. Illustrate the steps followed in the preparation of the trial balance?
3. What kind of errors can be discovered by preparing a trial balance?
4. What kind of errors in journalizing and posting are not detected by a trial balance even though it is in balance?
5. Why do we prepare the worksheet prepared?
6. Discuss the steps followed in preparing the worksheet?
7. When the total of the income statement credit column is larger than the total of the income statement debit column what is the amount of the difference called?
8. Why is the amount of net income obtained from the income statement column of the worksheet extended to the balance sheet credit column?

Exercise 3.5.1.

The trial balance of Dahalk Company appears below. The bookkeeper of the company incorrectly recorded some accounts while transferring the data from the ledger to the trial balance. Thus, the trial balance is not balanced. Present a correct trial balance based on the normal balance of each account.

Dahalk Company
Trial Balance
September 30, Current year

Account Title	Debit	Credit
Cash	29,000.00	
Office furniture		4,000.00
Equipment		500.00
Accounts Payable	3,000.00	
Capital		12,500.00
Sales Income	33,000.00	
Rent Expense	1,000.00	
Salary Expense	10,000.00	
General Expense		4,000.00
Total	76,000.00	21,000.00

Problem 3.5.1.

As a continuation to problem 3.4.1 prepare the trial balance for Forto Restaurant as of March 31 current year.

Problem 3.5.2.

As a continuation to problem 3.4.2 prepare the trial balance for Assab Swimming Pool as of January 31 current year.

Problem 3.5.3.

As a continuation to problem 3.4.3 prepare the trial balance for Semira Dental Care Services as of February 28 current year.

Problem 3.5.4.
As a continuation to problem 3.4.4 prepare the trial balance for Nur Salih Attorney as of October 31 current year.

Problem 3.5.5.
Genet cleaning company entered into the following transactions during the month of November current year. She made initial investment of Nakfa 250.

1 Acquired office supplies on account, Nakfa 220.
3. Paid rent for the month, Nakfa 170.
5. Paid telephone bill for the month, Nakfa 35.
9. Received cash for cleaning performed on this date, Nakfa 320.
10. Paid advertising in the local newspaper, Nakfa 55.
14. Withdrew cash from the business, Nakfa 125.
17. Billed customers for cleaning services rendered Nakfa 435.
19. Made a payment to creditors for the supplies acquired in November. 1 transaction, Nakfa 110
23. Paid salaries to employees, Nakfa 90.
27. Received payment from customers on account, Nakfa 315.
30. Paid electric bill for the month, Nakfa 45.

Additional information
1. On November 30 the supplies on hand remaining determined by physical count was Nakfa 200.

Required
1. Record the transactions in a general journal page number 1.
2. Post the transactions (use T-accounts in the posting process).
3. Prepare a trial balance.
4. Prepare the necessary adjustments and record them in the general journal.
5. Complete the worksheet.

Problem 3.5.6.
The trial balance of Bidho Company year ended October 31, current year was as follows:

Bidho Company
Trial Balance
October 31, current year

Cash	Nakfa19,600	
Accounts Receivable	30,800	
Office Supplies	31,200	
Office Equipment	70,000	
Accounts Payable		33,000
Bidho, Capital		94,500
Bidho, Withdrawals	8,200	
Fares Earned		80,100
Salary Expense	46,200	
Utilities Expense	1,600	
Total	207,600	207,600

Additional Information for Adjustments
1. Office Supplies on hand on October.31, current year are Nakfa 10,000.
2. The monthly depreciation expense of office equipment is Nakfa 1,000.

Instructions:

1. Complete the worksheet.

3.6 Financial Statements, Closing the Ledger and Post Closing Trial Balance

Focus Questions:

1. What do the terms temporary and permanent mean?
2. Could you distinguish the temporary and permanent workers in a business?
3. What do you understand by temporary accounts and permanent accounts in a business?

3.6.1 Financial Statements for Business Entities

Business entities communicate their financial information to interested users through published financial statements. These statements represent the end product of the general financial activity.

The main objective of financial accounting is to describe the financial conditions and operations of a business entity, and this is done through the financial statements. Financial statements are designed to provide users with information concerning the profitability and solvency (the capacity to pay debts of business entities).

3.6.2. Income Statement

The financial statement that reports the profitability of a business entity is the income statement. The statement showing the income, expense and the net income or the net loss for a particular period of time is called the ***income statement***. When the total income exceeds the total expense the difference is called ***net income (profit)***. When the total expenses exceed the total income, the difference is called ***net loss (loss)***.

Dehab Taxi Service
Income Statement
For the month ended September 30, current year

Fares Earned			200,000	00
Operating Expense:				
Salaries Expense	55,000	00		
Supplies Expense	10,000	00		
Rent Expense	5,000	00		
Utilities Expense	2,500	00		
Miscellaneous Expense	7,500	00		
Depreciation Expense	7,833	00		
Total Operating Expenses			87,833	00
Net Income			**112,167**	**00**

Revenue is the amount charged for goods or services rendered. It represents the inflow of economic resources to a business entity. For example: sales, commissions, rental fees, professional fees, fares, interest and others.

Expenses represent the economic resources consumed in providing products or services to customers. For example supplies, salary, rent, utilities and others.

Profit: when a business has more revenue than expenses, the difference is profit (Net income). When expenses exceed revenue, the difference is called net loss and it shows that the business has been unprofitable.

Steps in the Preparation of the Income Statement

1) Prepare heading.
2) Prepare the income section.
3) Prepare the expense section.
4) Figure out the net income (or net loss).
5) Rule the income statement.

3.6.3. Capital Statement

A report that summarizes the changes in the proprietor's capital that have occurred during the fiscal period is called ***capital statement***. It shows how owner's investment has changed from the start of the period to the end of a period. It is a connecting link between the income statement and the balance sheet.

Dehab Taxi Service
Capital Statement
For the Month ended September 30, Current year

Capital, September 1, current year			1,815,000	00
Net Income for the month	112,167	00		
Less Dehab's Drawings	0	00		
Increase in capital			112,167	00
Capital, September 30, current year			**1,927,167**	**00**

3.6.4. The Balance Sheet

The financial statement designed to show a business entity's financial position -what is owned and what it owed -*on a particular date* is called the balance sheet. The balance sheet consists of two sides. The left side represents what the firm owns, its assets, the right side represents what the firm owes, its liabilities, and the amount of owner's investment in the business, capital.

The **heading** of a balance sheet has **three** important parts, as follows:

Line 1: The name of the company
Line 2: The type of financial statement
Line 3: The date of the balance sheet

The balance sheet is a listing of assets, liabilities, and owner's equity *at a point in time*. The **assets** of an economic entity are the economic resources that are owned by the entity and are expected to provide future benefits. To be included on the balance sheet as an asset, an economic resource must be *measurable*. If not measurable it is not an asset. The assets of the firm may be physical in nature like cash, merchandise, supplies, equipment and non physical like accounts receivable, etc.

Liabilities are economic resources that are owed by the firm and are expected to provide future economic sacrifices (obligations).

Capital is the residual interest that is left to the owners after all the liabilities –debts- are settled or satisfied.

Dehab Taxi Service				
Balance Sheet				
September 30, current year				
Assets			**Liabilities and Capital**	
Cash		1,105,000.00	**Liabilities**	
Supplies		120,000.00	Accounts Payable	110,000.00
Automobiles	740,000		Taxes Payable	25,000.00
Less:Accu. Dep	-6,167	733,833.00	Total Liabilities	135,000.00
Furniture & fixtures	10,000			
Less: Accu. Dep	-83	9917.00		
Office Equipment	95,000		**Capital**	
Less: Accu. Dep	-1,583	93,417.00	Dehab's Capital	1,927,167.00
Total Assets		**2,070,000.00**	**Total Liabilities and Capital**	**2,070,000.00**

3.6.5. Closing the Books and Closing Entries

At the end of the accounting period, the company makes the accounts ready for the next period. This is called ***closing the books***. In closing the books, the company distinguishes between temporary and permanent accounts.

1. ***Permanent accounts*** or ***Real accounts*** are accounts that appear on the balance sheet (assets, liability and capital accounts). They ***are not closed*** from period to period.
2. ***Temporary accounts*** or ***Nominal accounts*** are accounts that appear on the income statement, which are revenue accounts and expense accounts. The drawings made by owners for personal use is also considered as nominal account and hence closed at the end of the fiscal period.

In this process of closing, all of the nominal or temporary accounts are reduced to zero (closed) so they will be ready for the next accounting period. The final effect of closing out such balances is a net increase or a net decrease in the capital account (owner's equity account).

An entry that transfers the balance from one account to another is called a ***closing entry***. The balance of each revenue account and each expense account is transferred at the end of the fiscal to ***Income Summary account.*** The income summary account for itself is a temporary account. The process of transferring the balances of the income and the expense accounts through a summary account to the proprietor's capital account is called ***closing the ledger.***

The closing process is the act of transferring (1) the balance in the revenue and expense accounts to income summary and then to owner's capital, and (2) the balance in the owner's drawing account to the owner's capital account.

Closing entries serve two basic purposes. The first is to return the balances of the revenue and expenses to zero so that these accounts may be used in next accounting period. The second purpose of closing entries is to update the balance of the capital account.

Generally four closing entries are needed: (1) close the revenue accounts to the income summary account, (2) close the expense accounts to the income summary account, (3) close the balance of theincome summary account to the capital account, and (4) close the drawing account to the capital account. The closing entries are recorded in the general journal immediately following the adjusting entries.

The four basic steps in the closing process are: using Dehab Taxi Services:

1. **Closing the revenue:** transferring the balances in the revenue accounts to income summary. A revenue account is closed by debiting it by an amount equal to its credit balance. Since income has a credit balance, it should be transferred to the debit side of the income summary account by the following entry:

General Journal																		**Page: 3**
Date		**Account Title**	**P/ R**	**Debit**							**Credit**							
	31	**Revenue**	**41**	2	0	0	0	0	0	00								
		Income Summary	**42**								2	0	0	0	0	0	00	

2. **Closing the expense accounts:** transferring the balances in the expense accounts to income summary. An expense account is closed by crediting it for the amount equal to the debit balance. Expenses have debit balances so it will be transferred to the debit side of income summary by the following entry:

General Journal																		Page: 3
Date		Account Title	P/ R	Debit							Credit							
	31	Revenue	41	2	0	0	0	0	0	00								
		Income Summary	42								2	0	0	0	0	0	00	
		Closing revenue accounts																
		Income Summary	42		8	7	8	3	3	00								
		Salary Expense	51									5	5	0	0	0	00	
		Rent Expense	52										5	0	0	0	00	
		Utility Expense	53										2	5	0	0	00	
		Miscellaneous Expense	54										7	5	0	0	00	
		Supplies Expense	55									1	0	0	0	0	00	
		Depreciation Expense	56										7	8	3	3	00	
		Closing expense accounts																

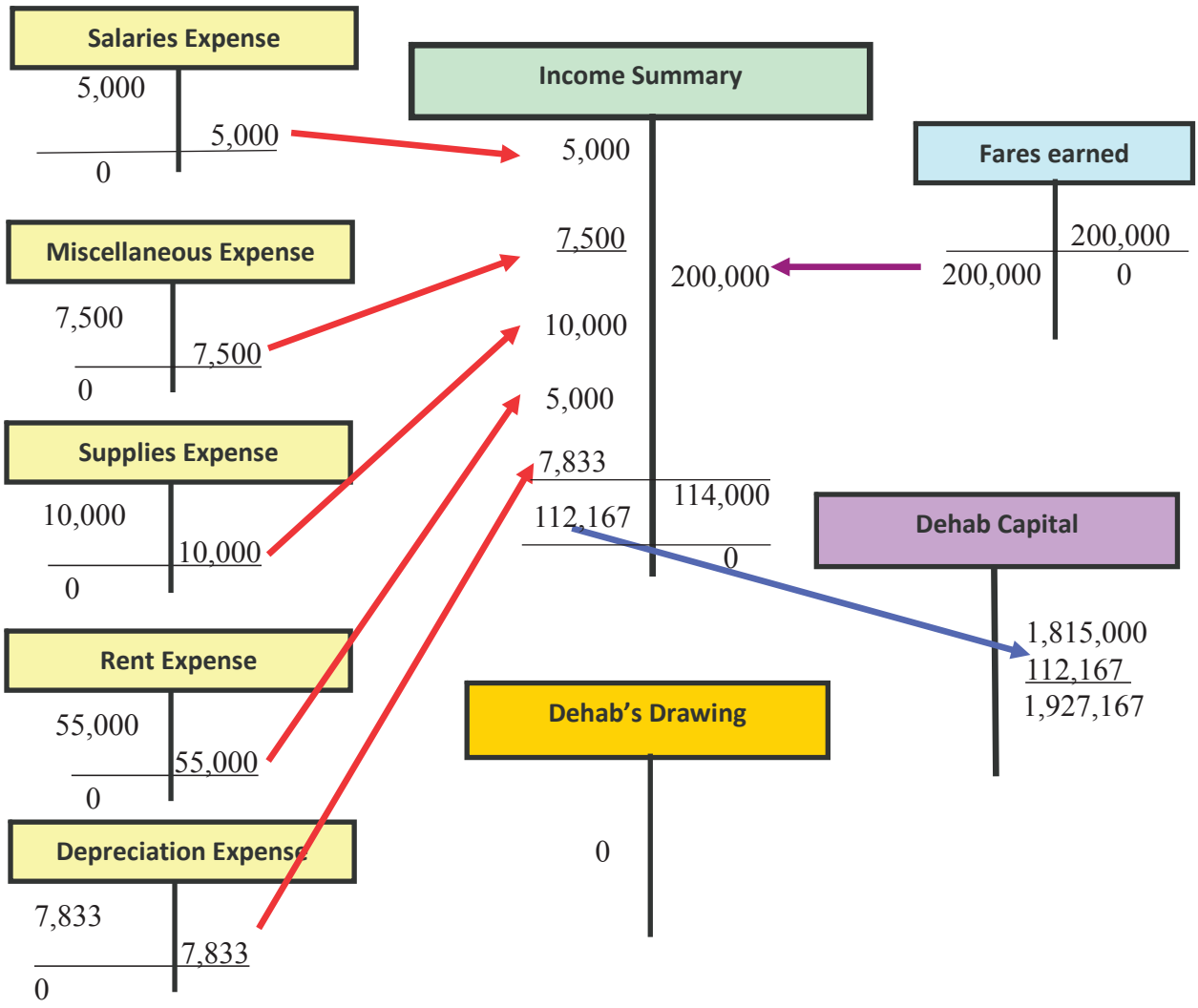
3. **Closing the income summary account:** transferring the balance of income summary account to owner's capital account. The income summary as its name indicates is just a summary. The income summary balance is the difference between the sum of the transferred debits (expenses) and the sum of transferred credits (revenues) which is the net income for the period. This will increase the capital account by the amount of net income, The balance in the income summary account is transferred to the capital account by the following entry.

General Journal																Page: 3		
Date		**Account Title**	**P/ R**	**Debit**							**Credit**							
	31	Revenue	**41**	2	0	0	0	0	0	00								
		Income Summary	**42**								2	0	0	0	0	0	00	
		Closing revenue accounts																
		Income Summary	**42**		8	7	8	3	3	00								
		Salary Expense	**51**									5	5	0	0	0	00	
		Rent Expense	**52**										5	0	0	0	00	
		Utility Expense	**53**										2	5	0	0	00	
		Miscellaneous Expense	**54**										7	5	0	0	00	
		Supplies Expense	**55**									1	0	0	0	0	00	
		Depreciation Expense	**56**										7	8	3	3	00	
		Closing expense accounts																
		Income Summary	**42**	1	1	2	1	6	7	00								
		Dehab's Capital	**31**								1	1	2	1	6	7	00	
		Closing Income Summary																

4. **Closing the owner's drawing account:** transferring the balance of the owner's drawing account to the owner's capital account. Since withdrawals are not expenses, it is not closed to the income summary. Instead, withdrawals are reductions in the capital of the business; they are accumulated in the withdrawing account. They are directly closed to the capital account. Dehab did not withdraw money for her personal purposes, thus her drawing account shows zero balance. Assume another businessperson, Mr. Henok, withdrew Nakfa 10,000 for his personal use. The closing entry is accomplished by the following general journal entry.

General Journal																Page: 3		
Date		**Account Title**	**P/ R**	**Debit**							**Credit**							
	31	Henok's Capital			1	0	0	0	0	00								
		Henok's Drawing										1	0	0	0	0	00	
		Closing Drawing account																

Remember that only revenue, expense and drawing accounts are closed



Posting the closing entries to the nominal accounts of Dehab Taxi services.

Account Title: Fares Earned																									Account Number: 41
Date		Item	P/R	Debit							Credit							Balance							
C/Y Sept.	30		J2								2	0	0	0	0	0	00	2	0	0	0	0	0	00
			J3	2	0	0	0	0	0	00													0	00

Account Title: Wages Expense																									Account Number: 51
Date		Item	P/R	Debit							Credit							Balance							
C/Y Sept.	30		J2		5	5	0	0	0	00									5	5	0	0	0	00
			J3									5	5	0	0	0	00						0	00

Account Title: Rent Expenses Account Number: 52

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	30		J2	500.00		500.00
			J3		500.00	0.00

Account Title: Utilities Expenses Account Number: 53

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	30		J2	250.00		250.00
			J3		250.00	0.00

Account Title: Miscellaneous Expenses Account Number: 54

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	30		J2	75.00		75.00
			J3		75.00	0.00

Account Title: Supplies Expenses Account Number: 55

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	30		J2	100.00		100.00
			J3		100.00	0.00

Account Title: Depreciation Expenses Account Number: 56

Date		Item	P/R	Debit	Credit	Balance
Current Sept.	30		J2	783.00		783.00
			J3		783.00	0.00

3.6.6. Post Closing Trial Balance

The trial balance taken after adjusting and closing entries have been posted is called ***Post Closing Trial Balance***. A post closing trial balance contains only assets, liabilities, and the owners capital account because the revenue, expense, and withdrawals accounts have been closed, and their balances having transferred to the capital account and left with a zero balance. As the name indicates the post closing trial balance is prepared after the adjusting and closing entries are posted to the general ledgers.

After the revenue and expense accounts have been closed, it is desirable to prepare an after-closing trial balance consisting solely of balance sheet accounts. The post-closing trial balance, gives assurance that the accounts of the general ledger are in balance and ready for recording transactions for the new accounting period.

Account Title: Cash — Account Number: 11

Date		Item	P/R	Debit								Credit							Balance							
C/Y Sep	1	Bal	J1		1	4	5	0	0	0	00									1	4	5	0	0	0	00
	30		C1	1	1	0	5	0	0	0	00								1	2	5	0	0	0	0	00
	30		C1									1	4	5	0	0	0	00	1	1	0	5	0	0	0	00

Account Title: Supplies — Account Number: 12

Date		Item	P/R	Debit							Credit							Balance							
CY Sep	1	Bal	J1		6	5	0	0	0	00									6	5	0	0	0	00
	10		J2		6	5	0	0	0	00								1	3	0	0	0	0	00
	30		J3								1	0	0	0	0	00		1	2	0	0	0	0	00

Account Title: Automobiles — Account Number: 13

Date		Item	P/R	Debit							Credit							Balance							
CY Sep	1	Balance	J1	7	4	0	0	0	0	00								7	4	0	0	0	0	00

Account Title: Furniture and Fixtures — Account Number: 14

Date		Item	P/R	Debit							Credit							Balance							
CY Sep	1	Bal	J1		1	5	0	0	0	00									1	5	0	0	0	00
	20		C2										5	0	0	0	00		1	0	0	0	0	00

Account Title: Office Equipment — Account Number: 15

Date		Item	P/R	Debit							Credit							Balance							
CY Sep	1	Balance	J1		5	0	0	0	0	00									5	0	0	0	0	00
	5		C2		4	5	0	0	0	00									9	5	0	0	0	00

Account Title: Accounts Payable — Account Number: 21

Date		Item	P/R	Debit							Credit							Balance							
CY Sep	1	Bal	J1									7	5	0	0	0	00			7	5	0	0	0	00
	10		J2									6	5	0	0	0	00		1	4	0	0	0	0	00
	15		C2		3	0	0	0	0	00									1	1	0	0	0	0	00

| Account Title: Taxes Payable | | | | Account Number: 22 | | | |

The income statement reports the profitability of a business entity. Profit: when a business has more revenue than expenses, the difference is net income. When expenses exceed revenue, the difference is called a net loss.

A capital statement reports changes in capital during a fiscal period.

A the balance sheet is a listing of assets, liabilities, and owner's equity *at a point in time*.

Key Terms

Income Summary account	Capital account	Expense accounts
Drawing account	Permanent accounts	Nominal accounts
Revenue accounts	Profit	Post closing trial balance
Income statement	Capital statement	Balance sheet

Review Questions

1. What does the closing process accomplish?
2. Discuss the purpose of an income statement?
3. Illustrate the purpose of a balance sheet?
4. What is the difference between the heading of an income statement and the heading of the balance sheet?
5. How does each expense and revenue transaction affect the capital account?
6. Discuss the four basic steps in the closing process?
7. What is the purpose of post closing trial balance?
8. Describe revenue?
9. Define an expense?
10. What is a capital statement?

Exercise. 3.6.1.

The worksheet of Elsa Beauty Salon for the month ended June 30, current year is given below:

Elsa Beauty Salon
Worksheet
For the month ended June 30 current year

Account Title	Trial Balance		Adjustments		Income Statement		Balance Sheet	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	260							
Supplies	250							
Equipment	1,710							
Accumulated Depreciation								
Accounts Payable		220						
Elsa's Capital		1,255						
Sales		1,450						
Advertising Expense	75							
Electricity Expense	30							
Miscellaneous Exp	160							
Rent Expense	90							
Salary Expense	350							
Total	**2,925**	**2,925**						
Supplies Expense								
Depreciation Expense								
Total								
Net Income								

Instructions:

i) The adjustments for the year are:
   a. Supplies on hand at the end of the year determined by physical count is Nakfa 100.
   b. Depreciation expense of the period is Nakfa 110.

ii) Complete the worksheet given above.
iii) Prepare the three basic financial statements.
iv) Record the closing entries in a two column general journal.
v) Prepare post closing trial balance.

Problem: **3.6.1.**
Prepare the three basic financial statements for Bidho Company given in problem 3.5.2.

Project 1.
Asmara Medical Studio has the following accounts in its ledger as of January1, current year.
Cash=12,000; Accounts Receivable=4,500; Supplies=6,500; Office equipment=15,000; Accounts Payable =13,000; Capital =25,000; Drawing; Fees Earned; Rent Expense.; Advertising . Expense; Salary Expense; Miscellaneous Expense.
The following transactions were completed during the month of January.

January
1. Paid rent for the month, Nakfa 2,750.
2. Paid cash for supplies, Nakfa 300.
8. Purchased office equipment on account, Nakfa 450.
13. Paid advertising expense, Nakfa 280.

15. Received cash from customers on account, Nakfa370.
18. Paid creditors on account, Nakfa 150.
25. Withdrew cash for personal use, Nakfa 300.
29. Paid telephone bill for the month, Nakfa 50.
30. Paid electricity bill for the month, Nakfa 90.
31. Fees earned for the month, Nakfa 9,000.
31. Paid employees, for the month's salary Nakfa 2,500.

Instructions:

1. Determine whether the item affected is asset, liability, or capital account.
2. Determine whether the item affected increases or decreases assets liabilities or capital.
3. Record the transactions in a two-column journal.
4. Post the transactions to the ledger (use T accounts) N.B. don't forget the existing balances.
5. Prepare a trial balance as of January 31, current year.
6. The following adjustments were necessary at the end of the month:
    a. The supplies on hand at the end of the month were Nakfa 6,600.
    b. Depreciation expense for the month was Nakfa 50.
7. Complete the worksheet filling in the adjustments.
8. Prepare the three basic financial statements.
9. Journalize the closing entries.
10. Prepare a post-closing trial balance.

Project 2

The complete bookkeeping cycle

The purpose of this project is to help you review all the steps in the bookkeeping process that have been developed in the preceding six sub units. These steps are:

1. Journalizing business transactions.
2. Footing, proving and ruling the cash journal.
3. Posting to the ledger accounts.
4. Preparing a trial balance and completing a worksheet.
5. Preparing financial statements.
6. Closing the ledger.
7. Preparing a post closing trial balance.

About the project

Name of the business: Africa Car Hire Agency.
Proprietor: Abraham Haile.
Type of income: Commission Income.

The agency earns income from the **rent of automobiles** and **sale of automobile**s. All income from the commission is recorded as "**Commission Income**".

The chart of accounts of Africa Car Hire Agency is shown below:

Car Hire Agency
Chart of Accounts

Account Title	Account Number	Account Title	Account Number
Assets		**Income**	
Cash	11	Commission income	41
Automobiles	12	**Expenses**	
Office Furniture	13	Adverting Expense	52
Office Machine	14	Automobile Expense	52
Liabilities		Entertainment Expense	53
Commercial bank	21	Miscellaneous Expenses	54
Helen's company	22	Rent Expenses	55
Capital			
Abraham Haile	31		

Instructions:

1. Open accounts in the ledger in the order listed in the chart of accounts. Allow three lines for each. Number them as given in the chart of accounts.
2. Copy the following balances in the ledger using the date December 1, current year. Then write the word balance in the item column of each account and place a check mark (√) in the post reference column.

	Debit Balance	Credit Balance
Cash	3,200	
Automobiles	14,690	
Office Furniture	450	
Office Machine	2,100	
Commercial bank		2,000
Helen's Comp		300
Abraham Haile Capital		18,140

3. Rule a Cash journal page 2. In the cash journal use the column heading Commission Income Credit.
4. Record the following transactions in the cash journal. Begin cheque number with 31 and receipt number with 51.

   NB.

   Advertising expense = for all advertising.
   Automobile expense = for the cost of operating the automobile for business purposes.
   Entertainment expense = for the cost of entertaining prospective customers.
   Miscellaneous expense = for expenses such as postage, stationery, electricity, telephone services and any expense item not covered by other expense
   Rent expense = for house rent.

5. **Transactions.**

December 1. Received cash as commission for sale of automobile Nakfa 200.00.
2. Paid November rent Nakfa 250.00.
3. Bought additional office furniture in cash Nakfa 270.00.
6. Received cash as commission for rental of automobile for tourist Nakfa 295.00.
8. Received cash as commission for sale of automobile Nakfa 2,500.00.
9. Bought new typewriter for Nakfa 998.00.
11. Bought gas oil for automobile Nakfa 13.20.
12. Received cash as commission for rental of automobile Nakfa 350.00.
13. Paid for advertising in daily newspaper, the Eritrean Profile Nakfa 79.00.

14. Paid restaurant bill entertaining prospective customer Nakfa 9.90.
14. Received cash as commission from sale of automobile to a private customer Nakfa 1,375.00.
15. Bought new office desk Nakfa 60.00 in cash.
15. Paid for advertising on TV Nakfa 120.00.
18. Paid restaurant bill entertaining prospective customer Nakfa 17.10.
20. Paid gas oil for automobile Nakfa 13.00.
20. Received cash as for sale of old furniture Nakfa 175.00.
23. Received cash as commission for rental of automobile Nakfa 700.00.
25. Received cash as for sale of old typewriter Nakfa 380.00.
26. Paid postage stamps Nakfa 10.00.
27. Paid cash for repairing the automobile Nakfa 105.00.
28. Received cash as commission for rental of automobile Nakfa 25.00.
29. Paid for electricity bill Nakfa 12.00.
29. Paid cash for telephone bill Nakfa 34.80.
30. Paid Helen's Comp all the amount owed Nakfa 300.00.
30. Paid Commercial Bank for amount owed Nakfa 100.00.
30. Received cash as commission for sale of automobile Nakfa 980

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