PRINCIPLES OF ACCOUNTING PART I (ACFN1031)

DEGREE PROGRAM

DEPARTMENT OF ACCOUNTING AND FINANCE
COLLAGE OF BUSINESS AND ECONOMICS
WOLLO UNIVERSITY

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PREFACE

Dear Students!

Why This Course? *Like the other disciplines, the accounting course offers something similar: To understand a business, you have to understand the financial insides of a business organization. An accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company or a single-owner simple shop, accounting helps to know about the company's financial position and operating result for a given period. Thus, knowing the fundamentals of accounting will help you understand what is happening in the organization. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will be much the wiser for having taken this course.*

Why This Module? *Hundreds of thousands of students have used the course entitled* ***Principles of Accounting****. This module contains features to help you learn best, whatever your learning style. To understand what your learning style is, spend about enough time until you grasp the principles and concepts of accounting. Then, look at and workout the self-examination questions provided at the end of each chapters. This is one course where doing is learning, and the more time you spend on the doing questions, the more likely you are to learn the essential concepts, techniques, and methods of accounting.*

Structures of the Module: *the course -* ***Principles of Accounting –*** *has two parts (Part I and Part II). In this module part I is covered and the next part provided in another module. Hence, Part I is the basis for the next module and for the other courses of Accounting and Finance. In this module about six chapters included (Chapter Introduction to accounting and business, Chapter 2: Accounting Cycle, Chapter 3: Accounting for Merchandising Enterprises, Chapter 4: Accounting for Manufacturing Businesses, Chapter 5: Accounting System and chapter 6: Cash and Receivables) and the first chapter is the basis for the second, the second chapter is the basis for the third chapter and so on. Thus you are expected to better understand each chapter before proceeding to the next chapter.*

ABOUT THE COURSE

Course Number	AcFn1031
Course Title	Principles of Accounting I
Degree Program	BA Degree in Accounting and Finance
Module	Basics of Accounting and Reporting
ETCTS Credits	6
Credit Hour	4
Course Objectives & Competences to be Acquired	The course has the general objective of introducing students to the basics of accounting and reporting of financial activities of business organizations. Upon the successful completion of this course, the students will be expected to: ▪ Understand the role of Accounting in business and develop an awareness of the accounting profession ▪ Understand the purpose of the financial accounting function and standard financial accounting practices ▪ Summarize and apply basic financial accounting terms, concepts, and principles. ▪ Define and apply accounting terminology, concepts, and principles in analyzing, recording, and reporting basic business transactions ▪ Take a series of transactions through the accounting cycle ▪ Analyze, record, and report transactions for service, merchandising, and manufacturing businesses. ▪ Prepare financial statements ▪ Analyze accounting system design and control ▪ Apply accounting principles and control of cash and receivables
Course Description	This course is designed to provide introductory knowledge of accounting principles, concepts, and practices. The course deals with the processes involved in financial statements preparation for service-giving businesses, merchandising businesses, and manufacturing businesses. Topics covered includes the features of accounting information, users of accounting information, nature of financial statements, the double entry system, financial statements preparation process including journals, ledgers, trial balance, adjustments, worksheets, accruals, adjusting and closing entries, and the accounting system. This course provides a foundation for more advanced work in the fields of Accounting and business.

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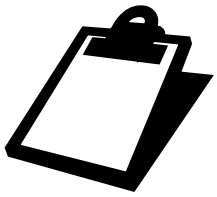
CHAPTER ONE: INTRODUCTION TO ACCOUNTING AND BUSINESS

Dear learner! In the earlier stage of economic development, a business enterprise was very often managed by its owner, and the accounting records and reports were used mainly by the owner/manager in conducting the business. Bankers and other lenders often relied on their personal relationship with the owner rather than on financial statements as the basic for making loan to business.

As business organizations grew in size and complexity, managers and outsiders became more clearly differentiated. From outsiders, which includes owners, creditors, government, banks, customers, and the public demanded for accurate financial information on the basis of which they could judge the performance of organization. In addition, as the size and complexity of the business unit increased, the accounting problems involved in the issue of financial statements became more and more complex. Along with these developments came an awareness of the need for a conceptual framework and generally accepted accounting principles that could serve as guidelines for preparing basic financial statements. In this unit, you will study the principles and concepts of accounting.

OBJECTIVES OF THE CHAPTER



After studying this chapter, you should be able to:

[a] *Explain what accounting is.*

[b] *Identify the users and uses of accounting.*

[c] *Identify and describe principles and concepts of accounting.*

[d] *State the accounting equation and define each element.*

[e] *Analyze the effects of business transactions on the accounting equation.*

[f] *Understand the four financial statements and how they are prepared.*

1.1. Evolution, Definition, and Importance of Accounting

Why accounting discipline evolved? Accounting like other fields of study has evolved in response to social and economic problems or needs. Accordingly, accounting developed to meet financial information needs of the society. In general, the following points contribute for evolution and development of accounting:

- Industrial revolution
- Appearance of corporate form of businesses
- Need of public accounting
- Coming of income tax concepts
- Influence of government and so on.

Activity

Question 1: What is mean by accounting?.....
.....
.....

The development of accounting passes through two stages:

(a) Primitive accounting (single entry system)

People in all civilizations have maintained various types of records of business activity. However, their systems of record keeping deal only with one aspect of financial operation and was not considered complete.

(b) Modern accounting (double entry system)

This is a system of record keeping that considers both aspect of a transaction so as to keep equilibrium. Meaning every transaction should affect at least two things. For instance, if a business purchase machinery for Br 1,200, this transaction is recorded both as asset which is machinery for Br 1,200 and as payment of cash of Br 1,200.

Definition of Accounting

Accounting is the process of identifying, recording (recording, classifying, and summarizing) and communicating (preparing, analyzing and interpreting) accounting reports for users. In short, it is an information system that measures business activities, processes that information into reports, and communicates the results to decision makers. The followings are the importance of accounting:

- It determines the operation results of the organization.
- It facilitates rational decision making, for decision makers.
- It keeps systematic record of business transaction.
- It plays important role in all economic social system.

Accounting

consists of three basic activities - it identifies, records, and communicates the economic events of an organization to interested users.

1.2. Accounting as an Information System

Accounting is called as the ***language of business***. This language viewed as information system to make an informed judgment and decision by the users' of the information. An Accounting

System is designed to accumulate data about a firm's financial affairs, classify the data in a meaningful way, and summarize it in periodic reports called *financial statements*.

Characteristics of Accounting Information and Its Users

Accounting information is composed principally of financial data about business transaction, expressed in terms of money, and accounting reports the financial data, by sorting and summarizing the recorded data.

The process by which accounting provides information to users is as follows:

1. Identify users.
2. Assess users' information needs.
3. Design the accounting information system to meet users' needs.
4. Record economic data about business activities and events.
5. Prepare accounting reports for users.

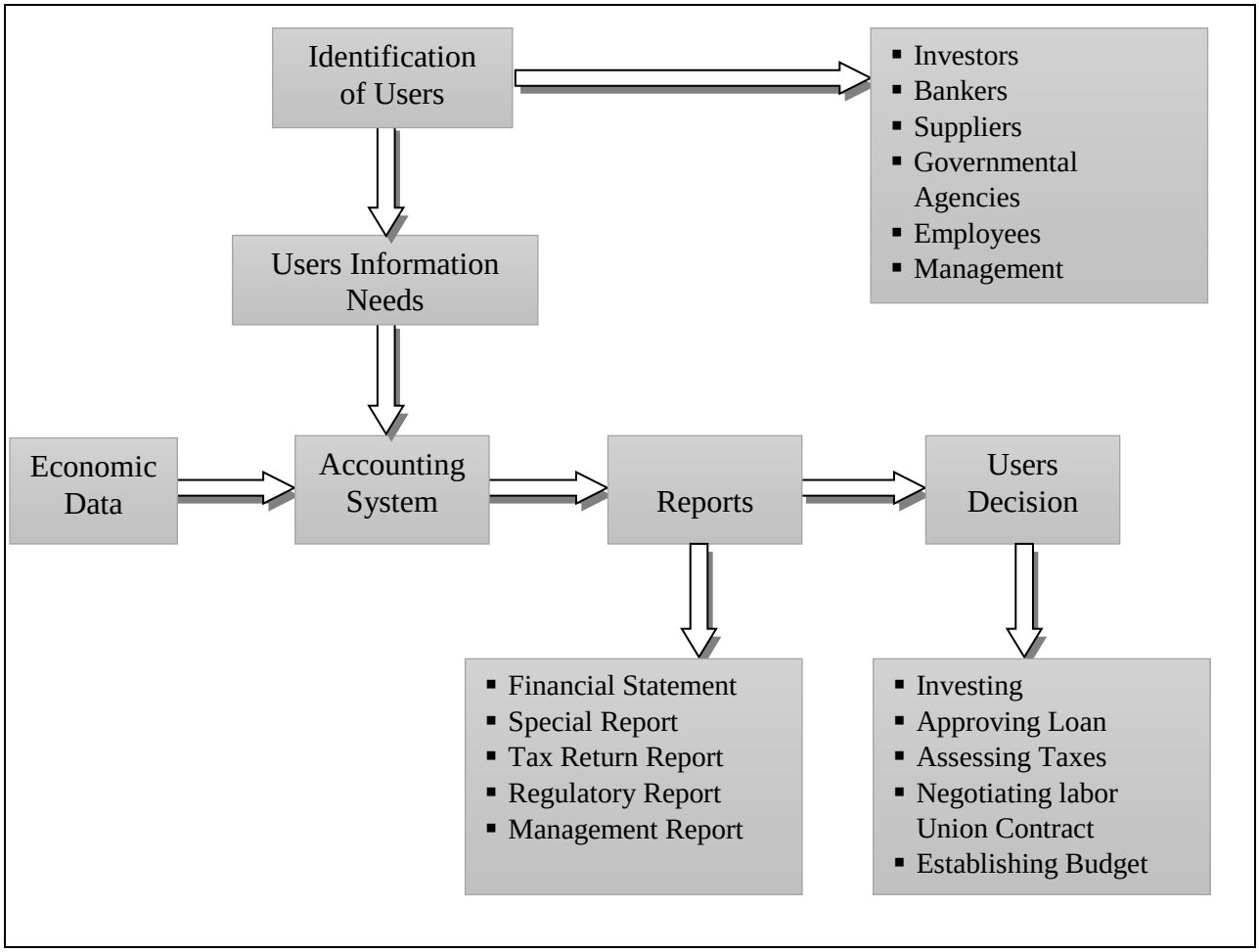
Users of Accounting Information

The results of accounting process are communicated to many individuals and organization. The users of accounting information may be divided into two broad groups: **internal and external information users.**

1. **Internal Users**: are those individuals directly involved in the process of either planning or controlling current operations or for formulating long- range plans and making major business decision.
   - ***Managers and Employees:*** Managers use accounting information to set plans for their organizations. They also evaluate progress toward those plans, and they take corrective action when it's needed. Employees are also interested in the financial information of the business that employs them.
2. **External Users**: are parties that are not directly involved in running the operations of the business.
   - ***Investors:*** They are interested in companies past success and its potential earnings. A thorough study of a firm's financial statements helps potential investors judge the prospects for a profitable investment. After investing, they must continually review their commitment, again by examining the firm's financial statements.
   - ***Creditors:*** Creditors, those who lend money or deliver goods and services before being paid, are interested mainly in whether a company will have the cash to pay interest

charges and to repay the debt at the appropriate time. They study a firm's liquidity and cash flow as well as its profitability.

- ***Government Regulatory Agencies:*** They are concerned with the financial activities of business organizations for purposes of regulation.
- ***Tax Authorities:*** Government at every level is financed through the collection of taxes. For instance, income tax is figured using accounting information. Sales tax depends upon a firm's sales. The process of using accounting information is illustrated in the following diagram:



1.3. The Profession of Accounting

Accounting as an old profession, records of business transactions have been prepared for centuries. However, only during the last half-century has accounting been accepted as a profession with the same importance as medical and legal professions. Today several million are

employed in accounting and accounting related fields all over the world. Accountants are typically engaged in either private accounting or public accounting. ***Private Accounting:*** accountants employed in a particular business firm or non- for- profit organization, perhaps as chief accountant, controller, and financial vice - president. ***Public Accounting:*** accountants who render accounting service on a fee basis and staff accountants employed by them. The followings are specialized accounting fields:

- ***Financial Accounting-*** concerned with recording of transactions for a business enterprise or other economic unit and the periodic preparation of various reports from such business.
- ***Auditing*** **–** an independent review of the accounting records of the business.
- ***Cost Accounting*** **–** the determination and control of costs. It is concerned primarily with the costs of manufacturing process and of manufactured products. The most duties of cost accountant are to gather and explain cost data, both actual and prospective.
- ***Managerial Accounting*** **–** uses both historical and estimated data in assisting management in daily operations and in planning future operations. The managerial accountant is frequently concerned with identifying alternative course of action and then helping to select the best one.
- ***Tax Accounting*** **-** preparation of tax returns and consideration of tax consequences of proposed business transactions or alternative course of action.
- ***Accounting System*** **–** concerned with the designing and implementation of procedures for the accumulation and reporting of financial data.

Also, there are some other types of field in accounting such as: budgetary accounting, non- for-profit accounting, social accounting, etc.

1.4. Accounting Principles and Concepts

The business transactions are recorded and processed using certain fundamentals, concepts and conventions, which are called as **Generally Accepted Accounting Principles**. GAAP is developed from research conducted, accepted accounting practices and pronouncements of accounting authoritative bodies and Financial Accounting Standard Board (FASB). **Accounting principles** may be defined as those rules of action or conduct, which are adopted by the accountants, universally, while recording the transactions. They are, however, not rigid. They are

subject to change. They have evolved in order to deal with practical problems experienced by a preparer and a user rather than to reflect some theoretical ideal. The term **'Accounting Concept'** refers to assumptions and conditions on which the accounting is based. Basic assumptions of accounting can never be ignored. Some of the principles and concepts of accounting presented as follow:

a. Business Entity Concept

The most basic concept in accounting is that of the entity. An accounting entity is an organization or a section of an organization that stands apart as a separate economic unit. In accounting, boundaries are drawn around each entity so as not to confuse its affairs with those of other entities. Assume Mr. Y started Y business on his own. Suppose he began with $5,000 obtained from a bank loan. Following the entity concept, Mr. Y would account for the $5,000 separately from his personal assets, such as his clothing, house, and automobile. To mix the $5,000 of business cash with his personal assets would make it difficult to measure the financial position of Y business. For example, MEDROC is a huge organization with several divisions operating in Ethiopia. Its management evaluates each division as a separate accounting entity. If sales in the one division are dropping, it can find out why. But if sales figures from all divisions of the company are combined, management will not know that the division's sales are going down. Thus, the entity concept applies to any economic unit that needs to be evaluated separately.

b. Money measurement concept

Accounting records only those transactions that can be expressed, in terms of money. If the events or transactions cannot be expressed in monetary value, however important they are, they are not recorded in accounts. For instance, a talented manager is assets to the firm, in the real sense, but monetary measurement is not possible so accounting books do not exhibit him.

c. Going concern concept

The underlying idea of this concept is that the business once started its operation will continue indefinitely for unlimited period of time, until unknown future, to earn profit.

Activity
Question 2: What is mean by GAAP?.....
.....

It is to be noted that the 'Going Concern Concept' does not imply permanent continuation of the enterprise, indefinitely. It rather presumes that the enterprise will continue in operation long enough that the cost of the fixed assets would be charged over the usual lives of the assets

d. Cost principle

It determines the amounts entered into the accounting records for purchase of properties and services for business operation. Then it states that actual cost, exchange price serves a basis for recording them. For example, you are considering the purchase of automobile for the business operation. The seller is asking $50,000 for automobile that costs her $35,000. An appraisal shows a value of $47,000. You first offer $44,000. The seller counteroffers with $48,000 and you agree on a price of $46,000. What dollar value for this automobile is reported on your financial statement? Which accounting concept or principle guides your answers?

Answer: According to the cost principle, assets and services should be recorded at their actual cost. You paid $46,000 for the automobile, so report the land at $46,000. Cost concept brings the advantage of objectivity in the preparation of financial statements. In the absence of this concept, accounting records would have depended on the subjective views of the persons.

However, it does not mean that the fixed assets are valued at the historic cost, original price at which they are acquired, for all the years rather depreciation is charged based on the original cost and net value shown on financial statement.

e. Periodicity principle

According to the 'going concern concept', every business would exist for a longer duration. However, periodicity principle requires dividing the long life of the business into specific periods (accounting periods) to provide periodic performance to users. After each period, it is necessary to 'stop' and 'see back' how things have been going. So, it is necessary to maintain accounts with reference to a specific period.

Activity

Question 3: What is business organization?.....
.....
.....

1.5. Types of Business Organizations

Business organizations can be classified in various categories basing different criteria. The two main classification is based on the forms of establishment and the nature of business operations. Based on the forms of establishment, businesses established either of sole proprietorship, partnership or corporation. These forms are entirely different each other and business should choose one only.

a. Sole proprietorship

A Sole proprietorship is business owned by an individual and often managed by that same individual. Single proprietors include physicians, lawyers, electricians, and other people who are in business for themselves. Many small service-type businesses and retail establishments are single proprietorships. No legal formalities are necessary to organize such businesses, and usually only a limited investment is required to begin operations.

In a single proprietorship, the owner is held solely responsible for all debts of the business. For accounting purpose, however, the business is a separate entity. Thus the financial activities of the business, such as the receipt of fees from selling services to the public, are kept separate from the personal house or car payment should not be entered in financial records of the business.

b. Partnership

A partnership is an unincorporated business owned by two or more persons associated as partners. The business is often managed by same persons. Many small retail establishments and professional practices, such as dentists, physicians, attorneys and other professional firms, are organized as partnerships.

Partnerships are created by a verbal or written agreement. A written agreement is preferred because it provides a permanent record of the terms of the partnership. Included in the agreement are such terms as the initial investment of each partner, the duties of each partner, the means of dividing profits or losses between the partners each year, and the settlement to be made up on the death or withdrawal of a partner. Each partner may be held liable for all the debts of the partnership and for the actions of each partner with in the scope of the business. However, as with in the single proprietorship, for accounting purposes, the partnership is a separate business entity.

c. Corporation

A corporation is a business incorporated under the law of the country and owned by a large number of persons. At most all large businesses are corporation. The corporation is unique in that it is a legal business entity. The owners of the corporation are called stockholders or shareholders. They buy shares of stock, which are unit of ownership, in the corporation. The personal assets of the owners are protected from the creditors of the corporation that is the owners have limited liability. The stockholders do not directly manage the corporation; they elect a board of directors to represent their interests. The board of directors selects the officers such as the president and vice presidents who manage the corporation for the stockholders.

On the other hand, based on the types of activity engaged or based on the nature of operation business established as service rendering, merchandising or manufacturing businesses.

a. **Service companies: S**ervice companies perform services for a fee. This group includes companies such as accounting firms, law firms, repair shops and many others.
b. **Merchandising companies**: Merchandising companies purchase goods that are ready for sale and sell them to customers. Merchandising companies include such companies as out dealership, clothing stores, and supermarkets.
c. **Manufacturing companies:** Manufacturing companies buy materials, convert them into products, and then sell the products to other companies or final consumers. Example of manufacturing companies is cloth manufactures, auto manufacturers and flour factories.

1.6. Business Transactions and the Accounting Equation

Business transactions: it is an economic event or condition that directly changes the entities financial position or directly affects its results of operation. For instance: payment of utility bills of Br 50 affects financial position to decline. Business transactions can be:

(a) *Simple transaction:* transaction occurs just only once in a time unless it comes on another time.
(b) *Complex transactions:* transactions that cause another transaction to occur. It is the case, in which a single transaction also brings other several transactions.
(c) *External transaction:* a transaction between the organization and outsider party
(d) *Internal transaction:* a transaction within the organization itself.

Accounting equation: Assets are resources owned by the business. Equities are rights or claims against these resources. Thus, a business that has Br 100,000 of assets also has Br 100,000 of claims against these assets. Fundamental accounting equation establishes this relationship, assets against its sources in equation form as follows;

Asset = Equities

The two principal sources of resources (assets) are owners and creditors. Therefore, equities (claims) may be further subdivided in to two categories; claims of creditors represent debt of the business called liabilities. Claim of owners are called owner's equity. The equation above is then expanded as follows;

Assets = Claims (creditors claim & owner's claim)

Thus the accounting equation is the following:

Asset = Liabilities + Owner's equity

It is customary to place 'liabilities' before 'owner's equity' in the accounting equation because creditors have a preferential right over owners in business resources or assets. If a company goes bankrupt, liabilities are paid off first to creditors, while equity is the last to be distributed. Therefore, owners' equity is also called *residual equity*.

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

Assets, liabilities, equity, revenue and expense

- ***Assets****:* are resources owned by a business. The common characteristics possessed by all assets are service potential or future economic benefit. The assets should provide future service or benefit to the business such as furniture, car, cash, office supplies and so on.
- ***Liabilities****:* are creditors claim on total assets of the business. Simply, it is existing debts and obligations. Example: account payables, wages payable, interest payable and so on.
- ***Owner's equity****:* it is the ownership claims on total assets. It equal to total assets minus total liabilities. In sole proprietor ship and partnership form of business, the principal sub divisions of owner's equity are; *capital, drawings, revenues and expense.*
- ***Capital****:* is the term used to describe the owner's investment in the business an investment made increases capital, ownership claims on the total asset. Example: Mr. X capital, ABC capital and so on.
- ***Drawing****:* refers to owners withdraw cash or other assets from the business for personal use. This decreases owner's equity in the business.

- ***Revenue:*** is the gross increase in owner's equity resulting from business activities entered into for earning profit such as sales revenue, fees revenue, rent revenue and so on.
- ***Expense:*** is the cost of assets consumed or services used in the process of earning revenue such as cost of goods sold, wages expense, supplies expense utility expense etc. It decreases owner's equity.

Illustration to the accounting equation: Assume Mr. X establishes sole proprietorship business that operates taxi services in Dessie town known as **ABC Taxi Company** on January 2016.

Transaction -A- Owner's investment

In order to start up the business, Mr. X deposited $10,000 in a bank account in the name of ABC Taxi Company. The effect of this transaction is to increase the assets (cash), left side of equation and to increase the owner's equity on the right side of the accounting question by the same amount.

	Assets	=	**Liabilities**	+	**Owner's Equity**
	Cash				Mr. X Capital
(A)	10,000				10,000 ← Investment

At this point, the company has no liabilities; the only party having claim over the assets of the company is the owner. Note that, the equation relates only to the business enterprise. Mr. X personal assets, such as his home and personal bank account and personal liability are excluded from consideration. The business must be treated as a separate entity.

Transaction -B- Purchase of land for cash

Mr. X purchased land, which costs $7,500 by paying cash, to be used as a future site for the business. This transaction changes the composition of the assets but it doesn't change the total amount of assets. It has no effect on the liability and owner's equity of the business.

	Assets		=	**Liabilities**	+	**Owner's Equity**
	Cash +	Land				Mr. X Capital
(A)	10,000	7,500				10,000
(B)	- 7,500					
Balance	2,500	7,500				10,000

After the above transaction, the company will have less cash but a new asset (land). The total assets (cash + Land) amount to Birr 10,000, which is equal to the owner's equity.

Transaction - C- Purchase of Supplies On credit

Mr. X purchased $850 of gasoline, oil, and other supplies and agreed to pay the money in the near future. This type of transaction is called *purchase on account* and liability *(account payable)* is created. The transaction's effect is increasing both the assets and liability amounts.

	Assets			=	**Liabilities**	+	**Owner's Equity**
	Cash	+ Supplies	+ Land		Account Payable		Mr. X Capital
Bal.	2,500		7,500				10,000
(C)		850			850		
Bal.	2,500	850	7,500		850		10,000

Goods that are physical consumed, such as a chalk to a school, gas oil for car, and stationry materials for an office, are called ***supplies***.

Transaction –D- Payment of liability

Mr. X paid for creditor $400 for the supplies purchases in the above transaction, the effect is decreasing the assets and liabilities.

	Assets			=	**Liabilities**	+	**Owner's Equity**
	Cash	+ Supplies	+ Land		Account Payable		Mr. X Capital
Bal.	2,500	850	7,500		850		10,000
(D)	- 400				- 400		
Bal.	2,100	850	7,500		450		10,000

Transaction -E- providing or Selling of service

Mr. X taxi provided taxi services for the customers and earned fares (revenue) of $ 4,500, Mr. X received the total amount of cash from the customers. In general, the amount charged to customers for goods or services sold is called *revenue.* Instead of requiring the payment of cash at the time goods or services are sold, a business may make sales on account, allowing the customers to pay latter. In such cases, the firm acquires an *account receivable*, which is a claim against the customers. Accounts receivable is as much as an asset as cash and revenue is realized. The effect of this transaction is increasing both the assets and owner's equity.

	Assets			=	**Liabilities**	+	**Owner's Equity**	
	Cash	+ Supplies	+ Land		Account Payable		Mr. X Capital	
Bal.	2,100	850	7,500		450		10,000	
(E)	+4,500						4,500	← Fares earned
Bal.	6,600	850	7,500		450		14,500	

Transaction -F- Payment and Recording Expenses

The amount of assets consumed or services used in the process of earning or generating revenue is called *expenses*. Mr. X taxi incurred and paid the following expenses during the month: wages $1,125; rent $850; utilities $ 150; miscellaneous $ 75. The effect of this transaction is reducing both assets and owner's equity.

	Assets			=	**Liabilities**	+	**Owner's Equity**
	Cash	+ Supplies	+ Land		Account Payable		Mr. X Capital
Bal.	6,600	850	7,500		450		14,500
(F)	-2,200						- 1,125 ← Wage expense
							-850 ← Rent expense
							- 150 ← Utilities expense
							-75 ← Miscellaneous expense
Bal.	4,400	850	7500		450		12,300

Transaction -G- Recording Expenses

Mr. X's supplies on hand (not yet used) accounts for $ 250 at the end of the month, the reminder 600 (850 - 250) have been used in the operation of the business. The effect of this internal transaction is decreasing both assets and owner's equity.

	Assets			=	**Liabilities**	+	**Owner's Equity**
	Cash	+ Supplies	+ Land		Account Payable		Mr. X Capital
Bal.	4,400	850	7500		450		12,300
(G)		- 600					-600 ← Supplies Expense
Bal.	4,400	250	7,500		450		11,700

Transaction -H- Owner's Withdrawal

At the end of the month, Mr. X withdraws $1,000 in cash from the business for his personal use. This internal transaction reduces the assets and owner's equity.

	Assets			=	**Liabilities**	+	**Owner's Equity**
	Cash	+ Supplies	+ Land		Account Payable		Mr. X Capital
Bal.	4,400	250	7,500		450		11,700
	-1,000						-1,000 ← Withdrawal
Bal.	3,400	250	7,500		450		10,700

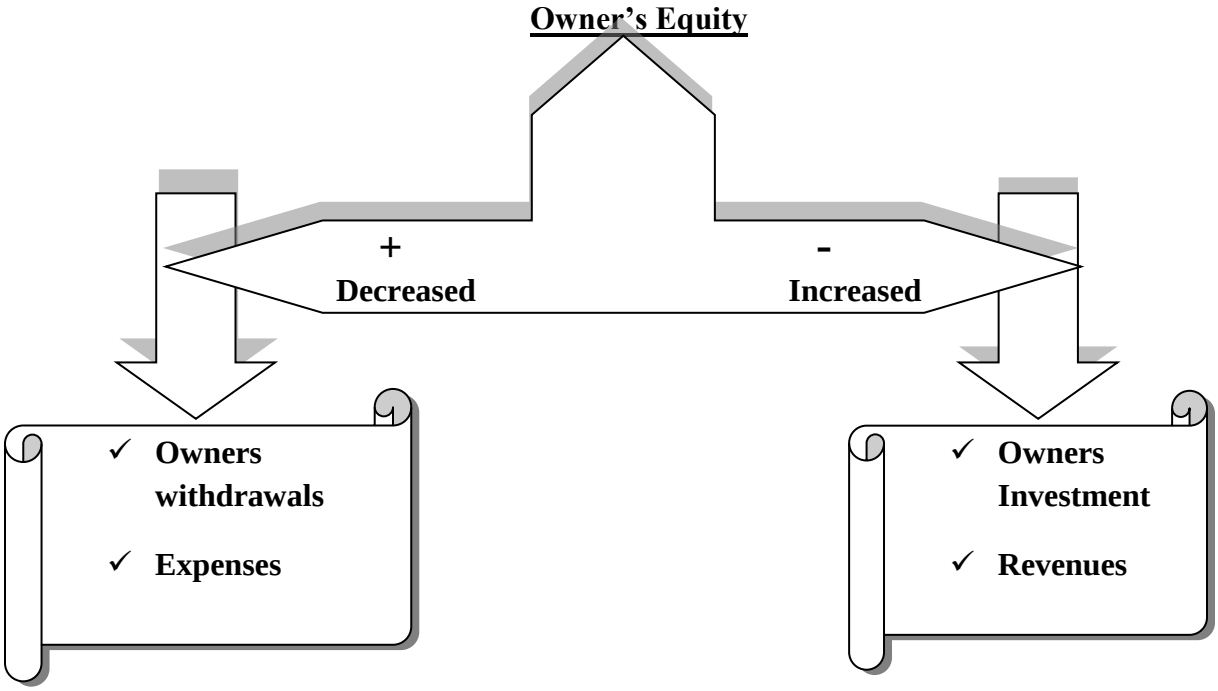
The transactions of ABC Taxi Service can be summarized in a tabular form as shown below. Letters identifies the transactions here and the balance of each item is shown after each transaction.

Summary of the above "A" to "H" transactions presented as follow:

	Assets			=	Liabilities	+	Owner's Equity	
	Cash	**+ Supplies**	**+ Land**		**Account payable**	**+**	**Mr. X Capital**	
(A)	10,000		7,500				10,000	←Investment
(B)	-7,500							
	2,500		7,500				10,000	
(C)		850			850			
	2,500	850	7,500		850		10,000	
(D)	-400				-400			
	2,100	850	7,500		450		10,000	
(E)	4,500						+4,500	←Fares earned
	6,600	850	7,500		450		14,500	
(F)	-2,200						-1,125	←Wages expense
							-850	←Rent expense
							-150	←Utility expense
							-75	←Misc. expense
	4,400	850	7,500		450		12,300	
(G)		-600					-600	←Supplies expense
	4,400	250	7,500		450		11,700	
(H)	-1,000						-1,000	←Withdrawal
	3,400	**250**	**7,500**		**450**		**10,700**	

As the above summary shows, at the end of transaction "H", ABC Taxi Company has a total cash of $3,400, supplies of $250, land of $7,500, and the company also owed (liability) $450 to others and the owner equity is $10,700. The following points apply for all types of business:

1. ***The effect of every transaction increases and/or decreases one or more of accounting equations elements.***
2. ***Equality of the two sides of the accounting equation should be satisfied always.***
3. ***Owner's equity is increased by the amounts invested by the owner and revenues earned. In contrast, it's decreased by the amounts withdrawal made by the owner and expenses incurred.***



1.7. Financial Statements

After the effect of the individual transaction has been determined, essential information is communicated to users. The accounting statements or reports that communicate this information are called *financial statements*. Generally, there are four types of financial statements.

1.7.1. Financial Statements for Sole Proprietorship and Partnerships

The principal financial statements for sole proprietorship are the following:

1. ***Income Statement:*** It is a summary of revenues and expenses of a business entity for **specific period of time**, such as a month or a year. The excess of revenues over expenses is called ***net income*** or *net profit*. If the expenses exceed the revenues, the excess is ***net loss***. The determination of the periodic net income or net loss is a ***matching*** process involving two steps. First, revenues are recognized during the period. Second, the assets consumed in generating these revenues must be *matched* against the revenues in order to determine the net income or net loss.

2. ***Statement of Owner's Equity:*** It is a summary of the **changes in the owner's equity** of a business entity that have occurred during **specific period of time**. Increases in owner's

equity come from: owner investments and net income, and decreases in owner's equity result from: owner's withdrawals and net loss.

3. ***Balance Sheet:*** It is a list of **assets, liabilities and owner's equity** of a business entity **as of a specific date**. The assets section of a balance sheet (left hand side) begins with cash followed by receivables, supplies, prepaid insurance and other assets that can be converted in to cash or used up in the near future. The assets of relatively permanent nature such as land, building and equipment follow that order. In the liability and owner's equity section of the balance sheet (right hand side), the liabilities presented first followed by owner's equity.
4. ***Statement of Cash Flows:*** It reports the **cash coming in (cash receipts) and the amount of cash going out (cash payments) during a period**. Business activities result in a net cash inflow (receipts greater than payments) or a net cash outflow (payments greater than receipts). The statement of cash flows shows the net increase or decrease in cash during the period and the ending cash balance. This statement is reported in three sections: **operating activities, investing activities, and financing activities.**
   i. ***Operating Activities:*** This section includes cash transactions that enter in to the determination of net income or net loss. The net cash flow from operating activities normally differs from the amount of net income for the period.
   ii. ***Investing Activities:*** This section includes the cash transaction for the acquisition and sale of relatively long term or permanent type of assets.
   iii. ***Financing Activities:*** This section includes the cash transaction related to cash investment by the owner's and borrowing and withdrawals by the owner.

   NB: the cash balance at the beginning of the period is added to the increase (or decrease) in cash for the period to obtain the cash balance at the end of the period.

Activity

Question 4: What are the four types of financial statements?.....
.....

The basic features of the four statements and their interrelationships are illustrated by taking data from Mr. X taxi business as follow:

ABC Taxi Company
Income Statement
For Month Ended January 31, 2016

Fares Earned		**$4,500**
Operating Expenses :		
Wages Expenses	$1,125	
Rent Expenses	850	
Supplies Expenses	600	
Utilities Expenses	150	
Miscellaneous Expenses	75	
Total Expenses		2,800
Net Income		$1,700

ABC Taxi Company
Statement of Owner's Equity
For Month Ended January 31, 2016

Investment During the Month		**$10,000**
Net Income for the Month	$1,700	
Less: Withdrawal	1,000	
Increase in Owner's Equity		700
Mr. X Capital, January 31, 2016		$10,700

ABC Taxi Company
Balance Sheet
January 31, 2016

Assets	
Cash	$3,400
Supplies	250
Land	7,500
Total Assets	$11,150
Liabilities	
Account Payable	$450
Owner's Equity	
Mr. X Capital	$10,700
Total Liabilities and Owner's Equity	$11,150

ABC Taxi Company
Statement of Cash Flow
For Month Ended January 31, 2016

Cash Flows from Operating Activities:		
Cash Received from Customers	$4,500	
Deduct: Cash Payments for Expenses And Payment to Creditor	2,600	
Net Cash Flow from Operating Activities		$1,900
Cash Flows from Investing Activities:		
Cash Payments for Acquisition of Land		(7,500)
Cash Flows from Financing Activities:		
Cash Received as Owner's Investment	$10,000	
Deduct: Cash Withdrawal by Owner	1,000	
Net Cash Flow from Financing Activities		9,000
Net Cash Flow And January 31, 2016 Cash Balance		$3,400

In general, the information generated by the income statement, is entered in to the statement of owner's equity. And the information generated by the statement of owner's equity is entered in the balance sheet in the list of owner's equity. Moreover, the information generated by the statement of cash flow is entered in the balance sheet in the list of Assets.

1.7.2. Financial Statement for Corporation

Business enterprises with large amount of assets are usually organized as corporations and have many owners, called ***stockholders***. The financial statements of corporations are similar to those of sole proprietorship and partnership except that retained earnings statement is prepared instead of statement of owner's equity. The owner's equity section of balance sheet is referred to as stockholders' equity rather than owner's equity. In addition, the cash flows from financing activities for a corporation arise from the sale of **capital stock** and the payment of **dividends**, rather than from owner's investment and drawings.

1. ***Statement of Retained Earning:*** The emphasis in reporting the changes in the *stockholders' equity* is on the changes in *retained earnings*, or net income retained in the business. The changes in retained earning that have occurred during a period are reported in *retained earnings statement*. Change in the amount of earnings retained in the business would have resulted from (1) *net income* and (2) *distribution of earnings*, called *dividends*, to owners.

2. ***Balance Sheet:*** The only difference between the balance sheet of sole proprietorship or/and partnership and corporation is that the stockholders' equity section is presented rather than owner's equity.
3. ***Statement of Cash Flows:*** The only difference between cash flows statement of corporation and sole proprietorship or/and partnership is on the cash flows from financing activities section, i.e., cash flows arise from the sale of capital stock and the cash payments to stockholders in the form of dividends.
4. ***Income Statement:*** Similar with the income statement prepared for sole proprietorship or/and partnership. Illustrations of financial statements for the corporation type of business assuming ABC Taxi Company was established as corporation:

ABC Taxi Company
Retained Earnings Statement
For the Month Ended January 31, 2016

Net Income for the Month	$1,700
Less: Dividends	1,000
Retained Earnings, January 31, 2016	**$700**

ABC Taxi Company
Balance Sheet
January 31, 2016

Assets		
Cash		$3,400
Supplies		250
Land		7,500
Total Assets		$11,150
Liabilities		
Account Payable		$450
Stockholders' Equity		
Capital Stock	$10,000	
Retained Earnings	700	
Total Stockholders' Equity		10,700
Total Liabilities and Stockholders' Equity		$11,150

ABC Taxi Company
Statement of Cash Flow
For Month Ended January 31, 2016

Cash Flows from Operating Activities:		
Cash Received from Customers	$4,500	
Less: Cash Payments for Expenses And Payment to Creditor	2,600	
Net Cash Flows from Operating Activities		$1,900
Cash Flows from Investing Activities:		
Cash Payments for Acquisition of Land		(7,500)
Cash Flows from Financing Activities:		
Cash Received from Sale of Capital Stock	$10,000	
Less: Cash Payment for Dividends	1,000	
Net Cash Flow from Financing Activities		9,000
Net Cash Flow and January 31, 2016 Cash Balance		$3,400

1.8. Summary

Explain the meaning of accounting. Accounting is the process of identifying, measuring recording and communicating the economic events of an organization (business or non business) to interested users of the information. Accounting helps us in the allocation of scarce resources in an efficient and effective manner.

Identify the users and uses of accounting. (a) Management uses accounting information in planning controlling and evaluating business operations. (b) Investors (owners) judge the wisdom of buying, holding, or selling their financial interests on the basis of accounting data, i.e. to see how their investment is doing. (c) Creditors evaluate the risks of granting credit or lending money. Other groups of users include taxing authorities, regulatory agencies, customers, labor unions, and economic panniers. These users are grouped in to two: 1- Internal users and ii- External users.

Explain the meaning of generally accepted accounting principles: Generally accepted accounting principles are a *common set of standards* used by accountants.

Explain the meaning of business entity assumption, cost principle and the monetary unit assumption. The business entity concept states the economic events of a particular business should be identified separate from other entities and the owner's personal records. The cost principle requires properties acquired by business enterprises to be recorded at actual amounts

paid and /or assumed in acquiring the properties. The monetary unit assumption requires only transactions capable of being expressed in terms of money be included in the accounting records of the business enterprise.

State the basic accounting equation and explain the meaning of assets, liabilities, and owner's equity. The basic accounting equation is:

Assets = Liabilities + Owner's Equity.

Assets are resources owned by a business, liabilities represent the claim of creditors on the total assets, and owner's equity is the ownership claim on the total assets. It is often referred to as residual equity.

Analyze the effects of business transactions on the basic accounting equation. Each business transaction must have a dual effect on the accounting equation. For example, if an asset is decreased, there must be a corresponding (1) Increase in another asset, or (2) decrease in a specific liability, or (3) decrease in owner's equity. After each transaction, the equality of assets to the sum of liabilities and Owner's equity must be maintained.

Prepare an income statement, owner's equity statement, and balance sheet. An income statement presents the revenues and expenses of a company for a specific period of time. An owner's equity statement summarizes the changes in owner's equity that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and owner's equity of a business at a specific date.

1.9. Self-Examination Questions

1. A profit-making business operating as a separate legal entity and in which ownership is divided into shares of stock is known as a:

   A. proprietorship. C. partnership.

   B. service business. D. corporation.

2. The resources owned by a business are called:

   A. assets. C. the accounting equation.

   B. liabilities. D. owner's equity.

3. A listing of a business entity's assets, liabilities, and owner's equity as of a specific date is a(n):

   A. balance sheet. C. statement of owner's equity.

   B. income statement. D. statement of cash flows.

4. If total assets increased $20,000 during a period and total liabilities increased $12,000 during the same period, the amount and direction (increase or decrease) of the change in owner's equity for that period is a(n):

   A. $32,000 increase. C. $8,000 increase.

   B. $32,000 decrease. D. $8,000 decrease.

5. If revenue was $45,000, expenses were $37,500, and the owner's withdrawals were $10,000, the amount of net income or net loss would be:

   A. $45,000 net income. C. $37,500 net loss.

   B. $7,500 net income. D. $2,500 net loss.

   (Answers) 1: D, 2: A, 3: A, 4: C, 5: B

Problem (Workout)

1. Cecil Jameson, Attorney-at-Law, is a proprietorship owned and operated by Cecil Jameson. On July 1, 2016, Cecil Jameson, Attorney-at-Law, has the following assets and liabilities: cash, $1,000; accounts receivable, $3,200; supplies, $850; land, $10,000; accounts payable, $1,530. Office space and office equipment are currently being rented, pending the construction of an office complex on land purchased last year. Business transactions during July are summarized as follows:

   a. Received cash from clients for services, $3,928.

   b. Paid creditors on account, $1,055.

c. Received cash from Cecil Jameson as an additional investment, $3,700.

d. Paid office rent for the month, $1,200.

e. Charged clients for legal services on account, $2,025.

f. Purchased supplies on account, $245.

g. Received cash from clients on account, $3,000.

h. Received invoice for License expense from government for July (to be paid on August 10), $1,635.

i. Paid the following: wages expense, $850; answering service expense, $250; utilities expense, $325; and miscellaneous expense, $75.

j. Determined that the cost of supplies on hand was $980; therefore, the cost of supplies used during the month was $115.

k. Jameson withdrew $1,000 in cash from the business for personal use.

Instructions

1. Determine the amount of owner's equity (Cecil Jameson's capital) as of July 1, 2016.
2. State the assets, liabilities, and owner's equity as of July 1 in equation form similar to that shown in this chapter. In tabular form below the equation, indicate the increases and decreases resulting from each transaction and the new balances after each transaction.
3. Prepare an income statement for July, a statement of owner's equity for July, and a balance sheet as of July 31, 2016.
4. Prepare a statement of cash flows for July.

Hint answer for the problem final balances

Cash	Account Receivable	Supplies	Land	Account Payable	Jameson, Capital
6,873	2,225	980	10,000	2,355	17,723
Net income $1,503					

1.10. Glossary of Terms

Accounting - the process of identifying, measuring, recording, and communicating the economic events of an organization to interested users of the information.

Assets – Resources owned by a business.

Auditing – the examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation.

Balance Sheet – A financial statement that reports the assets, liabilities, and owner's equity on a specific date.

Basic Accounting Equation - Assets=Liabilities + owner's equity

Bookkeeping – A part of accounting that involves only the recording of economic events.

Corporation – a business organized as a separate legal entity under state corporation law having ownership divided into transferable shares of stock.

Cost Principle – an accounting principle that states the assets should be recorded at their actual cost.

Drawings – Withdrawals of cash or other assets from the business for the owner's personal use.

Economic (Business) Entity Assumption – An assumption that states a business enterprise must be given separate and distinct existence from the owners, creditors, customers and any other party.

Expenses - the cost of assets consumed or services used in the process of earning revenue.

Income statement – A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.

Investment by owner – the assets put in to the business by the owner.

Liabilities – Represents the claim of creditors on the assets of the business.

Monetary unit assumption– An assumption stating that only transactions that can be expressed in terms of money be included in the accounting records of the business.

Net Income – the amount by which revenues exceed expenses.

Net loss – the amount by which expenses exceed revenues.

Owner's Equity Statement – A financial statement that summarizes the changes in owner's equity for a specific period of time.

Partnership – An association of two or more persons to carry on a business as co-owners for profit.

Private accounting – An area of accounting with in a company that involves such activities as cost accounting, budgeting, and accounting information systems.

Public Accounting – An area of accounting in which the accountant offers expert service to the general public on a fee bases.

Revenues – the gross increase in Owner's equity, resulting form business activities entered in for the purpose of earning income. It is the amount charged to customers for services sold or goods delivered to them.

Tax Accounting - an area of public accounting involving tax advice, tax planning, and preparing tax returns.

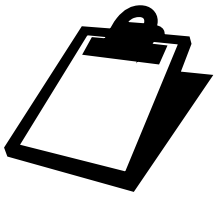
Transactions – The economic events of the business recorded by the accountant.

Chapter Two: The Accounting Cycle

Dear learner! In Chapter 1, we analyzed business transactions in terms of the accounting equation, and we presented the cumulative effects of these transactions in tabular form. Imagine a company like Commercial Bank of Ethiopia using the same tabular format as ABC Taxi Company to keep track of its transactions. In a single day, Commercial Bank of Ethiopia engages in thousands of business transactions. To record each transaction this way would be impractical, expensive, and unnecessary. Instead, companies use a set of procedures and records to keep track of transaction data more easily. This chapter introduces and illustrates these basic procedures and records.

OBJECTIVES OF THE CHAPTER

After studying this chapter, you should be able to:



[a] Explain what an account is and how it helps in the recording process.

[b] Define debits and credits and explain their use in recording business transactions.

[c] Identify the basic steps in journalizing process.

[d] Explain what posting is and how it helps in the recording process.

[e] Prepare a trial balance and explain its purposes, prepare a worksheet.

[f] Explain the process of adjusting and closing entries.

[g] Describe the content and purpose of a postclosing trial balance.

[h] State the required steps in the accounting cycle.

2.1. Introduction

The transaction completed by an enterprise during a specific period may cause increase or decrease in many different asset, liability or owner's equity items. An "**account**" is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item. For example, ABC Taxi Company (the company discussed in Chapter 1) would have separate accounts for Cash, Supplies, Accounts Payable, Fares Revenue, Rent and Wages Expense, and so on. A group of related accounts that comprise a complete unit is called a "**ledger**".

> An "**account**" is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item. A group of related accounts that comprise a complete unit is called a "**ledger**"

2.2. Classification of Accounts

In general, there are five types of accounts. Balance sheet accounts are classified as **assets**, **liabilities**, and **owner's equity**. Income statement accounts are classified as **revenues** and **expenses**.

- **Assets** – asset**s** are resources owned by the business entity. These resources can be physical items, such as cash and supplies, or intangibles that have value. Examples of intangible assets include patent rights, copyrights, and trademarks. Examples of other assets include accounts receivable, prepaid expenses (such as insurance), buildings, equipment, and land. Assets are categorized as current assets and plant assets.

  a. **Current assets**- an assets that might be expected to be realized in cash or sold or used up within one year or less in business operation. It includes cash, accounts receivable, notes receivable, prepaid expenses, etc.

     - **Cash** - is any medium of exchange that a bank will accept at face value, such as: bank deposit, currency, cheeks, etc.
     - **Notes receivable** - is claims against debtors evidenced by written promise.
     - **Account receivable** - is claim against debtors, but not less formal than notes receivable. **Prepaid expenses** - include supplies on hand and advance payments of expenses such as prepaid insurance and prepaid rent.

  b. **Plant assets**- are an assets used in the business that are of a permanent or relatively fixed nature. Sometimes called as **fixed assets**. It includes **equipment**, **machinery**, **buildings**, **land**, etc. except land, plant assets gradually **wear out** or **lose** their **useful life**.

- **Liabilities** are debts owed to outsiders (creditors). Liabilities are often identified on the balance sheet by titles that include the word *payable*. Examples of liabilities include accounts payable, notes payable, and wages payable. Cash received before services are delivered creates a liability to perform the services. There are two categories of liabilities i.e. current liabilities and long term liabilities.

  a. **Current liabilities** – are those liabilities that will be due within one year or less. It includes **account payable**, **notes payable**, **salary payable**, etc.

b. **Long term liabilities** – are those liabilities that will be due after long time. When a note is accompanied by security in the form of **mortgage**, the obligation referred as **mortgage note payable**.

- **Owner's Equity** – it is the **residual claim against the assets** of the business after the total liabilities are deducted. For corporations, it is termed as **stockholder's equity**. Stockholder equity in corporation might has more than two components i.e. **capital stock** and **retained earnings**. Capital stock is the investment of stockholders in corporation type of business, also retained earnings is the net income retained in the business.

  - **Drawing** represents the amount of withdrawal made by the owner of sole proprietor ship. For corporation, **dividend** represents the distribution made for stockholders of the corporation.

- **Revenues** – are the gross increases in owner's equity as a result of selling of goods, rendering of service etc. for customers. Examples of revenues include sales, fees earned, fares earned, commissions revenue, and rent revenue.

3. **Expenses** result from using up assets or consuming services in the process of generating revenues. Examples of expenses include wages expense, rent expense, utilities expense, supplies expense, and miscellaneous expense. Thus, expenses are costs that were incurred during generating revenue.

There are five types of accounts: assets, liabilities, owner's equity, revenues and expenses

2.3. Chart of Accounts

The number of accounts maintained by specific business affected by the type of business operation, the volume of business, managerial decision, tax authority, etc. A list of accounts in the ledger is called **chart of account**. There are five types of accounts i.e. **assets accounts**, **liability accounts**, **owner's equity accounts**, **revenue accounts**, and **expense accounts**. Accounts in the ledger may be numbered consecutively such as: asset accounts represented by 1, liability accounts represented by 2, owner's equity accounts represented by 3, revenue accounts represented by 4, and expense accounts represented by 5.

To illustrate: *chart of accounts for balance sheet accounts and income statement accounts are the followings: 11 cash, 12 AR, 13 Supplies, 14 Prepaid Rent, 21 AP, 22 Salary Payable, 31*

Capital, 32 Drawing, 33 Income Summary, 41 Sales, 51 Supplies Expense, 52 Salary Expense, 53 Rent expense, 54, Depreciation Expense etc.

2.4. Nature of an Account

The simplest form of an account has three parts: (1) a title, which is the name of the item recorded in the account; (2) a space for recording increases in the amount of the item; and (3) a space for recording decreases in the amount of the item. This form of an account is known as a T account, because its similarity to the letter "T".

Title

Debit	**Credit**

The term **debit** indicates the left side of an account, and **credit** indicates the right side. They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit. They **do not** mean increase or decrease, as is commonly thought. We use the terms *debit* and *credit* repeatedly in the recording process to describe **where** entries are made in accounts. For example, the act of entering an amount on the left side of an account is called **debiting** the account. Making an entry on the right side is **crediting** the account.

2.4.1. General Rules of Debit and Credit

Debit	**Credit**
▪ Increase in asset accounts	▪ Decrease in asset accounts
▪ Decrease in liability accounts	▪ Increase in liability accounts
▪ Decrease in owner's equity accounts	▪ Increase in owner's equity accounts
▪ Increase in Drawing/Withdrawals	▪ Decrease in Drawing/Withdrawals
▪ Decrease in Revenue	▪ Increase in Revenue
▪ Increase in Expense	▪ Decrease in Expense

2.4.2. Expanded Rules of Debit and Credit for Balance Sheet Accounts

Balance Sheet Accounts

Assets
Asset Accounts

Debit for **Increase**	**Credit** for **decrease**

Liabilities
Liability Accounts

Debit for **Decreases**	**Credit** for **increases**

Owner's Equity
Owner's Equity Accounts

Debit for decreases	**Credit for increases**

Every business transaction affects a minimum of two accounts. The transaction initially entered in a record called **journal**. The process of recording a transaction in the journal is called **journalizing**. The form of presentation is called a **journal entry.**

Based on the type of account **Debit** used to record either increases or decreases and **Credit** used to record either increases or decreases.

Illustration: Davis Carl establishes a business, to be known as Carl Repair, by initially depositing $ 3,500 cash in bank. The journal entry for the above transaction could be as follows:

Cash……..……. **3,500**
Carl Capital…… **3,500**

The data in the journal entry are transferred to the appropriate accounts by a process known as **posting**. The accounts after posting the above journal entry appear as follow:

Cash	
$3,500	

Carl Capital	
	$3,500

Carl purchased equipment at a cost of $ 2,800; Carl paid $ 1,800 in cash and agreed to pay the remaining $ 1,000 within one week.

Equipment …….2, 800
Cash ……..……..1,800
Account payable ……..……1, 000

The above transactions summarized in the following T accounts as follow:

Cash	
3,500	1,800
1,700	

Equipment	
2800	

Account Payable	
	1,000

Carl Capital	
	3,500

This equality of debit and credit for each transaction is inherent in the equation **A= L + OE**. It is because duality that the system is known as **double – entry accounting**.

2.4.3. Income Statement Accounts

Revenue increases owner's equity. Just as increases in owner's equity are recorded as credits, increases in revenues during an accounting period are recorded as credits. Expenses have the effect of decreasing owner's equity, and just as decreases in owner's equity are recorded as debits, increase in expenses accounts are recorded as debits.

Income Statement Accounts

Debit for decreases in Owner's Equity		**Credit for Increase in Owner's Equity**	
Expense Accounts		**Revenue Accounts**	
Debit for Increases	**Credit for decrease**	**Debit for decreases**	**Credit for increases**

At the end of the accounting period, all revenue and expense account balances are transferred to a summarizing account and the account then said to be closed. Because revenue and expense accounts are periodically **closed**, they are called **temporary accounts** or **nominal accounts**.

2.5. Journals and Accounts

The initial record of each transaction is evidenced by a business document, such as sales tickets, or bills. On the basis of evidence provided by the business documents, the transactions are entered in chronological order in a **journal**. The amounts of debits and credits in the journal are

then transferred or posted to the accounts in the ledger. The following two diagrams shows the standard format of journal and ledger.

THE STANDARD FORM OF JOURNAL

	Date		Description	Post Ref.	Debit	Credit	
1	**March 2016**	**1**					**1**
2							**2**
3							**3**

THE STANDARD FORM OF LEDGER

Account: _____ **Account No. ___**

	Date		Item	Post Ref.	Debit	Credit	Balance		
							Debit	Credit	
1									**1**
2									**2**

Companies initially record transactions in chronological order (the order in which they occur). Thus, the **journal** is referred to as the book of original entry. For each transaction the journal shows the debit and credit effects on specific accounts. Companies may use various kinds of journals, but every company has the most basic form of journal, a **general journal**. Typically, a general journal has spaces for dates, account titles and explanations, references, and two amount columns. See the format of the journal in the above diagram. *Whenever we use the term "journal" in this module without a modifying adjective, we mean the general journal.* The journal makes several significant contributions to the recording process:

a. It discloses in one place the **complete effects of a transaction**.

b. It provides a **chronological record** of transactions.

c. It helps to **prevent or locate errors**.

A complete entry consists of (1) the date of the transaction, (2) the accounts and amounts to be debited and credited, and (3) a brief explanation of the transaction.

Note the steps in the Process of Journalizing!

1. The date of the transaction is entered in the Date column.
2. The debit account title (that is, the account to be debited) is entered first at the extreme left margin of the column headed "Account Titles" and the amount of the debit is recorded in the Debit column.
3. The credit account title (that is, the account to be credited) is **indented** and entered on the next line in the column headed "Account Titles" and the amount of the credit is recorded in the Credit column.
4. If possible, a brief explanation of the transaction appears on the line below the credit account title. A space is left between journal entries.
5. The column titled Post Ref. (which stands for Reference) is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the ledger accounts.

2.5.1. Illustration of Journalizing and Posting

Ann Hill established a photographic business known as Hill Photographic Studio:

March 1. The following assets were invested in the enterprise: cash $ 3,500; accounts receivable $950; supplies $1200 and photographic equipment $15,000.

	Date		Description	Post Ref.	Debit	Credit	
1	March 2016	1	Cash		3,500		**1**
			Account receivable		950		
			Supplies		1,200		
			Photographic equipment		15,000		
			Ann Hill, capital			20,650	

March 1. Ann Hill paid $2,400 for house rental contract; the payment is for 3 month rent.

	Date		Description	Post Ref.	Debit	Credit	
	March 2016	1	Prepaid rent		2,400		
			Cash			2,400	

March 4. Purchased photographic equipment on account from Palmer Photographic Equipment Inc. for $2,500:

	Date		Description	Post Ref.	Debit	Credit	
	March 2016	4	Photographic equipment		2,500		
			Account payable			2,500	

March 5. Received $850 from customers in payment of their accounts:

Date		Description	Post Ref.	Debit	Credit
March 2016	5	Cash Account receivable		850	 850

March 6. Paid $125 for newspaper advertisement:

Date		Description	Post Ref.	Debit	Credit
March 2016	6	Miscellaneous expense cash		125	 125

March 10. Paid $500 to Palmer Photographic Equipment Inc. to apply on the $2,500 debt owed

Date		Description	Post Ref.	Debit	Credit
March 2016	10	Account payable cash		500	 500

March 13. Paid receptionist $575 for two week's salary:

Date		Description	Post Ref.	Debit	Credit
March 2016	13	Salary expense Cash		575	 575

March 16. Received $1,980 from sales for the first half of March:

Date		Description	Post Ref.	Debit	Credit
March 2016	16	Cash Sales		1,980	 1,980

March 27. Purchased and paid $650 for supplies:

Date		Description	Post Ref.	Debit	Credit
March 2016	27	Supplies Cash		650	 650

March 27. Paid receptionist $575 for two week's salary:

Date		Description	Post Ref.	Debit	Credit
March 2016	27	Salary expense Cash		575	 575

March 31. Paid $69 for telephone bill for the month:

Date		Description	Post Ref.	Debit	Credit
March 2016	31	Utility expense cash		69	 69

March 31. Paid $175 for electricity bill for the month:

Date		Description	Post Ref.	Debit	Credit
March 2016	31	Utility expense cash		175	 175

March 31. Received $1,870 from sales for the second half:

Date		Description	Post Ref.	Debit	Credit
March 2016	31	Cash Sales		1,870	 1,870

March 31. Sales on account totaled $1,675 for the month:

Date		Description	Post Ref.	Debit	Credit
March 2016	31	Account receivable Sales		1,675	 1,675

March 31. Hill withdrew $1,500 for her personal use:

Date		Description	Post Ref.	Debit	Credit
March 2016	31	Ann Hill drawing cash		1,500	 1,500

Dear learners! For educational purpose the above journal entries could be journalized using simple methods instead of making horizontal and vertical lines to make the journal. Example for march 1 transaction: (***after this point this type of journal entry made in this module***)

Cash 3,500
Accounts Receivable 950
Supplies 1,200
Photographic Equipment 15,000
Ann Hill, Capital 20,650

2.5.2. Posting of the above illustration to the account (ledger)

Transferring journal entries to the ledger accounts is called **posting**. This phase of the recording process accumulates the effects of journalized transactions into the individual accounts. Posting involves the following steps.

1. In the **ledger**, in the appropriate columns of the account(s) debited, enter the date, journal page, and debit amount shown in the journal.
2. In the reference column of the **journal**, write the account number to which the debit amount was posted.
3. In the **ledger**, in the appropriate columns of the account(s) credited, enter the date, journal page, and credit amount shown in the journal.
4. In the reference column of the **journal**, write the account number to which the credit amount was posted.

Posting should be performed in chronological order. That is, the company should post all the debits and credits of one journal entry before proceeding to the next journal entry. Postings should be made on a timely basis to ensure that the ledger is up to date.

Note the steps in the Process of Posting !

1. Post to debit account–date, journal page number, and amount.
2. Enter debit account number in journal reference column.
3. Post to credit account–date, journal page number, and amount.
4. Enter credit account number in journal reference column.

Activity

Question 1: Define Asset, liability, owner's equity, revenue and expense.....

.....

Account: Cash **Account No. 11**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1			3500		3500	
	1				2400	1100	
	5			850		1950	
	6				125	1825	
	10				500	1325	
	13				575	750	
	16			1980		2730	
	20				650	2080	
	27				575	1505	
	31				69	1436	
	31				175	1261	
	31			1870		3131	
	31				1500	1631	

Account: Account Receivable (AR) **Account No. 12**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1			950		950	
	5				850	100	
	31			1675		1775	

Account: Supplies **Account No. 14**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1			1200		1200	
	20			650		1850	

Account: Prepaid Rent **Account No. 15**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1			2400		2400	

Account: Photographic Equipment **Account No. 18**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1			15000		15000	
	4			2500		17500	

Activity

Question 2: What is mean by journal and ledger?.....

.....

Account: Account Payable (AP) **Account No. 21**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1				2500		2500
				500			2000

Account: Ann Hill, Capital **Account No. 31**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	1				20650		20650

Account: Ann Hill, Drawing **Account No. 32**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	31			1500		1500	

Account: Sales **Account No. 41**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	16				1980		1980
	31				1670		3650
	31				1675		5525

Account: Salary Expense **Account No. 52**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	13			575		575	
	27			575		1150	

Account: Utility Expense **Account No. 57**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	6			125		125	
Mar	31			69		194	
	31			175		244	

Account: Miscellaneous Expense **Account No. 59**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
Mar	6			125		125	

2.6. Trial Balance

The equality of debits and credits in the ledger should be verified at the end of each accounting period, such a verification, which is called a **trial balance**. Example for Ann Hill photographic studio is as follows:

Hill Photographic Studio
Trial Balance
March 31, 2016

Cash	1631	
Accounts Receivable	1775	
Supplies	1850	
Prepaid Rent	2400	
Photographic Equipment	17500	
Accounts Payable		2,000
Ann Hill, Capital		20,650
Ann Hill Drawing	1500	
Sales		5,525
Salary Expense	1150	
Utility Expense	244	
Miscellaneous Expense	125	
	28,175	**28,175**

2.6.1. Proof Provided by the Trial Balance

The trial balance does not provide complete proof of accuracy of the ledger. It indicates only that the debits and credits are equal. If the two totals of trial balance are not equal, it is probably due to one or more of the following types of errors:

1. Error in preparing trial balance:
   a. One of the columns of the trial balance was incorrectly added.
   b. The amount of an account balance was incorrectly recorded on the trial balance.
   c. A debit balance was recorded as credit, or vice versa, or a balance was omitted entirely.
2. Error in determining the account balance:
   a. A balance was incorrectly computed.
   b. A balance was entered in the wrong balance column.
3. Error in recording a transaction in the ledger
   a. An erroneous amount was posted to the account.
   b. A debit entry was posted as a credit, or vice versa.
   c. A debit or credit posting was omitted.

Among the types of errors that will not cause an inequality in the trial balance totals are the following:

1. Failure to record a transaction or to post a transaction.
2. Recording the same erroneous amount for both the debit and credit parts of a transaction.
3. Recording the same transaction more than one.
4. Posting a part of a transaction correctly as a debit or credit but not to the wrong account.

2.6.2. DISCOVERY OF ERRORS

The existence of an error can be determined in various ways:

1. By audit procedures
2. By chance discovery, or
3. Through the medium of the trial balance.

2.6.3. TYPES OF ERROR

a. **Addition:** For example, a difference of $10, $100, or $1,000 between totals is frequently the result of error in addition.
b. **Omission:** A difference between totals can happen due to the omission of a debit or a credit posting or, if it is divisible evenly by 2, to the posting of a debit or a credit, or vice versa. For example, if the debit and credit totals of a trial balance are $ 20,640 and $20,236 respectively, the difference of $404 may indicate that a credit posting of that amount was omitted or that a credit of $202 was erroneously posted as a debit.
c. **Transpositions:** It is the erroneous rearrangement of digit, such as writing $ 542 as $ 524 or $452.
d. **Slide:** It is the entire number is erroneously moved one or more spaces to the right or the left, such as writing $542.00 as $54200 or $54.20.

2.7. Matching Principle

Revenues and expenses may be reported on the income statement by: (1) **the cash basis of accounting, or (2) the accrual basis of accounting.** When the **cash basis** is used, revenues are reported in the period, in which **cash is received**, and expenses are reported in the period in which cash is paid. I.e. **net income** or **net loss** is the difference between **cash received from revenues** and **cash disbursements for expenses**. When the **accrual basis** of accounting is used, revenues are reported in the period in which they are **earned**, and expenses are reported in the period in which they are **incurred** in an attempt to produce revenues.

- ***Most enterprises use the accrual basis of accounting. Generally accepted accounting principles (GAAP) requires the use of the accrual basis, so that revenues recognized are matched with the expenses incurred in producing the revenues.***

2.8. Adjustments

Some of the trial balance amounts are not correct. The amounts listed for prepaid expenses are normally overstated. This is because of the day to day consumption or expiration of these assets has not been recorded. There are two effects on the ledger when the daily reduction in prepaid expenses is not recorded:

1. *Asset accounts are overstated, and*
2. *Expense accounts are understated, then the net income will be overstated or the net loss understated.*

For example, salary expense incurred between the last payday and the end of the accounting period would not be recorded in the account. The entries required to record at the end of an accounting period to bring the accounts up to date and to assure the proper matching of revenues and expenses are called **adjusting entries**.

The matching principle, as explained earlier requires that revenues be recognized and recorded in the period it is earned. Thus the matching principle stresses that in order to measure income expenses incurred to produce revenues must be matched (associated) with the revenue generated in the same accounting period.

At the end of an accounting period, adjusting entries are needed so that all revenues earned is reflected in the financial statements regardless of whether it has been collected. Adjusting entries are also needed for expenses to assure that all expenses incurred are matched against the revenues of the current period regardless of when cash payment of the expense occurs.

Thus adjusting entries help in achieving the goals of accrual accounting – which states recording revenues when it is earned and recording expenses when the related goods and services are used, i.e. when expenses are incurred.

Accountants use adjusting entries to apply accrual accounting to transactions that span more than one accounting period. That is, adjusting entries are needed whenever transactions affect the revenues on expense of more than one accounting period.

Adjusting entries are journal entries that are required at the end of an accounting period to bring the ledger up to date. Adjusting entries can be classified as either **deferrals** or **accruals**.

- **Deferrals - 1. *Prepaid Expenses*.** Expense that are paid in cash before they are used or consumed.

  2. ***Unearned Revenues*.** Revenues received in cash before delivering goods or services.

- **Accruals - 1**. ***Accrued Expenses.*** Expenses incurred but not yet paid in cash or recorded.

  2. ***Accrued revenues*.** Revenues earned but not yet received in cash or recorded.

Prepaid expenses (deferred expenses)

It is already paid before using the service or property. Such as: prepaid rent, prepaid insurance.

Illustration: The inventory of supplies on March 31 is determined that $890 is on hand, the amount to be moved from asset account to expense account is $960 i.e. (1,850-890=960).

Supplies Expense 960
  Supplies 960

Prepaid rent was used for one month (March 1 up to March 31).

Rent Expense 800
  Prepaid Rent 800

Activity

Question 3: What is the purpose of trial balance?.....
.....

As time passes, equipment does lose its capacity to provide useful service. This decrease in usefulness is a business expense, which is called **depreciation**. This expired portion of the cost of plant asset is both an **expense** and a **reduction** in the **asset**. The adjusting entry to record is **depreciation expense debited** and **accumulated depreciation credited**.

Illustration: The estimated amount of depreciation of the photographic equipment for the month is assumed to be $175:

Depreciation expense 175
  Accumulated Depreciation – Photographic Equipment 175

Accrued Expenses (Liabilities)

Accrued expense is an accumulated expense that is unpaid and unrecorded, such as: unpaid and unrecorded amount of salary for employees. The accrued expense and the related liabilities must be recorded in the account by the adjusting entry.

Illustration: The debit of $ 575 on March 13 and 27 in the salary expense account were biweekly payments on Fridays for the payroll periods ended on those days. The salaries expense on Monday and Tuesday, March 30 and 31 total $ 115.

Salary Expense 115
Salary Payable 115

2.9. Work Sheet

A type of working paper frequently used by accountants prior to preparation of financial statements is called **work sheet**. Work sheet is **not a required report or a financial statement** (it is not available to external decision makers), yet using of work sheet has several benefits, such as:

- *Aids the preparation of financial statements.*
- *Reduce the possibilities of errors.*
- *Links accounts and adjustments to their impacts in the financial statements.*

Work sheet has an **account title column** and **ten money columns**, ranged in five parts of debit and credit columns. The main headings are: **adjustments**, **adjusted trial balance**, **income statement** and **balance sheet**.

Trial Balance Column: The trial balance data can be assembled directly on the work sheet form or can be prepared on another sheet and then copied on to the work sheet form.

Adjustments Column: Both the debit and credit parts of an adjustment should be inserted on the appropriate lines before going on to another adjustment.

a. Supplies:
   Supplies account $1,850
   Less: Supplies on hand 890
   Supplies Expense 960

b. Rent:
   Prepaid rent (for 3 month) $2,400
   Less: Remaining prepaid rent (2 month) 1,600
   Rent Expense for March 800

c. Depreciation: depreciation of photographic equipment is estimated to be $175 for the month:
   Depreciation expense…….175
   Accumulated depreciation ……175

d. Salaries: Salaries accrued but not yet paid at the end of the month of March is $115. This is an increase in expense and an increase in liability.

Adjusted Trial Balance: The data in the trial balance columns are combined with the adjustments data and extend to the adjusted trial balance columns.

Income Statement and Balance Sheet: The data in the adjusted trial balance columns are extended to one of remaining four columns. The amounts of assets, liabilities, owner's equity and drawing (or dividends) are extended to the balance sheet columns; and the revenues and expenses are extended to income statement columns.

The net income or net loss for the period is the amount of the difference between the totals of the two income statement columns. If the credit column total is greater than the total of debit column, the excess is the net income. The net balance will be transferred to the capital account (or retained earnings account) in the ledger. This transfer is accomplished on the work sheet by entries in the income statement and balance sheet.

Steps in Preparing a Worksheet

We will use the March 31 trial balance and adjustment data of Hill Photographic Studio to illustrate how to prepare a worksheet. We describe each step of the process and demonstrate these steps in the following pages.

STEP 1. PREPARE A TRIAL BALANCE ON THE WORKSHEET

Enter all ledger accounts with balances in the account titles space. Enter debit and credit amounts from the ledger in the trial balance columns. This trial balance is the same one that appears in section 2.6.

STEP 2. ENTER THE ADJUSTMENTS IN THE ADJUSTMENTS COLUMNS

Enter all adjustments in the adjustments columns. In entering the adjustments, use applicable trial balance accounts. If additional accounts are needed, insert them on the lines immediately below the trial balance totals. A different letter identifies the debit and credit for each adjusting entry. The term used to describe this process is **keying**. **Companies do not journalize the adjustments until after they complete the worksheet and prepare the financial statements.** The adjustments for Pioneer Advertising Agency are the same as the adjustments illustrated previously as follows.

[a] Supplies Expense 960

[b] Rent Expense for March 800

[c] Depreciation of photographic equipment is estimated to be $175 for the month:

[d] Salaries accrued but not yet paid at the end of the month of March is $115.

After Hill Photographic Studio has entered all the adjustments, the adjustments columns are totaled to prove their equality.

STEP 3. ENTER ADJUSTED BALANCES IN THE ADJUSTED TRIAL BALANCE COLUMNS

Hill Photographic Studio determines the adjusted balance of an account by combining the amounts entered in the first four columns of the worksheet for each account. For example, the Prepaid Rent account in the trial balance columns has a $2400 debit balance and a $800 credit in the adjustments columns. The result is a $1600 debit balance recorded in the adjusted trial balance columns. **For each account, the amount in the adjusted trial balance columns is the balance that will appear in the ledger after journalizing and posting the adjusting entries.** After Hill Photographic Studio has entered all account balances in the adjusted trial balance columns, the columns are totaled to prove their equality. If the column totals do not agree, the financial statement columns will not balance and the financial statements will be incorrect.

STEP 4. EXTEND ADJUSTED TRIAL BALANCE AMOUNTS TO APPROPRIATE FINANCIAL STATEMENT COLUMNS

The fourth step is to extend adjusted trial balance amounts to the income statement and balance sheet columns of the worksheet. For instance, enters Cash in the balance sheet debit column, and Account Payable in the credit column. Extends Accumulated Depreciation—Equipment to the balance sheet credit column; the reason is that accumulated depreciation is a contra-asset account with a credit balance. Because the worksheet does not have columns for the owner's equity statement, extends the balance in owner's capital to the balance sheet credit column. In addition, extends the balance in owner's drawings to the balance sheet debit column because it is an owner's equity account with a debit balance. Enters the expense and revenue accounts such as Depreciation and Wages Expense and Sales Revenue in the appropriate income statement columns.

STEP 5. TOTAL THE STATEMENT COLUMNS, COMPUTE THE NET INCOME (OR NET LOSS), AND COMPLETE THE WORKSHEET

Now total each of the financial statement columns. The net income or loss for the period is the difference between the totals of the two income statement columns. If total credits exceed total debits, the result is net income. In such a case, as shown in Illustration for Hill Photographic Studio "Net Income" inserted in the account titles space. Then enter the amount in the income statement debit column and the balance sheet credit column. **The debit amount balances the income statement columns; the credit amount balances the balance sheet columns.** In addition, the credit in the balance sheet column indicates the increase in owner's equity resulting from net income.

What if total debits in the income statement columns exceed total credits? In that case, the company has a net loss. Enter the amount of the net loss in the income statement credit column and the balance sheet debit column. After entering the net income or net loss, the company determines new column totals. The totals shown in the debit and credit income statement columns will match. So will the totals shown in the debit and credit balance sheet columns. If either the income statement columns or the balance sheet columns are not equal after the net income or net loss has been entered, there is an error in the worksheet.

Hill Photographic Studio
Work Sheet
For the Month Ended March 31, 2016

Account Title	Trial Balance		Adjustments		Adjusted Trial balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	1631				1631				1631	
Accounts receivable	1775				1775				1775	
Supplies	1850			(a) 960	890				890	
Prepaid Rent	2400			(b) 800	1600				1600	
Photo. Equip.	17500				17500				17500	
Accounts Payable		2000				2000				2000
Ann Hill Capital		20650				20650				20650
Ann Hill Drawing	1500				1500				1500	
Sales		5525				5525		5525		
Salary Expense	1150		(d)115		1265		1265			
Utility Expense	244				244		244			
Miscellaneous Expense	125				125		125			
	28175	28175								
Supplies Expense			(a)960		960		960			
Rent Expense			(b)800		800		800			
Depreciation Exp.			(c)175		175		175			
Accumulated Depr. P.E				(c)175		175				175
Salaries Payable				(d) 115		115				115
			2050	2050	28465	28465	3569	5525	24896	22940
Net income							1956			1956
							5525	5525	24896	24896

2.10. Financial Statements

Work sheet is an aid in preparing financial statement. The income statement, statement of owner's equity and balance sheet prepared from work sheet. For Hill Photographic Studio, the financial statements are presented as follows:

Hill Photographic Studio
Income Statement
For Month Ended March 31, 2016

Sales		5,525
Operating Expenses:		
Salary Expense	1,265	
Supplies Expense	960	
Rent Expense	800	
Utility Expense	244	
Depreciation expense	175	
Miscellaneous Expense	125	
Total Operating Expenses		3,569
Net Income		**1,956**

Hill Photographic Studio
Statement of Owner's Equity
For Month Ended March 31, 2016

Ann Hill Capital, March 1, 2016……		20,650
Net Income for the Month……...	1956	
Less: Withdrawals……	1500	
Increase in Owner's Equity……..…..		456
Ann Hill Capital, March 31, 2016……		21106

Hill Photographic Studio
Balance Sheet
March 31, 2016

Assets		
Current Assets:		
Cash	1,631	
Account Receivable	1,775	
Supplies	890	
Prepaid Rent	1,600	
Total Current Assets		5,896
Plant Assets:		
Photographic Equipment	17,500	
Less: Accumulated Depreciation	175	17,325
Total Assets		**23,221**
Liabilities		
Current Liabilities:		
Account Payable	2,000	
Salaries Payable	115	
Total Liabilities		2,115
Owner's Equity		
Ann Hill, Capital		21,106
Total Liabilities and owner's Equity		**23,221**

2.11. Journalizing and Posting Adjusting Entries

At the end of the accounting period, the adjusting entries appearing in the work sheet are recorded in the journal and posted to the ledger. The adjusting entries are dated as of the last day of period. The adjusting entries for Hill Photographic Studio as of March 31 are as follows:

Supplies Expense……..960
Supplies…….960

Rent Expense…….800
Prepaid rent……...800

Depreciation Expense…….175
Accumulated depreciation…….175

Salary Expense……...115
Salary Payable……...115

2.12. Closing Entries

The revenue, expense, and drawing (or dividends) accounts are temporary accounts used in classifying and summarizing changes in the owner's equity during the accounting period. At the end of the period, the net effect of the balances in these accounts must be recorded in the permanent capital (or retained earnings) account. The balance must also be removed from temporary accounts, these processes done by **closing entries**.

Journalizing and Posting Closing Entries

An account title income summary is used for summarizing the data in the revenue and expense accounts (used only at the end of accounting period). And opened and closed during the closing process. Four entries are required to close temporary account. They are as follows:

1. Each **revenue** is **debited** and **income summary** is **credited** for the total revenues.
2. Each **expense** is **credited** and **income summary** is **debited** for the total of expenses.
3. **Income summary** is **debited** for the amount of its balance ***if income is generated*** and **capital** account is **credited**. ***If it is net loss***, **capital** account is **debited** and **income summary** is credited for the amount of its balance.
4. The **drawing** account is **credited** for the amount of its balance, and **capital** account **debited.**

For corporation type of business, entry 3 is closed to retained earnings account and entry 4, the dividend is closed to retained earnings account. Closing entry for Hill Photographic Studio is as follows:

Sales…….5525
Income Summary…….5525

Income Summary……3569
Salary Expenses……..1265
Supplies Expenses……..……..960
Rent Expenses……..800
Utility Expense ……244
Depreciation Expenses……..…175
Miscellaneous Expenses…….……..…125

Income Summary……1956
Ann Hill, Capital……...1956

Ann Hill, Capital…….1500
Ann Hill drawing…….…….1500

After journalizing, the journal entries should be posted to the ledger. **The sales, expenses, income summary, and drawing accounts then get zero balance.**

2.13. Post-Closing Trial Balance

The last procedure of the accounting cycle is the preparation of post closing trial balance after all of the temporary accounts has been closed. The purpose of the post closing trial balance is to make sure that the ledger is balance at the beginning of the new accounting period. The following is Hill Photographic Studio post closing trial balance as of March 31, 2016:

Hill Photographic Studio
Post Closing Trial Balance
March 31, 2016

Cash	1,631	
Accounts receivable	1,775	
Supplies	890	
Prepaid Rent	1,600	
Photographic Equipment	17,500	
Accumulated Depreciation		175
Accounts Payable		2,000
Salary Payable		115
Ann Hill, Capital		21,106
	23,396	23,396

2.14. Fiscal Year

The annual accounting period adopted by a business is known as its **fiscal year**. Fiscal years begin with the first day of the month selected and end on the last day of the following twelfth month. The period most commonly used is the calendar year. Other periods are not unusual, especially for businesses organized as corporations. For example, government organizations in Ethiopia fiscal year starts July 8 (Hamle 1, 2008) of the current year and ends July 7 (Sene 30, 2009) of the next year. In general, the maximum length of an accounting period is usually one year (12 months).

2.15. Summaries of the Accounting Cycle

The principal accounting sequence of a fiscal period called the **accounting cycle**. The most significant output of the accounting cycle is the **financial statements**.

The followings are the accounting cycle sequence:

1. ***Transactions are analyzed and recorded in a journal (journal entries).***
2. ***Journal entries posted to the ledger.***
3. ***Trial balance is prepared, adjustments are made and work sheet is completed.***
4. ***Financial statements are prepared.***
5. ***Adjusting and closing entries are journalized.***
6. ***Adjusting and closing entries are posted to the ledger.***
7. ***Post-closing trial balance is prepared***

2.16. Self-Examination Questions

1. Which of the following statements about an account is *true*?

a. In its simplest form, an account consists of two parts.

b. An account is an individual accounting record of increases and decreases in specific asset, liability, and owner's equity items.

c. There are separate accounts for specific assets and liabilities but only one account for owner's equity items.

d. The left side of an account is the credit or decrease side.

2. Debits:

a. increase both assets and liabilities.

b. decrease both assets and liabilities.

c. increase assets and decrease liabilities.

d. decrease assets and increase liabilities.

3. A revenue account:

a. is increased by debits.

b. is decreased by credits.

c. has a normal balance of a debit.

d. is increased by credits.

4. Accounts that normally have debit balances are:

a. assets, expenses, and revenues.

b. assets, expenses, and owner's capital.

c. assets, liabilities, and owner's drawings.

d. assets, owner's drawings, and expenses.

5. Which of the following is *not* part of the recording process?

a. Analyzing transactions.

b. Preparing a trial balance.

c. Entering transactions in a journal.

d. Posting transactions.

6. The purchase of supplies on account should result in:

a. a debit to Supplies Expense and a credit to Cash.

b. a debit to Supplies Expense and a credit to Accounts Payable.

c. a debit to Supplies and a credit to Accounts Payable.

d. a debit to Supplies and a credit to Accounts Receivable.

7. The order of the accounts in the ledger is:

a. assets, revenues, expenses, liabilities, owner's capital, owner's drawings.

b. assets, liabilities, owner's capital, owner's drawings, revenues, expenses.

c. owner's capital, assets, revenues, expenses, liabilities, owner's drawings.

d. revenues, assets, expenses, liabilities, owner's capital, owner's drawings.

8. A ledger:

a. contains only asset and liability accounts.

b. should show accounts in alphabetical order.

c. is a collection of the entire group of accounts maintained by a company.

d. is a book of original entry.

9. Posting:

a. normally occurs before journalizing.

b. transfers ledger transaction data to the journal.

c. is an optional step in the recording process.

d. transfers journal entries to ledger accounts.

10. Before posting a payment of $5,000, the Accounts Payable of Senator Company had a normal balance of $16,000. The balance after posting this transaction was:

a. $21,000. **c.** $11,000.

b. $5,000. **d.** Cannot be determined.

11. A trial balance:

a. is a list of accounts with their balances at a given time.

b. proves the mathematical accuracy of journalized transactions.

c. will not balance if a correct journal entry is posted twice.

d. proves that all transactions have been recorded.

12. Adjustments for prepaid expenses:

a. decrease assets and increase revenues.

b. decrease expenses and increase assets.

c. decrease assets and increase expenses.

d. decrease revenues and increase assets.

13. Accumulated Depreciation is:

a. a contra asset account.

b. an expense account.

c. an owner's equity account.

d. a liability account.

14. In a worksheet, net income is entered in the following columns:

a. income statement (Dr) and balance sheet (Dr).

b. income statement (Cr) and balance sheet (Dr).

c. income statement (Dr) and balance sheet (Cr).

d. income statement (Cr) and balance sheet (Cr).

15. All of the following are required steps in the accounting cycle *except*:

a. journalizing and posting closing entries.

b. preparing financial statements.

c. journalizing the transactions.

d. preparing a worksheet.

(Answers) 1:B, 2:C, 3:D, 4:D, 5:B, 6:C, 7:B, 8:C, 9:D, 10: A, 11:B, 12:C, 13:A, 14:C, 15:D

Problem 1 (Workout)

Kelly Pitney has operated a part-time consulting business from her home. As of April 1, 2010, Kelly decided to move to rented quarters and to operate the business on a full-time basis. The business will be known as Kelly Consulting. During April, Kelly Consulting entered into the following transactions:

April 1. The following assets were received from Kelly Pitney as initial investment: cash, $13,100; accounts receivable, $3,000; supplies, $1,400; and office equipment, $12,500. There were no liabilities received.

1. Paid three months' rent on a lease rental contract, $4,800.

2. Paid the premiums on property and casualty insurance policies, $1,800.

4. Received cash from clients (customers) as an advance payment for services to be provided and recorded it as unearned fees (deferred revenue), $5,000.

5. Purchased additional office equipment on account from Office Station Co., $2,000.

6. Received cash from clients on account, $1,800.

10. Paid cash for a newspaper advertisement, $120.

12. Paid Office Station Co. for part of the debt incurred on April 5, $1,200.

12. Recorded services provided on account for the period April 1–12, $4,200.

14. Paid part-time receptionist for two weeks' salary, $750.

17. Recorded cash from cash clients for fees earned during the period April 1–16, $6,250.

18. Paid cash for supplies purchased, $800.

20. Recorded services provided on account for the period April 13–20, $2,100.

24. Recorded cash from cash clients (in cash transaction) for fees earned for the period April 17–24, $3,850.

26. Received cash from clients on account, $5,600.

27. Paid part-time receptionist for two weeks' salary, $750.

29. Paid telephone bill for April, $130.

30. Paid electricity bill for April, $200.

30. Recorded cash from cash clients for fees earned for the period April 25–30, $3,050.

30. Recorded services provided on account for the remainder of April, $1,500.

30. Kelly withdrew $6,000 for personal use.

Requirements

[1]. Journalize the above transactions and events

[2]. Post the journal entries (Hint answers cash and revenue balances are 22,100 and 20,950, respectively)

[3]. Prepare trial balance (Hint answers total debit and credit is 56,750)

[4]. Prepare the worksheet using the following data which was assembled on April 30, 2016.

- **a.** Insurance expired during April is $300.
- **b.** Supplies on hand on April 30 are $1,350.
- **c.** Depreciation of office equipment for April is $330.
- **d.** Accrued receptionist salary on April 30 is $120.
- **e.** Rent expired during April is $1,600.
- **f.** Unearned fees on April 30 are $2,500.

(Hint answers total debit and credit of adjustments column is 5,700, net income is 18,300)

[5]. Prepare the Financial Statements (3 of them)

[6]. Journalizing and Posting Adjusting Entries

[7]. Journalizing and Posting Closing Entries

[8]. Preparing a Post-Closing Trial Balance

Problem 2 (Workout)

Mr. X wants to operate taxi service in Dessie and started the business on March first of 2016. The following transactions were taking place for the month of March:

March 1 - Mr. X invested the following assets for the business to be effective by borrowing $4,000 cash from his friend and $5,000 cash of his own; account receivable $1,500; supplies $950; and Minibus that cost $80,000.

March 2 - Purchased gasoline, oil and other supplies of $4,500 from **Mobil Gas Station**, Mr. X agreed to pay $1,500 after two weeks and paid the remaining amount.

March 3 - Taxi service provided for customers and received $6,200 cash.

March 10–Mr. X paid $900 for driver's salary.

March 15 -Taxi service provided for customers on account totaled $2000.

March 17 -Mr. X paid for Mobil Gas Station the unpaid amount of money that was occurred on March 2 transactions.

March 20 - Paid $ 850 for driver salary

March 21 - Mr. X received $1,500 of his receivable that has been invested on March 1.

March 23 –The Minibus maintained in garage and Mr. X paid $420 cash for maintenance.

March 31 - Mr. X withdrew $1,500 for his personal use.

<u>Requirements</u>

1. Journalize the transactions that have been took place from the month of March 1 up to 31.
2. Post the journal entries to the ledger.
3. Prepare trial balance
4. Prepare worksheet using the following adjustment information:
   a. The inventory of supplies determined that $2000 is on hand.
   b. Depreciation on Minibus during the month of March estimated $536.
   c. Salary accrued but not paid at March 31, 2016 is $300.
5. Prepare the 3 financial statements
6. Journalize and post the adjusting entries as of March 31, 2016.
7. Journalize and post the closing entries as of March 31, 2016.
8. Prepare post-closing trial balance.

Problem 3 (Workout)

The trial balance of Betty Beauty Saloon does not balance. The errors in the accounting work are given below. Determine the correct balance of each account and prepare the corrected trial balance.

Betty Beauty Saloon

Trial balance

April 30

Cach	5,902.00	
Accounts Receivable	6,300.00	
Supplies	1,600.00	
Equipment	5,200.00	
Accounts payable		4,300.00
Betty capital		10,000.00
Service income		4,700.00
Operating expenses	1,980.00	
Total	20,982.00	19,200.00

The errors are the following:

- Cash received form a customer on account was recorded (both debit and credit) as birr 1,400 instead of Birr 1,120
- The purchase on account of an equipment costing Birr 780 was recorded as a debit to operating expense and credit to accounts payable.
- Service was performed to clients Birr 1,780 for which accounts Receivable was debited birr 1,780 and service income was credit birr 178
- A payment of Birr 80 for telephone charges was debited to Operating Expense and it was also debited to cash
- The ledger balance of the service income account is birr 4,700 rather than Birr 4,720.

2.17. Glossary of Terms

Account –a record showing separately the increases and decreases of a financial statement item during a period.

T account- the simplest format of an account, which resembles the letter 'T'.

Chart of Accounts- a list of the account s used by an organization and their codes.

Debit- the left side of an account.

Credit- the right side of an account.

Source Documents- documents such as an invoice or a cash receipt voucher that evidence the occurrence of a transaction.

Journal- a book or record where a transaction's full debits and credits and other details are first recorded.

Journal Entry-the debits and credits recorded in the journal for one transaction.

Ledger- a book, where increases and decreases in each account are separately recorded. It is therefore the collection of the individual accounts of an organization.

Trial Balance – a form showing the final balance of each ledger account. It is used to somehow check if any errors were made during the period.

Work Sheet –a working paper that accountants use to collect adjustment data and to easly prepare the financial statements.

Adjustments – entries required to up-date some accounts before preparing financial statements.

Post Closing Trial Balance- a trial balance prepared after all the accounts have been closed.

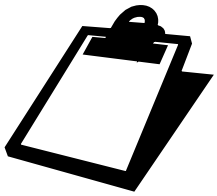
Chapter Three: Accounting for Merchandising Enterprises

Hill Photographic Studio, the business described in Chapter 2, is a service business; it provides photographic services for customers. However, many other businesses purchase goods to sell. Goods that a business purchases to sell are called **merchandise**. A business that purchases and sells goods is called a **merchandising business**. A merchandising business that sells to those who use or consume the goods is called a **retail merchandising business**. A business that buys and resells merchandise to retail merchandising businesses is called a **wholesale merchandising business**. Service and merchandising businesses use many of the same accounts. A merchandising business has additional accounts on the balance sheet and income statement to account for the purchase and sale of merchandise.

In general, Merchandising is one of the largest and most influential industries in the world. Therefore, understanding the financial statements of merchandising companies is important. In this chapter, you will learn the basics about reporting merchandising transactions. In addition, you will learn how to prepare and analyze a commonly used form of the income statement—the multiple-step income statement.

OBJECTIVES OF THE CHAPTER

After studying this chapter, you should be able to:



[a] Identify the differences between service and merchandising companies.

[b] Explain the recording of purchases and sales of merchandise.

[c] Describe the type of transportation term agreements.

[d] Explain the procedures to compute and determine the cost of merchandise sold.

[e] Explain accounting cycle for a merchandising company.

[f] Distinguish between a multiple-step and a single-step income statement.

3.1. Introduction

Businesses might be established either to provide services or selling goods for the customers or both. Chapter two of this course deals with the service companies, and this chapter only deals with those companies that purchase goods and resale the goods to customers, i.e., ***merchandising***

companies. In general, there are differences in the accounting system between the service companies and merchandising companies.

The main business activities of merchandising companies are purchasing and selling of various products and goods for customers.

Merchandises are products or goods which are acquired to resale for others. The other name of merchandise is **inventory**. Merchandising enterprise acquires merchandise for resale to customers. It is the selling of merchandise. Thus in a case of merchandising company, the accounting systems deals with the ***purchases*** and ***selling*** of merchandises. Merchandise transactions are recorded in the accounts, using the rules of debit and credit that we described and illustrated in chapter two.

The various businesses that sales electronics materials and stationary items in Ethiopia are called merchandising companies because they buy and sell merchandise rather than perform services as their primary source of revenue. The primary source of revenues for merchandising companies is the sale of merchandise, often referred to simply as sales revenue or sales. A merchandising company has two categories of expenses: cost of merchandise sold (will be discussed later) and operating expenses.

3.2. Accounting for Purchase

Purchases of merchandise identified (recorded) in the ledger as **purchases**. Merchandising enterprise can accumulate in the purchases account the cost of all merchandise purchased for resale during the accounting period. When purchases are made for cash, the transaction could be recorded as follows:

Purchases……..510
Cash…..…….510

Activity

Question 1: What is the merchandise?.....
.....

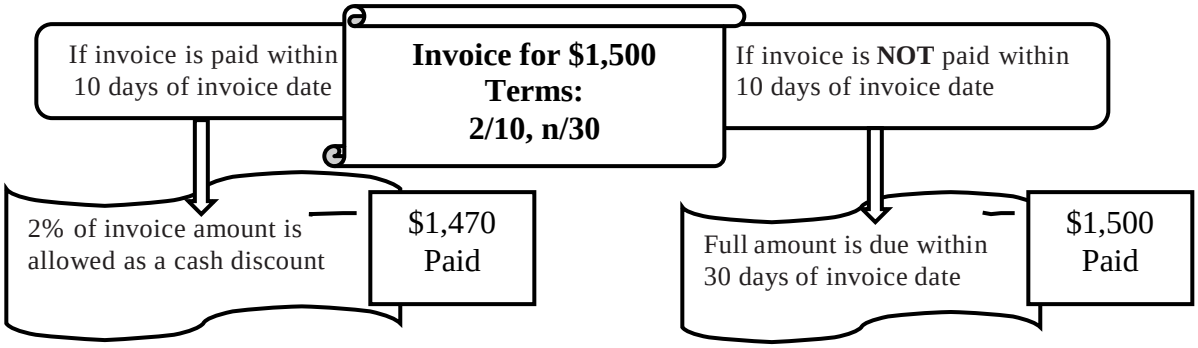
When purchases are made on account, the transaction could be recorded as follows:
Purchases……..510
AP…….…….510

3.2.1. Purchase Discounts

The agreement by the buyer and seller as to when payments to be made for the merchandise purchased and sold are called **credit terms**. If payment is required for the merchandise sold, up on the delivery of merchandise to the buyer, the term is said to be **cash** or **net cash**. Otherwise, the buyer is allowed an amount of time, known as the **credit period**, in which to pay. For example, Habesha Company purchased merchandise on account from ABC Company:

The credit period usually begins with the date of the sale as shown on the invoice (invoice is a source document that the seller sends to the buyer when transact with on account) prepared by the seller. If payment is due within a stated number of days after the date of the invoice, such as 30 days, the terms are **net 30 days**. These terms may be written as **n/30**. If payment is due by the **end of the month** in which the sale was made, the terms are written as **n/eom**.

As means of encouraging payment before the ***end of the credit period***, the seller may offer a discount for the early payment of cash. Thus, the expression "**2/10, n/30**" means, the **credit period is 30 days**, the buyer may **deduct 2%** of the amount of purchase if payment is made **within 10 days** of the purchased date. Refer this diagram:



Discount taken by the buyer for early payment of an invoice (liability) are called **purchases discount**. It is recorded by crediting the purchases discounts account and viewed as a deduction from the initial (original) recorded of purchases. Purchase discount is a **contra (or offsetting)** account to purchases. Take this illustration:

Illustration 1: Habesha Company on October 11, 2016 purchased $1,500 of merchandise on account, with a credit terms of 2/10, n/30 from ABC Company. The journal entry to record the purchase of merchandise on account is the following.

October 11, 2016	Purchases	1,500	
	AP		1,500

Illustration 2: On October 21, 2016, Habesha Company made cash payment to the ABC Company for the merchandise purchased on October 11, 2016. The journal entry to record the payment of cash is as follow:

October 21, 2016	AP	1,500	
	Cash		1,470
	Purchases Discount		30

Bear in mind that, when buyer returns merchandise prior to the payment of the invoice (liability), the amount of debit memorandum is deducted from the invoice amount before purchase discount is computed.

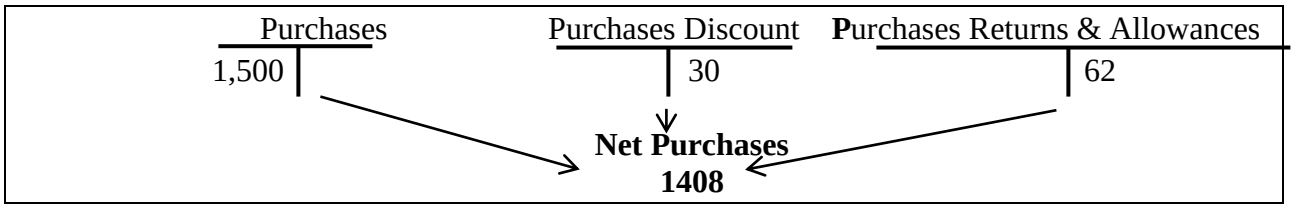
3.2.2. Purchases Returns and Allowances

If the merchandise purchased has defects, out of the value or due to other reason, the buyer company might return the merchandise to the seller company (purchases return) or price adjustments are requested by the buyer (purchase allowances) for the merchandise that has defect or other reasons. In these cases, the buyer and the seller communicate with a document called ***debit memorandum***. Purchases returns and allowances accounts are deduction from the amount initially recorded in purchases and it is a contra (offsetting) accounts.

Illustration 3: Habesha Company sent a debit memorandum for ABC Company for the purchases return of merchandise that amounted to $62. The journal entry to record this transaction is as follow:

Account Payable	62	
Purchases Returns & Allowances		62

The following T accounts summarize the three purchases-related transactions of Habesha Company and show their combined effect on net sales.



3.3. Accounting for Sales

So far we have seen the accounting systems on the side of the buyer, thus the opposite of buyer records will be used in recording on the side of the seller company. Merchandise sales are identified in the seller company's ledger as **sales**. Sales of merchandise in cash should be recorded as follows:

Cash……510
Sales……510

When the business sells merchandise on account, the sales recorded as follow.

Account Receivable……510
Sales……510

3.3.1. Sales Discounts

Discount taken by the buyer for early payment is called **sales discounts.** Sales discounts are recorded as debit to sales discounts and it is a reduction in the amount initially recorded in sales.

Illustration 1: On December 1, 2016, Habesha Company has sold merchandise of $500 on account to XYZ Company with credit terms of 2/10, n/30. The journal entry to record sale of merchandise on account is as follow:

Account Receivable 500
Sales 500

Illustration 2: On December 9, 2016, Habesha Company received cash from XYZ Company for December 1, 2016 transaction. The journal entry to record the receipt of cash is as follow:

Cash 490
Sales Discounts 10
AR 500

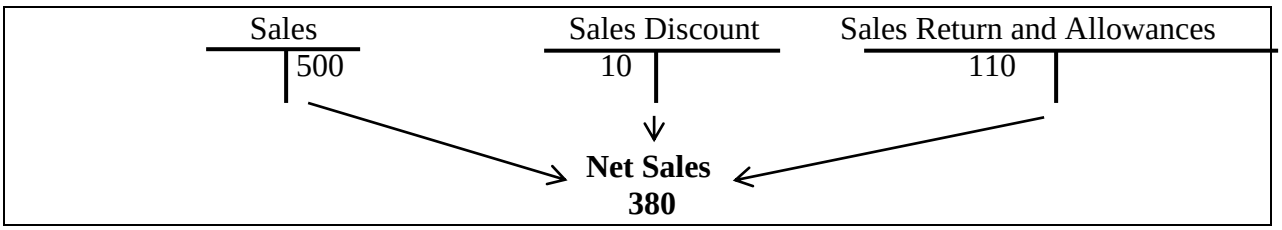
3.3.2. Sales Returns and Allowance

Merchandise sold may be returned by the buyer (sales return) or, because of defects or other reasons, the buyer may be allowed a reduction from the original price at which the goods were sold (sales allowance). Sales returns and allowances is a reduction in sales revenue and a reduction in cash or accounts receivable. Sales returns and allowances are a contra (or offsetting) accounts to sales. The seller and the buyer communicate the return of merchandise or reduction in the original price with a document called **credit memorandum**.

Illustration: Habesha Company received credit memorandum for sales returns and allowances of $110.

Sales Returns & Allowances…… 110
AR……110

The following T accounts summarize the three sales-related transactions of Habesha Company and show their combined effect on net sales.



Bear in mind that, when buyer returns merchandise prior to the payment of the invoice (liability), the amount of credit memorandum is deducted from the invoice amount before sales discount is computed.

3.4. Transportation Costs

Once merchandise has been bought or sold it has to be moved from the seller's place to the buyer's place. A third party comes in to the scene here: the transportation company (or shipper) who moves the goods between the two places. So, the question is, who is going to pay to the freighter (transportation) company. Who covers the transportation costs depends, as you might have guessed, on the agreement between the buyer and seller.

The terms of a sale should indicate when the ownership (title) of the merchandise passes to the buyer. This point determines which party, the buyer or the seller, must pay the transportation costs. Thus, the term of the agreement between buyer and seller include provisions concerning:

1. When the ownership (title) of the merchandise passes to the buyer; and
2. Which party is to bear the cost of delivering (cost of transportation) the merchandise to the buyer.

If ownership passes to the buyer when seller delivers the merchandise to the shipper, the buyer absorbs transportation cost and the term is said to be **FOB Shipping Point**. FOB Shipping Point means the seller place the merchandise "free on board" and the buyer responsible for the transportation cost beyond that point.

If ownership passes to buyer when the merchandise is received by the buyer, the seller assumes cost of transportation and the term is said to be **FOB Destination**. The shipping point is presented as follow:

Concerns	FOB Shipping Point	FOB Destination
Ownership (title) passes to the buyer when merchandise is	Delivered to shipper	Delivered to buyer
Transportation cost are borne (paid) by …	Buyer	Seller

When merchandise is purchased on terms of FOB shipping point, transportation cost paid by the buyer should be debited to **Transportation In** or **Freight In** account and credited to cash. The balance of transportation in account should be **added to net purchases** to determine the total cost of merchandise purchased. If the seller prepay the transportation cost and add them to the invoice, the buyer will debit transportation in for transportation cost.

Dear Students! Bear in mind that, when the terms provide for a discount for early payment, the discount is based on the amount of sale rather than on the invoice total.

Illustration: On June 10, Durban Co. purchased merchandise of $900 from Bell Corp. on account, terms of FOB shipping point, 2/10, n/30, with prepaid transportation cost of $50 added to the invoice. The entry by Durban Co. could be as follows:

Purchases	900	
Transportation In	50	
AP		950

When the agreement states that the seller is to bear the delivery costs (FOB destination), the amounts paid by the seller for delivery are **debited to transportation out** (it is expense account and presented as selling expense).

3.5. Sales Taxes

Almost all countries throughout the world levy a tax on sales of merchandise. Thus, unless the merchandising company remits the collected taxes to the government, liability for the sales tax is incurred at the time when sale is made, regardless of the terms of the sale. At the time of a cash sale, the seller collects the sales tax. When a sale is made on account, the seller charges the tax to

the buyer by debiting Accounts Receivable. The seller credits the sales account for the amount of the sale and credits the tax to Sales Tax Payable. In the case of Ethiopia, most businesses are required to collect 15% of VAT when they made sales for the customers.

Illustration: ABC company located in Ethiopia sold Birr 1000 of merchandise on account, subject to a value added tax (VAT) rate of 15%.

AR……1,150
Sales…….. 1000

Activity

Question 2: Why business give purchase discounts for their customers?.....
.....

Question 3: What are the two types of transportation term agreement?.....
.....

Question 4: How can we determine the net purchases?.....
.....

VAT Payable……150

Periodically, the appropriate amount of the sales tax is paid to the taxing unit, and sales tax payment is debited.

3.6. Inventory System

Inventory refers to products a company owns and expects to sell in its normal operations of business (Merchandise inventory refers to products that a company owns and intends to sell).

The value of goods (merchandise) on hand at the end of the year for resale would be reported on the Balance Sheet as one asset. This means that we need to open a separate ledger account in which to record merchandise inventory information.

The two alternatives in dealing with this account are:

1. To update this account every time when goods are bought and sold (continuously = perpetually) or
2. To update this account only at the end of the period (periodically).

Thus, there are **two** systems of accounting for merchandise: **periodic** and **perpetual system**

The Periodic Inventory System

Under this system, as the name periodic suggests, the inventory account is updated only periodically i.e., only at the end of a period.

When goods are bought, a temporary ***purchases*** account is debited instead of the inventory account itself. Likewise, when goods are sold revenue is recorded, but the fact that there is a reduction in merchandise inventory is not recognized. This is because the Merchandise Inventory account is not credited every time goods are sold.

Therefore, if one wants to know the cost of goods on hand, it is a must that a physical inventory be conducted first. The account doesn't reflect the value of goods on hand because it was not up dated when merchandise was bought and sold. ***Physical inventory*** means counting the quantity of goods on hand. Once the quantity of goods on hand has been determined, it is multiplied by the unit price of those goods to determine the cost of goods on hand.

> In conclusion, under the periodic system, since the merchandise inventory account is not continually updated, the cost of merchandise on hand is determined only at the end of the period after carrying out a physical inventory.

Companies such as department stores or 'super markets', which sell small items, use periodic systems.

Perpetual Inventory Systems

A perpetual inventory system continuously records the amount of inventory on hand (perpetual/continuous). Under this system, the merchandise inventory account is debited or credited every time (goods) are bought or sold. When an item is sold, its cost is recorded in a separate cost of goods sold account in addition to recording sales.

The cost of merchandise on hand can be looked up from the merchandise Inventory account any time, without conducting a physical inventory.

Cost of Merchandise Sold

Cost of merchandise sold is the cost of merchandise sold to customers during a period. In other words, it is the amount of money incurred for those merchandises that have been sold for

customers. In periodic inventory system, the cost of merchandise sold during a period is reported in a separate section in the income statement.

Illustration: ABC Corporation begun its operation on January 3, 2015, and purchased $340,000 of merchandise during the year. If inventory at December 31, 2015 is $59,700; the cost of merchandise sold determined (computed) as follows:

Cost of merchandise sold:
Purchases…….…$340,000
Less: Merchandise inventory Dec. 31, 2015……..59,700
Cost of merchandise sold……..280,300

Assume, during 2016 ABC Corporation purchased additional merchandise of $521,980, received credit memorandum of purchased returns and allowances of $9,100, in addition ABC take purchases discount of $2,525, and pays transportation costs of $17,400 for FOB Shipping Point agreement. *The purchases returns and allowances and discounts are deducted from the total purchases to yield the net purchases, and the transportation costs are added to the net purchases to yield the cost of merchandise purchased.* The following is cost of merchandise purchased for 2016.

Purchases…….$521,980
less: Purchases returns and allowances…… $9,100
Purchases discount…….2,525 11,625
Net Purchases……..$510,355
Add: Transportation In……..…..17,400
Cost of Merchandise Purchased ……..……$527,755

The ending inventory of ABC Corporation on Dec. 31, 2015, $59,700, becomes the beginning inventory for 2016. In the cost of merchandise sold section of income statement for 2016, this beginning inventory is added to the cost of merchandise purchased to yield the merchandise available for sale. The **ending inventory**, which is assumed to be $62,150, is then **subtracted from the merchandise available for sale** to yield the **cost of merchandise sold**.

Cost of merchandise sold:
Merchandise inventory Jan. 1, 2016…….59,700
Purchases……521,980
Less: Purchases returns and allowances……..…..9,100
Purchases discount……..2,525 11,625
Net Purchases…….510,355
Add: Transportation In…….…...17,400
Cost of merchandise purchased……..…….527,755
Merchandise available for sale……....587,455
Less: Merchandise inventory Dec. 31,2016…….....62,150
Cost of merchandise sold……525,305

3.7. Merchandise Inventory Adjustments

The best methods to report the cost of merchandise sold is maintaining a separate account entitled **merchandise inventory**. At the end of the period, the amount of inventory at the beginning of the period should be replaced by the amount of inventory at the end of the period. This is adjusted by two entries:

***Entry 1*:** Transfer the beginning inventory to income summary. For ABC Corporation it is illustrated as follows:

Income Summary…….59,700
Merchandise Inventory……59,700

Dear Students! Note that, this inventory is part of cost of merchandise sold. It is also subtracted from assets account.

Entry 2: Debit the cost of merchandise inventory at the end of the period to the asset account, i.e. merchandise inventory:

Merchandise Inventory……62,500
Income Summary…….….62,500

Dear Students! Note that, the credit portion of the entry effects is a deduction of the unsold merchandise from the total cost of merchandise available for sale during the period.

3.8. Adjustment for Deferrals and Accruals

- **Deferral** is a delay of the recognition of an expense already paid or, revenue already received. It is as either prepaid expenses or unearned revenues. Adjusting entries for

deferrals are required at the statement date to record the portion of the prepayment that represents the expense incurred or the revenue earned in the current accounting period.

- **Accrual** is an expense that has not been paid, or revenue that has not been received.

Deferred Expenses (prepaid expenses)

- expected benefit a short period of time
- listed on the balance sheet among the current assets section
- Long term prepayments that can be charged to the operation of several years are presented on the balance sheet section as **deferred charges.**

Deferred Revenue

- Is unearned revenue or revenues received in advance
- Listed on the balance sheet as current liabilities
- Example of deferred revenue is if someone rented his house and received advance payments.

Accrued Expense

Accrued Expense are those liabilities which exist at the end of an accounting period but not yet been recorded. The amount of such accrued but unpaid items at the end of the accounting period are both an expense and liability. It is for this reason that such accruals are called accrued liabilities or accrued expenses. Accrued liabilities represent obligations to make payments, which are not legally due at the balance sheet date. Accrued Expense listed on the balances sheet as accrued liabilities.

Accrued Revenues

Accrued revenues are those assets which exist at the end of an accounting period but which have not yet been recorded. The amount of such accrued but not received items at the end of the accounting period are both revenue and an asset. It is for this reason that such accruals are called accrued assets or accrued revenues. Accrued revenues listed on the balances sheet as accrued assets.

Adjusting Entries for Deferrals (prepaid expenses)

Prepaid expenses are the cost of goods or services that have been purchased but not used at the end of the accounting period. The portion of the assets that has been used during the period

becomes an expense. Prepaid expense includes as prepaid insurance, prepaid rent, prepaid interest, etc.

Illustration: assume that ABC Corporation office supplies account has balance of $1,090 on Dec. 31, 2016. Office supplies on hand amounted to $480 on Dec. 31, 2016. Office supplies expense is 610 i.e. (610=1090-480).

Office Supplies Expense……..610
Office Supplies……..610

ABC Corporation prepaid insurance balance was $4,560 at Dec. 31, 2016. $1,910 of insurance premiums has expired during the year.

Insurance Expense……..……1,910
Prepaid Insurance……1,910

Adjusting Entries for Unearned Revenue (Deferrals)

Revenue received during a particular period may be only partly earned by the end of the period. Items of revenue that are received in advance represent a liability that are received in advance represent a liability that may be termed unearned revenue.

Illustration: assume ABC Corporation on Oct. 1, 2016 rents a portion of building that it has been leased for a period of one year, receiving $2,400 in payment for the entire year's rental. The transaction was originally recorded as debit to cash and credit to liability account of unearned rent. On Dec. 31, 2016, one fourth of the amount has been earned and three fourth of the amount remains a liability.

Unearned Rent……..600
Rent Income……...600

Adjusting Entries for Accrued Liabilities (Accrued Expense)

Some expenses accrue from day to day but are usually recorded only when they are paid such as salaries paid for employees and interest paid on notes payable. The amount of such accrued but unpaid items at the end of the fiscal period are both **expense** and **liability**.

Illustration: On Dec. 31, 2016, the end of the fiscal year, the sales salaries expense account for ABC Corporation has a balance of $59,250 and the office salaries expense account has a debit

balance of $20,660. For this fiscal year, the records of the business show that the accruals for sales salaries and office salaries are $780 and $ 360, respectively, at the end of the year.

Sales Salary Exp……780
Office Salary Exp……..……360
Salary Payable……...1,140

Adjusting Entries for Accrued Assets (accrued Revenue)

During a fiscal period, it is common to record some types of revenue only as the cash is received; consequently, at the end of the period there may be items of revenue that have not been recorded. In such cases, the amount of accrued revenue must be recorded by debiting an asset account and crediting a revenue account.

Illustration: on Dec. 31, 2016, ABC Corporation has an interest bearing note receivable. All interest income will be collected in 2013, when payment is due on the note. The interest earned but not collected as of Dec. 31, 2016 is $ 200.

Interest Receivable……...200
Interest Income……..…….200

3.9. Work Sheet for Merchandising Enterprise

After yearend posting of the journals is completed, worksheet is used to assist in preparing the adjusting entries, closing entries, and financial statements. The primary difference between the worksheet of merchandise enterprise and service enterprise is that of the beginning and ending merchandise inventories, which are shown in the income summary account, appear in both the debit and credit income statement columns of the worksheet. The data needed for adjusting the accounts of ABC Corporation are summarized as follows:

- Interest accrued on note receivable $200
- Merchandise inventory as of Dec. 31, 2016 62,150
- Office supplies as of Dec. 31, 2016 480
- Insurance expired during 2016 1910
- Depreciation during 2016 on:
  - Store equipment 3100
  - Office equipment 2490
- Salaries accrued on Dec. 31, 2016
  - Sales salary……780
  - Office salary…… 360 1,140
- Rent income earned during 2016 600

The balances of the accounts in the trial balance columns and the amount of any adjustments are added or deducted as appropriate. The adjusted balances are then extended in to the adjusted trial balance columns, which are totaled to prove the equality of debits and credits. Both the debit and credit amounts for the income summary are extended.

After all of the items have been extended into the statement sections of the work sheet, the four columns are totaled and the net income or net loss is determined. The following work sheet is for ABC Corporation illustration:

(a) Interest earned but not received on notes receivable, 200
(b) Beginning merchandise inventory, 59,700
(c) Ending merchandise inventory, 62,150
(d) Office supplies used, 610 = 1090- 480
(e) Insurance expired, 1910
(f) Depreciation of store equipment, 3,100
(g) Depreciation of office equipment, 2,490
(h) Salaries accrued but not paid (sales salary, 780 and office salary 360) total 1,140
(i) Rent earned from amount received in advance, 600

Activity

Question 5: Outline the steps used to compute the cost of merchandise sold.....
.....

ABC Corporation
Work Sheet
For Year Ended Dec. 31, 2016

Account Title	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	62,950				62,950				62,950	
Notes receivable	40,000				40,000				40,000	
AR	60,880				60,880				60,880	
Interest Receivable			(a)200		200				200	
Merchandise Inv.	59,700		(c)62,150	(b)59,700	62,150				62,150	
Office Supplies	1,090			(d)610	480				480	
Prepaid Insurance	4,560			(e)1,910	2,650				2,650	
Store Equipment	27,100				27,100				27,100	
Accum.Dep St.Eq.		2,600		(f)3,100		5,700				5,700
Office Equipment	15,570				15,570				15,570	
Accum.Dep of.Eq		2,230		(g)2,490		4,720				4,720
AP		22,420				22,420				22,420
Salaries Payable				(h)1,140		1,140				1,140
Unearned Rent		2,400	(i)600			1,800				1,800
Note Payable		25,000				25,000				25,000
Capital Stock		100,000				100,000				100,000
Retained Earning		53,800				53,800				53,800
Dividends	18,000				18,000				18,000	
Income Summary			(b)59,700	(c)62,150	59,700	62,150	59,700	62,150		
Sales		720,185				720,185		720,185		
Sales R&A	6,140				6,140		6,140			
Sales Discount	5,790				5,790		5,790			
Purchases	521,980				521,980		521,980			
Purchases R&A		9,100				9,100		9,100		
Purchas Discount		2,525				2,525		2,525		
Transportation In	17,400				17,400		17,400			
Sales Salary Exp.	59,250		(h)780		60,030		60,030			
Advertising Exp.	10,860				10,860		10,860			
Depn. Exp. St. Eq.			(f)3,100		3,100		3,100			
Misce Selling Exp	630				630		630			
Office Salary Exp	20,660		(h)360		21,020		21,020			
Rent Exp	8,100				8,100		8,100			
Depn. Exp.Of. Eq.			(g)2,490		2,490		2,490			
Insurance Exp			(e)1,910		1,910		1,910			
Office Supply Exp			(d)610		610		610			
Misce Admin Exp	760				760		760			
Rent Income				(i)600		600		600		
Interest Income		3,600		(a)200		3,800		3,800		
Interest Expense	2,440				2,440		2,440			
	943,860	943,860	131,000	131,900	1,012,940	1,012,940	722,960	798,360	289,980	214,580
Net Income							**75,400**			**75,400**
							798,360	798,360	289,980	289,980

3.10. Preparation of Financial Statement

The basic financial statement for merchandising enterprise includes income statement, balance sheet, statement of owner's equity, and statement of cash flow, are similar to those of service

enterprise. For corporation type of merchandise enterprise, the financial statement includes statement of retained earnings rather than statement of owner's equity.

The basic difference between the financial statement of merchandise enterprise and service enterprise is the **income statement section of cost of merchandise sold** and the **balance sheet section of merchandise inventory**.

Income Statement

There are two widely used forms for the income statement: **multiple – step** and **single – step.**

Multiple – Step for of Income Statement

The multiple – step income statement is so called because of its many sections, sub sections and intermediate balances. Such as:

1. **Revenue from sales:** the total of all charges to customers for merchandise sold, both on account and cash, is reported in this section. Sales return and allowances and sales discounts are deducted from the gross amount to yield **net sales**.
2. **Cost of Merchandise Sold:** this section is for the determination of cost of merchandise sold. The other name of cost of merchandise sold is ***cost of goods sold*** or ***cost of sales***.
3. **Gross Profit:** the excess of the net revenue from sales over the cost of merchandise sold is called **gross profit** or **gross margin**. It is called gross because operating expenses must be deducted from it.
4. **Operating Expenses:** for retail business, operating expenses can be sub divide in to two categories: **selling** and **administrative expenses**. **Selling expenses** are incurred directly and entirely in connection with sale of merchandise. They include such expenses such as: salaries for sales man, store supplies used, depreciation of the store equipment and advertisement cost. **Administrative expenses or general expenses** incurred in the administration of the business, such as: office salaries, depreciation of office equipment, and office supplies used rent expenses, insurance expenses etc.
5. **Income from Operations:** the excess of gross profit over total operating expenses is called income from operation. If **operating expenses are greater than gross profit**, the excess is called **loss from operations**.

6. **Other Income:** revenue sources other than the principal activities of the business are classified as other income, or non-operating income. Such as: income from rent, interest income and gain from sales of plant assets.
7. **Other expenses:** expenses that are not associated with operations of the business, such as interest expenses and loss from disposals (sales) of the business plant assets.

The two categories of non-operating items are offset against each other on the income statement. If the total of ***other income exceeds the total of other expenses****, the* ***difference is added to income from operations****. If the total of* ***other expenses exceeds*** *the* ***difference is subtracted from income from operations****.*

8. **Net Income or net loss:** the final figure on the income statement is net income (or net loss).

Single – Step form of Income Statement

In single – step income statement the total expenses deducted from the totals of revenues. An objection (disadvantage) of the single – step form of income statement is the relationships as of gross profit to sales and income from operations to sales are not as readily determinable as they are when the multiple – step form of income statement

In the following pages the multiple – step income statement and single – step income statement for ABC Corporation illustration is presented as follows respectively:

Summary of Important Relationships on the Income Statement

1. Net sales = Gross sales- (Sales Discounts + Sales Returns and allowances)
2. Net purchases = Purchases – (Purchase Disc. + Purchase Ret. & allowance)
3. Total cost of Purchase = Net purchase + Transportation –In
4. Cost of goods sold = Beg inventory + Total cost of purchase –Ending inventory
5. Gross profit = Net sales – Cost of goods sold
6. Net Income = Gross Profit – operating (i.e., selling & administrative) expenses.

Multiple – step income statement for ABC Corporation

ABC Corporation
Income Statement
For the Year Ended December 31, 2016

Revenues from Sales:			
Sale			$720,185
Less: Sales returns and allowances	$6,140		
Sales discounts	5,790		11,930
Net Sales			$708,255
Cost of Merchandise Sold:			
Merchandise Inventory, Jan. 1, 2016		59,700	
Purchases		521,980	
Less: Purchases returns and allowances	9,100		
Purchases discount	2,525	11,625	
Net Purchases		510,355	
Add: Transportation in		17,400	
Cost of Merchandise Purchased		527,755	
Merchandise Available for Sale		587,455	
Less: Merchandise Inventory, Dec. 31, 2016		62,150	
Cost of merchandise Sold			525,305
Gross Profit			182,950
Operating Expenses:			
Selling Expenses:			
Sales Salary Exp		60,030	
Advertising Exp		10,860	
Depreciation Exp. Store Equipment		3,100	
Miscellaneous Selling Exp		630	
Total Selling Exp			74,620
Administrative expenses:			
Office salary Exp		21,020	
Rent Exp		8,100	
Depreciation Exp. Office Equipment		2,490	
Insurance Exp		1,910	
Miscellaneous Administrative Exp		760	
Total Administrative Exp			34,890
Total Operating Exp			109,510
Income from Operation			73,440
Other Income:			
Interest Income		3,800	
Rent Income		600	
Total Other Income			4,400
Other Expenses:			
Interest Expense	2,440		1,960
Net Income			75,400

Single – step income statement for ABC Corporation

ABC Corporation Income Statement For the Year Ended December 31, 2016	
Revenues:	
Net Sales	708,255
Interest Income	3,800
Rent Income	600
Total Revenue	712,655
Expenses:	
Cost of Merchandise Sold	525,305
Selling Expenses	74,620
Administrative Expenses	34,890
Interest Expenses	2,440
Total Expenses	637,255
Net Income	75,400

Retained Earnings Statement

Retained earnings statement summarizes the changes which have occurred in the retained earnings account during the fiscal period. It serves as a link between the income statement and the balance sheet.

ABC Corporation Retained Earnings Statement For the Year Ended December 31, 2016	
Retained Earnings, January 31, 2016	53,800
Net Income for the Year	75,400
Less: Dividends	18,000
Increase in Retained Earnings	57,400
Retained Earnings, December 31,2016	111,200

Balance Sheet

The arrangement of assets on the left hand side of the balance sheet and, liabilities and owner's equity on the right hand side of the balance sheet is called **account form**. The arrangement of the three section of the balance sheet in the downward sequence called **report form**.

ABC Corporation
Balance Sheet
December 31, 2016

Assets

Current Assets:		
Cash		62,950
Notes Receivable		40,000
Accounts Receivable		60,880
Interest Receivable		200
Merchandise Inventory		62,150
Office Supplies		480
Prepaid Insurance		2,650
Total Current Assets		229,310
Plant Assets:		
Store Equipment	27,100	
Less: Accumulated Depreciation	5,700	21,400
Office Equipment	15,570	
Less: Accumulated Depreciation	4,720	10,850
Total Plant Assets		32,250
Total Assets		**261,560**

Liabilities

Current Liabilities:	
Account Payable	22,420
Note Payable(Current Portion)	5,000
Salary Payable	1,140
Unearned Rent	1,800
Total Current Liabilities	30,360
Long – Term Liabilities:	
Note Payable	20,000
Total Liabilities	**50,360**

Stockholders' Equity

Capital Stock	100,000
Retained Earnings	111,200
Total Stockholders' Equity	**211,200**
Total Liability and Stockholders' Equity	**261,560**

3.11. Adjusting Entries

The followings are adjusting entries which were previously discussed for ABC Corporation as of December 31, 2016.

Interest Receivable…….200
Interest Income……...200

Income Summary……59700
Merchandise Inventory…….…….....59700

Merchandise Inventory……62150
Income Summary……..…….….62150

Office Supplies Expense…….…....610
Office Supplies…….……..610

Insurance Expense……..…1910
Prepaid Insurance……..……1910

Depreciation Expense- Store Equipment……....3100
Accumulated Depreciation –Store Equipment…….….3100

Depreciation Expense- Office Equipment……..…….2490
Accumulated Depreciation –Office Equipment…….……...2490

Sales Salary Expense…….……780
Office Salaries Expense……...….…….360
Salary Payable……..…….……....1140

Unearned Rent…….....600
Rent Income…….……...…600

3.12. Closing Entries

The closing entries are recorded in the journal immediately following the adjusting entries. Closing entries cleared all of the temporary owner's equity accounts, reducing them to zero balance. The final effect of closing entries is a net increase or a net decrease in the retained earnings. The closing entries for ABC Corporation as of December 31, 2016 are the followings:

Sales……...…...720,185
Purchases Returns And Allowances……..…9100
Purchases Discounts……...…..2525
Interest Income…….....…..3800
Rent Income……600
Income Summary……736,210

Income Summary……663,260
Sales Returns And Allowances…….…….$6,140
Sales Discounts…….……..……..... 5,790
Purchases…….521,980

Transportation In…….....17,400
Sales Salary Exp……...….60,030
Advertising Exp……...…….……...…..10,860
Depreciation Exp. Store Equipment……..……..3,100
Miscellaneous Selling Exp……...…….630
Office Salary Exp……..21,020
Rent Exp…….....8,100
Depreciation Exp. Office Equipment…….....2,490
Insurance Exp…….1,910
Office Supplies Expense……610
Miscellaneous Administrative Exp……...760
Interest Expense……..2,440

Income Summary……75400
Retained Earnings…….……75400

Retained Earnings……..18000
Dividends……...…..18000

The effects of the four closing entries are:

1. The first entry closes all income statement account with credit balance by transferring to the credit side of the income summary.
2. The second entry closes all income statement account with debit balance by to the debit side of the income summary.
3. The third entry closes income summary by transferring its balance to the retained earnings.
4. The fourth entry closes dividends by transferring its balance to the retained earnings.

After all temporary owner's equity accounts have been closed, the only account with balances are the assets, contra assets (e.g. accumulated depreciation), liability, capital stock and retained earnings.

3.13. Reversing Entries

To simplify the analysis and recording of subsequent transactions related to such adjusting entries, an optional procedure is the use of reversing entries may be used. Reversing entry is the exact reverse of the adjusting entry to which it relates. The amounts and the accounts are the same as the adjusting entry; the debits and credits merely reversed.

Illustration: the adjusting entry for ABC Corporation recorded on Dec. 31, 2015 for accrued salary expense and salary payable was as follows:

Sales Salary Exp……..……780
Office Salary Exp…….360
Salary Payable……..1140

The reversing entry could be recorded on Jan. 1, 2016 is as follows:

Salary Payable……1140
Sales Salary Exp…….…780
Office Salary Exp……...…….…360

Illustration: ABC Corporation recorded the adjusting entry for accrued interest receivables as follows:

Interest Receivable……..…….200
Interest Income…….…….....200

The reversing entry for accrued interest receivable is as follows:

Interest Income…….……..200
Interest Receivable…….…….……200

3.14. Interim Statements

Business enterprises frequently prepare financial statements at intervals within the fiscal year, such as monthly, quarterly, or semiannually. Statements issued for periods covering less than a fiscal year are called **interim statements**. The analysis and recording of transaction is performed on a continuous basis throughout the fiscal year, regardless of when financial statements are to be prepared. When interim financial statements are to be prepared, the adjustment data are assembled and worksheet is completed as of the end of the interim period. However, **adjusting** and **closing entries** are **not recorded in the accounts**. **These entries are recorded only at the end of the fiscal year**.

3.15. Correction of Errors

Occasional errors in journalizing and posting transactions are an avoidable. Procedures used to correct errors in the journal and ledger varies in accordance with the nature of the error and the phase of the accounting cycle in which the error is discovered.

When an error in account title or amount in the journal is discovered before the entry is posted, the correction may be made by drawing a line through the error and inserting the correct title or amount immediately above.

When an entry in the journal is prepared correctly, but the debit portion is incorrectly posted to the account as credit (or vice versa), the incorrect posting may be corrected by drawing a line through the error and posting the item correctly

When an erroneous account title appears in a journal entry and the error is not discovered until after posting is completed, the preferable procedure is to journalize and post a correcting entry. **For example,** purchase of office equipment which was paid in cash, was erroneously journalized and posted as a $500 to office supplies of debit but correctly journalized and post as $500 to credit to cash. The correcting entry should be as follows:

Office Equipment……..500
Office Supplies……500

3.16. Self-Examination Questions

1. Gross profit will result if:

a. operating expenses are less than net income.

b. sales revenues are greater than operating expenses.

c. sales revenues are greater than cost of goods sold.

d. operating expenses are greater than cost of goods sold.

2. A credit sale of $750 is made on June 13, terms 2/10, net/30. A return of $50 merchandise is granted on June 16. The amount received as payment in full on June 22 is:

a. $700. **b.** $686 **c.** $685. . **d.** $650.

3. If sales revenues are $400,000, cost of goods sold is $310,000, and operating expenses are $60,000, the gross profit is:

a. $30,000. **b.** $90,000. **c.** $340,000. **d.** $400,000.

4. In determining cost of goods sold:

a. purchase discounts are deducted from net purchases.

b. freight-out is added to net purchases.

c. purchase returns and allowances are deducted from net purchases.

d. freight-in is added to net purchases.

5. If beginning inventory is $60,000, cost of goods purchased is $380,000, and ending inventory is $50,000, cost of goods sold is:

a. $390,000. **b.** $370,000. **c.** $330,000. **d.** $420,000.

6. The steps in the accounting cycle for a merchandising company are the same as those in a service company *except*:

a. an additional adjusting journal entry for inventory may be needed in a merchandising company.

b. closing journal entries are not required for a merchandising company.

c. a post-closing trial balance is not required for a merchandising company.

d. a multiple-step income statement is required for a merchandising company.

7. In a worksheet, Inventory is shown in the following columns:

a. Adjusted trial balance debit and balance sheet debit.

b. Income statement debit and balance sheet debit.

c. Income statement credit and balance sheet debit.

d. Income statement credit and adjusted trial balance debit.

8. Which of the following expenses would normally be classified as other expense on a multiple-step income statement?

a. Depreciation expense—office equipment

b. Sales salaries expense

c. Insurance expense

d. Interest expense

9. What distinguishes a merchandising business from a service business?

(Answers) 1: C, 2: B, 3:B, 4:D, 5:A, 6:A, 7:A, 8:D

1. On March 6, 2016, ABC company sold merchandise to customers $6000.

Required: prepare journal entries to record this information assuming:

a. The merchandise was sold for cash.

b. The merchandise was sold for cash.

2. On May 8, 2016, Paradox Company sold $8000 of merchandises for ABC Trading; goods were sold on terms of 5/10, n/ 30.

Required: prepare journal entries to record this information assuming:

a. Journalize sales

b. Paradox company receive payment on May 16, 2016

c. Paradox company receive payment on May 22, 2016

3. Paradox Company received returned merchandises (sent a credit memorandum) of amounted to $1,500; which were sold on May 8, 2016 for ABC Trading.

Required: prepare journal entries to record this information assuming:

a. The merchandise was received on May 10, 2016.

b. The merchandise was received on May 21, 2016.

4. On August 1, 2016, Grant Company purchased goods at a price of $10,000. Discount terms of 2/10, n/30 were available. For each of the following independent cases, prepare all the necessary journal entries assuming that the invoice in each case was paid within the discount period.

Case	**Transportation Term**	**Freight paid(by)**
A	FOB Shipping Point	$2,000 (buyer)
B	FOB Destination	2,000 (seller)
C	FOB Shipping Point	2,000 (seller)
D	FOB Destination	2,000 (buyer)

5. Selected transactions for Addis Company for July 2016 are given below. Addis Company uses three accounts to record sales and sales related transactions; namely, sales, sales discounts, sales return and allowances. The sales returns and allowances account is maintained at gross invoice price. All sales are subject to a 5% sales tax.

July 1. Sold merchandise to ABC Company, $24,000, terms of 2/10, n/30, FOB Destination. ABC Company paid transportation costs of $240.

July 3. Issued a credit memorandum to ABC Company for merchandise returned by ABC Company with invoice price of $4,000 for merchandise sold on July 1.

July 8. Received the amount due from ABC Company.

Required: Prepare the necessary journal entries to record the above transactions

6. The beginning merchandise inventory of Alpha Trading PLC as of January 1, 2016 is **$23,700** and the ending merchandise inventory as of Dec. 31, 2016 is **$18,500.** ABC Company start its business on January 1, 2016 by purchasing merchandise from Sony Corporation, as of December 31, 2016 i.e. at the end of the year, ABC Company has ending merchandise inventory of $25,000.

Required: Journalize adjusting entries for the above two cases.

Problem (Workout)

After various transactions recorded for the month year ended 2016, Alpha Trading PLC determined the balance of its account in the ledger and prepare the trial balance. The trial balance for **Alpha Trading PLC** on December 31, 2016 is presented below:

Alpha Trading PLC
Trial Balance
For Year Ended Dec. 31, 2016

Account	Dr.	Cr.
Cash	2,300	
AR	12,500	
Prepaid Insurance	5,600	
Merchandise Inventory Jan. 1, 2016	23,700	
Supplies	5,700	
Equipment	17,300	
Accumulated Depreciation Equip		3,500
AP		3,500
Note Payable		19,600
Sales Tax Payable		3,400
Larson, Capital		25,600
Larson, Drawings	3,000	
Sales		110,200
Sales R & A	3,100	
Sales Discount	2,300	
Purchases	67,800	
Purchases R & A		1,200
Purchas Discount		1,300
Transportation In	3,900	
Salary Exp.	11,400	
Miscellaneous Exp.	9,700	
Total	**168,300**	**168,300**

Additional Information:

a. The ending merchandise inventory amount is **$18,500**.

b. Accrued salary expense on December 31, 2016 amounts **$3,500**.

c. The prepaid insurance reported on the trial balance is an amount paid on January 1, 2016. This amount applies for four years starting from the date of payment.

d. Supplies on hand amounts **$3,100** as of December 31, 2016.

e. The depreciation expense for 2016 is **$500**.

Required:

a. Journalize the above additional information (make adjusting entries).

b. Prepare work sheet.

c. Prepare Multiple-step income statement, balance sheet and statement of owner's equity.

d. Journalize closing entries.

3.17. Glossary of Terms

A Merchandising Business- a business that buys and sells goods at a profit.

Merchandise- anything that a merchandising company buys in order to resale it to its customers.

Periodic Inventory System- a system of recording inventories that updates inventory records only once in an accounting period.

Perpetual Inventory System- a system of recording inventories that continuously shows the balance of inventory on hand as the records about inventory are continuously updated.

Physical Inventory- the act of counting (measuring, weighing, etc) merchandise in order to determine the quantity of goods on hand on a particular date.

Trade Discount- deduction from the normal selling price (list price) to determine the invoice price of goods.

Cash Discount- deduction from the invoice price of goods for early payment when goods are sold on credit. Cash discounts are called sales discounts for the seller whereas they are referred to as purchase discounts by the buyer.

Purchase (or Sales) Returns- merchandise returned to the seller after it has already been sold or bought.

Purchase (or Sales) Allowance- a deduction from the invoice price of goods when the goods bought or sold are agreed to be of defective or unsatisfactory for any reason.

Contra Account- if an account is a contra account; its balance would be deducted from another account when it is presented in the financial statements.

FOB Destination- an agreement that requires the seller of the goods to cover transportation costs. It is read as free on board at destination.

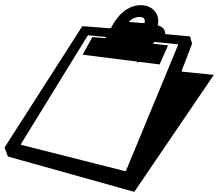
FOB Shipping Point- an agreement that requires the buyer of merchandise to cover transportation costs. It is read as free on board at shipping point.

Chapter Four: Accounting Cycle for Manufacturing Businesses

Dear Students! As we have discussed in chapter one, based on the nature of business operations, businesses classified as service companies, merchandising companies and manufacturing companies. Chapter two and three discussed about service companies and merchandising companies, respectively. In this chapter we will see some highlights of the accounting cycle for manufacturing companies. For instance, to manufacture different closes, Kombolcha Textile Factory first purchase raw materials like cotton, hire employees to work on the machine and use various equipment and machine to convert the cotton in to finished cloths like towel. Thus in these processes, the accounting systems of the company must have to record various accounting information and transactions.

OBJECTIVES OF THE CHAPTER

After studying this chapter, you should be able to:



[a] Identify the characteristics of manufacturing companies.

[b] Explain the classification of manufacturing costs.

[c] Explain the classification of non-manufacturing costs.

[d] Describe the different classification of cost.

[e] Explain the two product costing systems

[f] Record the flow of costs through production process

[g] Prepare the financial statements

4.1. Characteristics of Manufacturing Business

The operations of a business can be classified as service, merchandising, or manufacturing. The accounting for service and merchandising businesses has been described and illustrated in earlier chapters. For this reason, this chapters focus primarily on manufacturing businesses.

A manufacturing company makes the goods it sells. **Manufacturing companies** buy materials, convert them into products, and then sell the products to other companies or to the final consumers. They use labor, plant, and equipment to convert raw materials into new finished products. Manufacturing companies include steel mills, auto manufacturers, and clothing manufacturers. They must also develop, design, market, and distribute its products.

Manufacturing companies vary in size and complexity. The accounting cycle is the same in a manufacturing company, merchandising company, and a service company.

4.2. Classification of Costs

A **cost** is a payment of cash or the commitment to pay cash in the future for the purpose of generating revenues. For example, cash (or credit) used to purchase equipment is the cost of the equipment. If equipment is purchased by exchanging assets other than cash, the current market value of the assets given up is the cost of the equipment purchased.

4.2.1. Manufacturing costs

The cost of a manufactured product includes the cost of materials used in making the product. In addition, the cost of a manufactured product includes the cost of converting the materials into a finished product. For example, Kombolcha Textile Factory uses employees and machines to convert cotton (and other supplies) into cloths (finished goods). Thus, the cost of a finished cloths includes the following:

Using raw materials, labor and means of productions, manufacturing companies produce goods. The three types of manufacturing costs are Direct Materials, Direct labor and Factory Overheads

1. Direct materials cost (DM)
2. Direct labor cost (DL)
3. Factory overhead or manufacturing overhead cost (FOH or MOH)

The cost of manufacturing a product includes not only the cost of tangible materials entering into the manufacturing process, but also the costs incurred in changing the materials into a finished product ready for sale. Generally, most manufacturing companies divide manufacturing costs into three broad categories: direct materials cost, direct labor cost, and factory overhead costs.

1. **Direct materials cost**

The materials that go into the final product are called **raw materials**. Actually, raw materials refer to any materials that are used in final product; and the finished product of one company can be the raw materials of another company. The cost of materials entering directly into the manufactured product is classified as **direct materials cost**, sometimes referred to as **raw materials cost**.

In order for a cost to be classified as a direct materials cost, the cost must not only be an integral part of the end product, but it must be a significant birr portion of the total cost of the product. Examples of direct material costs include the cost of steel and tires for an automobile manufacturer, the cost of lumber for a furniture manufacturer, and the cost of paper and ink for a printer.

2. **Direct labor cost**

Direct labor is sometimes called **touch labor**, since direct labor workers typically touch the product while it is being made. The cost of wages paid to employees directly involved in changing direct materials into a finished product is classified as **direct labor cost**.

For the cost of employee wages to be classified as direct labor cost, the employee must not only be directly involved in the creation of the finished product, but the wages must be a significant portion of the total product cost.

Examples of direct labor costs include wages and fringe benefits paid to machine operators and assembly-line workers who convert direct materials purchased to finished goods.

3. **Factory overhead costs**

Costs other than direct materials cost and direct labor cost incurred in the manufacturing process are classified as factory overhead cost, sometimes referred to as manufacturing overhead or factory burden.

If the costs of direct materials or direct labor are not a significant portion of the total product cost, these costs are classified as factory overhead.

Examples of factory overhead costs include the cost of supplies, indirect materials such as lubricants, indirect labor such as plant maintenance and cleaning labor, plant rent, plant insurance, property taxes on the plant, plant depreciation, and the compensation of plant managers that are only related the production of products.

Prime Costs and Conversion Costs

The total cost of a manufactured product consists of three elements: Direct materials, direct labor, and factory overhead costs. These costs are often grouped in various classifications for analysis and reporting purposes.

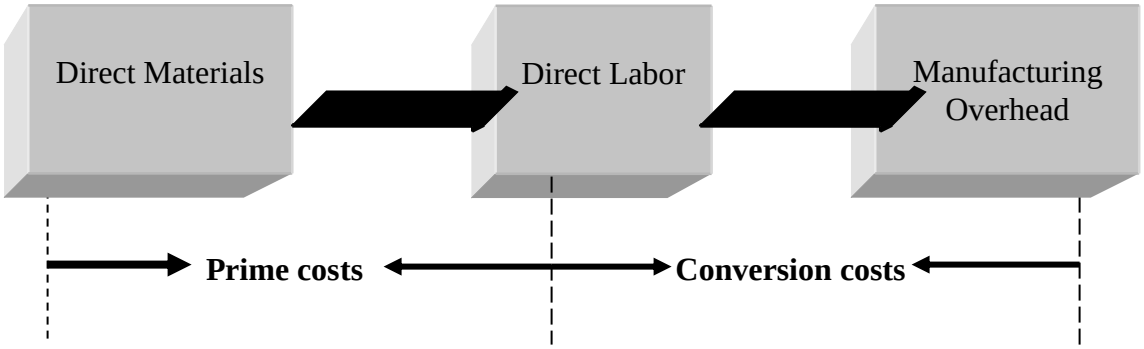
Two common classifications of manufacturing costs often reported to management for planning and decision making purposes are prime costs and conversion costs.

Prime costs are the combination of direct materials and direct labor costs. They are generally the largest component of the total cost of a manufactured product. They are direct in nature.

Prime Costs = Direct Material Costs + Direct Labor Costs

Conversion costs are the combination of direct labor and factory overhead costs. They are the costs of converting the materials into a finished manufactured product.

Conversion Costs = Direct Labor Costs + Factory Overhead Costs



4.2.2. Nonmanufacturing Costs

Nonmanufacturing costs are not involved directly in the manufacturing process and mainly they expire as time passes on. Generally classified into two categories, such as selling and administrative costs.

Selling costs are costs that are incurred in marketing the product and delivering the sold product to customers. Examples of selling costs include the salaries paid to marketing personnel,

advertising expenditures, sales commissions, salespersons' salaries, and depreciation on store equipment.

Administrative costs are costs that are incurred in the administration of the business and that are not related to the manufacturing or selling functions. Examples of administrative costs include office salaries, office supplies, depreciation on office building and equipment.

By classifying nonmanufacturing costs into selling and administrative, the managerial accountant enables management to establish accountability and control over the cost of the two major functional activities: selling activities and administrative activities.

The accounting for nonmanufacturing costs is similar for manufacturing, merchandising, and service enterprises. Most selling and administrative costs are initially recognized as expenses because they benefit only the period in which they are incurred.

Product Costs and Period Costs

In the previous section, costs were classified as manufacturing and nonmanufacturing. These costs may be classified as either product costs or period costs.

Product costs are composed of the three elements of manufacturing costs: direct materials, direct labor, and factory overhead costs. These costs are treated as assets until the product is sold and are reported as a part of inventory on the balance sheet. In this sense, product costs are sometimes referred to as inventoriable costs. It includes all costs that are involved in making a product.

Dear Students! Costs of manufacturing companies classified as manufacturing cost and nonmanufacturing cost.

The manufacturing costs are direct materials, direct labor and factory overhead.

Nonmanufacturing costs are selling and administrative expenses.

Period costs are those costs that are used up in generating revenue during the current period and that are not involved in the manufacturing process. Selling and administrative costs are period

costs. They are recognized as expenses on the current period's income statement. It includes all costs that are not included in product costs.

4.3. Product Costing Systems

Cost accounting systems measure, record, and report product costs. Managers use product costs for setting product prices, controlling operations, and developing financial statements. The two main types of cost accounting systems for manufacturing operations are:

1. Job order cost systems
2. Process cost systems

A **job order cost system** provides product costs for each quantity of product that is manufactured. Each quantity of product that is manufactured is called a *job*. Job order cost systems are often used by companies that manufacture custom products for customers or batches of similar products.

In computing the cost of a product or service, managers are faced with a difficult problem. Many costs (such as rent) do not change much from month to month, whereas production may change frequently, with production going up in one month and then down in another. Two product costing systems are commonly used in manufacturing companies; these two systems are known as job-order costing and process costing.

A job-order costing system is used in situations where many different products are produced each period. In job-order costing system, costs are allocated to the job and then the costs of the job are divided by the number of units in the job to arrive at average cost per unit.

Process costing system is used in situations where the company produces many units of a single product for long period of time. It applies costs to homogeneous products that are produced in a continuous fashion through a series of production steps or processes.

The basic approach in process costing is to accumulate costs in a particular operation or department for an entire period (month, quarter, and year) and then to divide this total by number of units produced during the period. To compute the unit cost of one product the following equation is used:

Unit Cost = Total Manufacturing Cost/Total Units Produced

Process costing Vs job order costing

Similarities

- ✓ Both have the same ultimate purpose (i.e. assign production costs to units of output)
- ✓ Manufacturing cost elements are the same (DM, DL, FOH) in both cases
- ✓ Flow of costs through the manufacturing accounts is the same

Differences

Job order costing	**Process costing**
Costs are accumulated by jobs (job orders)	Costs are accumulated by department
Cost are recorded by job cost sheets	Department production report is the key document in process costing
The cost of each unit in a particular job is found by dividing the total cost of the job order by the number of units in the job	The cost per unit is found by averaging the total cost incurred over the units produced

4.4. Recording the Flow of Costs through Production Process

- Journal entries are used to record transactions, adjusting journal entries are used to recognize costs and revenues in the appropriate period, financial statements are prepared, and closing entries are recorded.
- Raw material purchases are recorded in the raw material inventory account if the perpetual inventory method is used, or the raw materials purchases account if the periodic inventory method is used.

For example, using the periodic inventory method, on May 27, 2016, the purchase of Br. 750 of raw materials on account is recorded as an increase (debit) to raw materials purchases and an increase (credit) to accounts payable.

General Journal

Date	***Account and Title Description***	***PR***	***Debit***	***Credit***
2016 May 27	Raw Materials Purchases Accounts Payable		750	 750

The entry to record payroll would include an increase (debit) to direct labor instead of wages expense and an increase (credit) to the withholding liability account and wages payable. To record Br. 1,000 wages, the entry would be:

General Journal

Date	*Account and Title Description*	*PR*	*Debit*	*Credit*
2016	Direct Labor		1,000	
May 31	Wages Payable			1,000

The factory building depreciation of Br 9,500 is classified as a manufacturing cost. It is recorded with an increase (debit) to factory depreciation and an increase (credit) to accumulated depreciation—building.

General Journal

Date	*Account and Title Description*	*PR*	*Debit*	*Credit*
2016	Factory Depreciation Expense		9,500	
May 31	Accumulated Depreciation - Building			9,500

Some companies use one account, factory overhead, to record all costs classified as factory overhead. If one overhead account is used, factory overhead would be debited in the previous entry instead of factory depreciation.

Work Sheet

A worksheet is a working paper used by an accountant to organize accounting information for preparing the financial statements and adjusting entries. It is similar to rough paper used for its help of reducing the chance of error, omission, duplication, and assures mathematical accuracy prior to the actual preparation of the formal financial statements. The worksheet helps organization to try preparation of adjusting entries and financial statements before they are directly entered into the permanent records i.e., journals and ledgers, and put them on the financial statements for distribution to external users. Unlike the financial statements, worksheet is for internal use only. It is not distribution to outsiders. Thus, the use of worksheet is optional. The following procedures may be used to prepare and complete the ten column worksheet:

i. **Unadjusted trial balance** – Copy names and balances of all accounts from the general ledger to the unadjusted trial balance column of the worksheet.
ii. **Adjustment** – Enter adjusting entries in the adjustment column of the worksheet.

iii. **Adjusted trial balance** – Determine and enter adjusted account balances in the adjusted trial balance column and then total debits and credits.

iv. **Manufacturing statement –** Transfer adjusted balances of manufacturing statement accounts to the manufacturing statement columns and then total debits and credits.

v. **Income statement** – Transfer adjusted balances of income statement accounts to the income statement column. Net income appears on the debit or net loss in the credits.

vi. **Balance sheet** – Transfer adjusted balances of balance sheet accounts to the balance sheet column. Net income appears on the debit or net loss in the debit.

The trial balance of King Company at December 31, 2016 shows the following account balances before adjusting entries are journalized and posted.

King Company
Trial Balance
December 31, 2016

Account Title	Debit	Credit
Cash	Br 14,400	
Raw Materials Inventory	8,000	
Work in Process Inventory	2,500	
Finished Goods Inventory	11,200	
Prepaid Factory Insurance	4,550	
Factory Supplies	6,700	
Office Supplies	1,750	
Machinery	75,000	
Accumulated Depreciation – Machinery		Br 28,125
Accounts Payable		4,420
Bella., Capital		56,605
Sales		170,550
Raw Material Purchases	45,100	
Freight on Raw Material Purchases	1,000	
Direct Labor	19,000	
Indirect Labor	8,400	
Factory Utilities	2,100	
Delivery Expense	9,000	
Office Salaries Expense	27,200	
Sales Salaries Expense	13,200	
Advertising Expense	9,000	
Miscellaneous General Expense	1,600	
Total	**Br 259,700**	**Br 259,700**

Additional Information:

a. Raw Materials Inventory at December 31, 2016, Br. 2,500.
b. Work in Process Inventory at December 31, 2016, Br. 3,100.
c. Finished Goods Inventory at December 31, 2016, Br. 2,000.
d. Unexpired portion of Prepaid Factory Insurance at December 31, 2016, Br. 50.
e. Factory Supplies on hand at December 31, 2016, Br. 700.
f. Office Supplies on hand at December 31, 2016, Br. 50.
g. Accrued direct labor and indirect labor were Br. 500 and Br. 100 respectively at December 31, 2016.
h. Machinery was being depreciated for the last 15 years on straight line basis.

Required:

1. Prepare a ten – column work sheet for King Company.
2. Prepare the statement of Cost of Goods Manufactured.
3. Prepare the (a) Income Statement, (b) statement of Owner's Equity and (c) Balance Sheet for King Company.
4. Pass the (a) adjusting and (b) closing entries.

Ten Column Work Sheet

King Company
Worksheet
For the year ended December 31, 2016

Account Titles	Trial Balance		Adjustments		Manufacturing Statement		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	14,400								14,400	
Raw Materials Inventory	8,000		(b) 2,500	(a) 8,000					2,500	
Work in Process Inventory	2,500		(b) 3,100	(b)2,500					3,100	
Finished Goods Inventory	11,200		(d)2,000	(c)11,200					2,000	
Prepaid Factory Insurance	4,550			(e) 4,500					50	
Factory Supplies	6,700			(f) 6,000					700	
Office Supplies	1,750			(g) 1,700					50	
Machinery	75,000								75,000	
Accumulated Depn– Machinery		28,125		(i) 1,875						30,000
Accounts Payable		4,420								4,420
King., Capital		56,605								56,605
Sales		170,550						170,550		
Raw Material Purchases	45,100				45,100					
Freight on Raw Material Purchas	1,000				1,000					
Direct Labor	19,000		(h) 500		19,500					
Indirect Labor	8,400		(h) 100		8,500					
Factory Utilities	2,100				2,100					
Delivery Expense	9,000						9,000			
Office Salaries Expense	27,200						27,200			
Sales Salaries Expense	13,200						13,200			
Advertising Expense	9,000						9,000			
Miscellaneous General Expense	1,600						1,600			
Total	**259,700**	**259,700**								
Income Summary			(c) 11,200	(d) 2,000			11,200	2,000		
Manufacturing Summary			(a) 10,500	(b) 5,600	10,500	5,600				
Factory Insurance Expense			(e) 4,500		4,500					
Factory Supplies Expense			(f) 6,000		6,000					
Accrued Wages Payable				(h) 600						600
Office Supplies Expense			(g) 1,700				1,700			
Depreciation Expe – Machinery			(i) 1,875		1,875					
Total			**43,975**	**43,975**	**99,075**	**5,600**				
Cost of Goods Manufactured						93,475	93,475			
Total							**166,375**	**172,550**	97,800	91,625
Net Income							6,175			6,125
Total							**172,550**	**172,550**	**97,800**	**97,800**

4.5. Financial Statements for a Manufacturing Business

The financial statements for manufacturing businesses are more complex than those for service and merchandising businesses. Since a manufacturing business manufactures the products that it sells, the manufacturing costs describing in the preceding sections must be properly accounted for and reported in the financial statements. These manufacturing costs primarily affect the preparation of the balance sheet and income statement.

Income Statement

The major difference in the income statements for merchandising and manufacturing businesses is in the reporting of cost of goods sold for a merchandising business and cost of goods sold for a manufacturing business. For a merchandising business, merchandise is purchased in a finished state for resale to customers.

For a manufacturing business, the product to be sold is manufactured by processing direct materials, using direct labor and factory overhead. The cost of the product sold is called the **cost of goods sold**. The cost of manufacturing the product, which is comparable to the purchases reported by a merchandising business, can be reported in a **statement of cost of goods manufactured**.

In the statement of cost of goods manufactured, the amount listed for the work in process inventory at the beginning of the period is composed of the estimated cost of the direct materials, the direct labor, and the factory overhead applicable to the inventory of partially processed products at the end of the preceding period. The cost of the direct materials placed in production is determined by adding the beginning inventory of direct materials and the net cost of the direct materials purchased and deducting the ending inventory. The amount of direct labor is then listed. The factory overhead costs are listed individually in the statement or in a separate schedule. The sum of the costs of direct materials placed in production, the direct labor, and the factory overhead represents the total manufacturing costs incurred during the period. Addition of this amount to the beginning inventory of work in process yields the total cost of the work that has been in process during the period. The estimated cost of the ending inventory of work in process is then deducted to yield the cost of goods manufactured.

1) Statement of Cost of Goods Manufactured

King Company Statement of Cost of Goods Manufactured For the Year Ended December 31, 2016			
Work in Process Inventory, January 1, 2016			Br 2,500
Direct Materials:			
Raw Materials Inventory, January 1, 2016		Br 8,000	
Raw Material Purchases	Br 45,100		
Freight on Raw Material Purchases	1,000		
Cost of Raw Material Purchased		46,100	
Raw Materials Available for Use		Br 54,100	
Less: Raw Materials Inventory, December 31, 2016		(2,500)	
Direct Materials Used			51,600
Direct Labor			19,500
Factory Overhead Costs:			
Indirect labor		Br 8,500	
Factory Utilities		2,100	
Factory Insurance Expense		4,500	
Factory Supplies Expense		6,000	
Depreciation Expense – Machinery		1,875	
Total Factory Overhead Costs			22,975
Total Manufacturing Costs			Br 96,575
Less: Work in Process Inventory, December 31,2016			(3,100)
Cost of Goods Manufactured			Br 93,475

2) (a) **Income Statement**

King Company Income Statement For the Year Ended December 31, 2016		
Revenue:		
Sales		Br 170,550
Cost of Goods Sold:		
Finished Goods Inventory, January 1,2016	Br 11,200	
Cost of Goods Manufactured	93,475	
Cost of Goods Available for Sale	Br 104,675	
Less: Finished Goods Inventory, December 31,2016	(2,000)	
Cost of Goods Sold		102,675
Gross Profit		Br 67,875
Operating Expenses:		
Office salaries Expense	Br 27,200	
Sales Salaries Expense	13,200	
Delivery Expense	9,000	
Advertising Expense	9,000	
Office Supplies Expense	1,700	
Miscellaneous General Expense	1,600	(61,700)
Net Income		Br 6,175

(b) Statement of Owner's Equity

King Company Statement of Owner's Equity For the Year Ended December 31,2016	
King, Capital, January 1,2016	Br 56,605
Add: Net Income	6,175
King, Capital, December 31,2016	Br 62,780

Balance Sheet

A manufacturing business reports three types of inventory on its balance sheet: direct materials inventory, work in process inventory, and finished goods inventory. The **direct materials inventory** for a manufacturing business consists of the cost of the direct materials which have not yet entered into the manufacturing process. The **work in process inventory** for a manufacturing business consists of the direct materials costs, the direct labor costs, and the factory overhead costs which have entered into the manufacturing process, but are associated with products that have not been finished. The **finished goods inventory** of a manufacturing business consists of the finished products on hand that have not been sold.

(c) Balance Sheet

King Company Balance Sheet December 31,2016		
Assets		
Cash		Br 14,400
Inventory:		
Raw Materials	Br 2,500	
Work in Process	3,100	
Finished Goods	2,000	7,600
Prepaid Factory Insurance		50
Factory Supplies		700
Office Supplies		50
Machinery	Br 75,000	
Less: Accumulated Depreciation – Machinery	(30,000)	45,000
Total Assets		Br 67,800
Liabilities and Owner's Equity		
Accounts Payable		Br 4,420
Accrued Wages Payable		600
Total Liabilities		Br 5,020
King, Capital		62, 780
Total Liabilities and Owner's Equity		Br 67,800

Adjusting and Closing Entries for a Manufacturing Business

To record adjusting and closing entries for Costs of Goods Manufactured, Ending Goods-In Process and Raw Materials (for closing the manufacturing ledger accounts and for adjusting the inventory balances).

At the end of the cycle, the closing entries are prepared. For a manufacturing company that uses the periodic inventory method, closing entries update retained earnings for net income or loss and adjust each inventory account to its period end balance. A special account called manufacturing summary is used to close all the accounts whose amounts are used to calculate cost of goods manufactured. The manufacturing summary account is closed to income summary. Income summary is eventually closed to retained earnings. The manufacturing accounts are closed first. The closing entries that follow are based on the accounts included in the cost of goods manufactured schedule and income statement for King Company.

3) Adjusting and Closing Entries

(a) **Adjusting Entries**

(a) Eliminating beginning balances		
Manufacturing Summary	10,500	
Raw Materials Inventory		8,000
Work in Process Inventory		2,500
(b) Updating the manufacturing inventory accounts		
Raw Materials Inventory	2,500	
Work in Process Inventory	3,100	
Manufacturing Summary		5,600
(c) Eliminating the beginning balance		
Income Summary	11,200	
Finished Goods Inventory		11,200
(d) Updating the Finished Goods Inventory account		
Finished Goods Inventory	2,000	
Income Summary		2,000
(e) Factory insurance		
Factory Insurance Expense	4,500	
Prepaid Factory Insurance		4,500
(f) Factory Supplies		
Factory Supplies Expense	6,000	
Factory Supplies		6,000

(g) Office Supplies		
Office Supplies Expense	1,700	
Office Supplies		1,700
(h) Accrued Wages		
Direct Labor	500	
Indirect Labor	100	
Accrued Wages Payable		600
(i) Depreciation		
Depreciation Expense – Machinery	1,875	
Accumulated Depreciation - Machinery		1,875

(b) Closing Entries

(a) Closing Manufacturing Cost accounts		
Manufacturing Summary	88,575	
Raw Materials Purchases		45,100
Freight on Raw Material Purchases		1,000
Direct Labor		19,500
Indirect Labor		8,500
Factory Utilities		2,100
Factory Insurance Expense		4,500
Factory Supplies Expense		6,000
Depreciation Expense - Machinery		1,875
(b) Closing revenue accounts		
Sales	170,550	
Income Summary		170,550
(c) Closing expense accounts		
Income Summary	155.175	
Office Salaries Expense		27,200
Sales Salaries Expense		13,200
Delivery Expense		9,000
Advertising Expense		9,000
Office Supplies Expense		1,700
Miscellaneous General Expense		1,600
Manufacturing Summary		93,475

(d) Closing the income summary account		
Income Summary	6,175	
King, Capital		6,175

4.6. Self-Examination Questions

1. Indirect labor is a:

a. nonmanufacturing cost.

b. raw material cost.

c. product cost.

d. period cost.

2. Which of the following costs are classified as a period cost?

a. Wages paid to a factory custodian.

b. Wages paid to a production department supervisor.

c. Wages paid to a cost accounting department supervisor.

d. Wages paid to an assembly worker.

3. Which of the following is *not* an element of manufacturing overhead?

a. Sales manager's salary.

b. Plant manager's salary.

c. Factory repairman's wages.

d. Product inspector's salary.

4. A cost of goods manufactured schedule shows beginning and ending inventories for:

a. raw materials and work in process only.

b. work in process only.

c. raw materials only.

d. raw materials, work in process, and finished goods.

5. A company is more likely to use a job costing system if:

a. it manufactures a large volume of similar products.

b. its production is continuous.

c. it manufactures products with unique characteristics.

d. it uses a periodic inventory system.

(Answers) A1:C, 2:C, 3:A, 4:D, 5:C

4.7. Glossary of Terms

Direct labor The work of factory employees that can be physically and directly associated with converting raw materials into finished goods.

Direct materials Raw materials that can be physically and directly associated with manufacturing the finished product.

Indirect labor Work of factory employees that has no physical association with the finished product, or for which it is impractical to trace the costs to the goods produced.

Indirect materials Raw materials that do not physically become part of the finished product or cannot be traced because their physical association with the finished product is too small.

Job order cost system A cost accounting system in which costs are assigned to each job or batch.

Manufacturing overhead Manufacturing costs that are indirectly associated with the manufacture of the finished product.

Period costs Costs that are matched with the revenue of a specific time period and charged to expense as incurred.

Product costs Costs that are a necessary and integral part of producing the finished product.

Process cost systems An accounting system used to apply costs to similar products that are mass-produced in a continuous fashion.

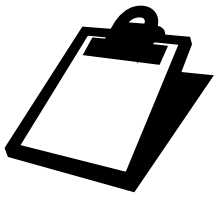
Chapter Five: Accounting Systems

The **accounting information system** collects and processes transaction data and communicates financial information to decision makers. It includes each of the steps in the accounting cycle that you studied in earlier chapters. It also includes the documents that provide evidence of the transactions, and the records, trial balances, worksheets, and financial statements that result. An **accounting system** may be either manual or computerized. Most businesses these days use some sort of computerized accounting system, whether it is an off-the-shelf system for small businesses, like QuickBooks or Peachtree, or a more complex custom-made system.

Efficient and effective accounting information systems are based on certain basic principles. These principles are (1) cost-effectiveness, (2) usefulness, and (3) flexibility. If the accounting system is cost-effective, provides useful output, and has the flexibility to meet future needs, it can contribute to both individual and organizational goals.

OBJECTIVES OF THE CHAPTER

After studying this chapter, you should be able to:



[a] Identify the basic concepts of an accounting information system.

[b] understand principles of accounting information systems

[c] Describe the nature and purpose of a subsidiary ledger.

[d] Explain how companies use special journals in journalizing.

[e] explain the impacts technology on accounting information systems.

5.1. Computerized Accounting Systems and Manual Accounting Systems

Computerized Accounting Systems

Many small businesses eventually replace their manual accounting system with a computerized general ledger accounting system. **General ledger accounting systems** are software programs that integrate the various accounting functions related to sales, purchases, receivables, payables, cash receipts and disbursements, and payroll. They also generate financial statements. Computerized systems have a number of advantages over manual systems. First, the company typically enters data only once in a computerized system. Second, because the computer does

most steps automatically, many errors resulting from human intervention in a manual system, such as errors in posting or preparation of financial statements, are eliminated. Computerized systems also provide information up-to-the-minute. More timely information results in better business decisions. Many different general ledger software packages are available.

Manual Accounting Systems

Manual accounting systems perform each of the steps in the accounting cycle by hand. For example, someone manually enters each accounting transaction in the journal and manually posts each to the ledger. Other manual computations must be made to obtain ledger account balances and to prepare a trial balance and financial statements. In the remainder of this chapter, we illustrate the use of a manual system.

You might be wondering, "Why we studied manual accounting systems if the real world uses computerized systems?" First, small businesses still abound. Most of them begin operations with manual accounting systems and convert to computerized systems as the business grows. You may work in a small business, or start your own someday, so it is useful to know how a manual system works. Second, to understand what computerized accounting systems do, you also need to understand manual accounting systems.

The manual accounting system represented in the first four chapters of this module is satisfactory in a company with a low volume of transactions. However, in most companies, it is necessary to add additional ledgers and journals to the accounting system to record transaction data efficiently.

5.2. Components of an accounting system

Dear Students! A system is a way of doing something. In accounting is also a system, it records, processes and reports about the business's transactions. There are five basic elements of an accounting system. These are:

5.2.1. Source Documents

Source documents provide the basic information to be processed by the accounting system. Invoices from suppliers, bills sent to customers, and payroll records are some examples of source documents. You have already seen their meaning and importance in previous chapter.

5.2.2. Input Devices

Input devices capture information from source documents and enable its transfer to the information-processing component of the system. Journal entries, both paper based and electronic are a type of input devices.

5.2.3. Information Processors

An information processor is a system that interprets, transforms and summarizes information for use in analysis and reporting. As indicated earlier, the information processing in an accounting system can be manual or computerized. Now a day, computer is being increasingly used to process information. Many businesses in Ethiopia, for example, use the Peachtree accounting software to process accounting information.

5.2.4. Information Storage

After being input, processed data are usually saved for use in future analysis or report. Information storage is the component of an accounting system that keeps data in a form accessible to information processors.

5.2.5. Output Device

Output devices are the means to take information out of an accounting system and make it available to users. Output devices include printers, and monitors, which provide such outputs as financial statements, bills to customers and internal reports.

Activity

Question 1: Give one example of an information storage device**?**.....

.....

5.3. Fundamental Principles of Accounting Systems

5.3.1. Control Principle

Any accounting information system should allow managers to control and monitor business activities. To achieve this, accounting system must have internal control as an element. **Internal controls** are methods and procedures that direct operations to one goal, ensure reliability of financial reports and safeguard business assets. Internal controls are discussed separately and at a greater detail in the next chapter.

5.3.2. Relevance Principle

The information that an accounting system provides should be relevant to decision makers. This means, an information system should be designed to capture data that make difference in decision. To ensure this, it is important that all decision makers, be considered when identifying relevant information for disclosure.

5.3.3. Compatibility Principle

The compatibility principle requires that an accounting system conform to the company's activities, personnel and structure. The system must also be customized to the unique characteristics of the company. All in all, accounting systems must be consistent with the aims of the company, i.e., they should work in harmony with company goals.

5.3.4. Flexibility Principle

Accounting information systems must be flexible to adjust to changes in the company, in the business environment and needs of decision makers. These changes can be technological developments, consumer tastes or company activities. A system must be designed to adapt to these and other changes.

5.3.5. Cost-Benefit-Principle

You wouldn't do anything in your daily life without first weighing the costs and the benefits. Likewise, the benefits of performing an activity in an accounting system should be greater than its costs. For example, when you decided whether or not to report certain information, you have to compare the benefits (its usefulness to decision making) and the costs (of computing, personnel and other indirect costs).

5.4. Subsidiary Ledgers and Special Journals

5.4.1. Subsidiary Ledgers

When a business has so many customers and suppliers, a **control** account for Accounts Receivable and a control account for Accounts Payable are established in the general ledger. But in addition to these, **subsidiary** ledger for receivables and payables may be added to the accounting system to show the balances for each individual customer and supplier separately.

A control account is an account in the general ledger that shows the total balances of all the subsidiary accounts related to it. Subsidiary ledger accounts show the details supporting the related general ledger control account balance. For example, the subsidiary (supporting) accounts for accounts Receivable may be used to send out to each customer statements showing the balance they owe the company.

A subsidiary ledger is therefore, a group of related accounts showing the details of the balance of general ledger accounts.

Subsidiary ledgers are used to relieve the general ledger of a mass of detail. Thereby, the general ledger trial balance is shortened. What's more, having separate ledgers promotes the division of labor as one employee can handle the control account while its subsidiary can be assigned to another employee. The relationship between a control account in the general ledger and its subsidiary accounts can be illustrated as follows in T- account form.

Control account in the General Ledger

Accounts Receivable

2001	
Dec. 31	
Bal. 10,000	

Subsidiary accounts in the Accounts Receivable subsidiary Ledger

Customer A

2001	
Dec. 31	
Bal. 1,000	

Customer B

2001	
Dec. 31	
Bal. 4,000	

Customer C

2001	
Dec. 31	
Bal. 2,000	

Customer D

2001	
Dec. 31	
Bal 3,000	

As you can see the sum of all balances in the subsidiary accounts (1,000 + 2,000 + 4,000 + 3,000) on December 31, 2001 is equal to the balance in the control account (10,000).

When a transaction is recorded as a journal entry, it must indicate which of the subsidiary ledger accounts is affected. Posting will be made to both the control account and the subsidiary ledger account.

Example: A Br. 450 sale was made on account to Gome Balcha on January 2, 2016. The journal entry would be:

Jan. 2	Accounts Receivable-Gome	450	
	Sales		450

The Br. 450 would be posted as a debit to both the Account Receivable control account in the general ledger and G.Balcha's account in the subsidiary ledger. The credit would, of course, be to the Sales account in the general ledger. The following can be a summary of what's discussed above:

General ledger Control Account		Subsidiary ledger
Accounts Receivable	⟷	Accounts Receivable subsidiary Ledger (account for each customer)
Accounts Payable	⟷	Accounts Payable subsidiary Ledger (account for each supplier)
Office Equipment, Delivery Equipment, Office Furniture	⟷	Equipment subsidiary ledger (Account for each item of equipment).

Activity

1. **Question 1:** What factors would affect a company's decision to set up subsidiary ledger accounts for the general ledger accounts?.....
.....

5.4.2. Special Journals

A general journal is an all-purpose journal where we can record any transaction. However, as the transactions of a company increase, it is better to use special journals along with the general

journal to record transactions of similar type in one, such as sales on account or cash payments. Special journals record transactions of a similar nature.

Special journals are designed to systematize the original recording of major transactions, which occur very repeatedly. The number and format of special journals used by a company depends on the nature and size of the company's business transactions. The following are some of the typical examples of special journals used by most merchandising businesses.

1. Sales Journals
for recording credit sales.

2. Cash Receipt journal
for recording cash receipts.

3. Purchase journal
for recording credit purchases.

4. Cash payment journal
for recording cash payments

5. General journal
for transactions not recorded in any of the special journal

Advantages of using special journals

a) Time is saved in journalizing. The amount of writing is reduced because it is not necessary to repeat the account titles printed already at the top of the special columns for every debit and credit.
b) Time is saved in posting- many amounts are posted as column totals rather than individually.
c) Detail is eliminated from the general ledger column. Totals are posted to the ledger means that detail is left in the special journals.

d) Division of labor is promoted. Several persons can work simultaneously on the accounting records. This allows management to fix responsibility and quickly locate errors.
e) Management analysis is aided. The special journal can be useful to management in analyzing classes of transactions, such as sales, because similar transactions are in one place.

Sales Journal: In the **sales journal**, companies record **sales of merchandise on account**. Cash sales of merchandise go in the cash receipts journal. Credit sales of assets other than merchandise go in the general journal.

Cash Receipts Journal: In the **cash receipts journal**, companies record all receipts of cash. The most common types of cash receipts are cash sales of merchandise and collections of accounts receivable. Many other possibilities exist, such as receipt of money from bank loans and cash proceeds from disposal of equipment. A one- or two column cash receipts journal would not have space enough for all possible cash receipt transactions. Therefore, companies use a multiple-column cash receipts journal.

Purchases Journal: In the **purchases journal**, companies record all purchases of merchandise on account. Each entry in this journal results in a debit to Inventory and a credit to Accounts Payable.

Cash Payments Journal: In a **cash payments (cash disbursements) journal**, companies record all disbursements of cash. Entries are made from prenumbered checks. Because companies make cash payments for various purposes, the cash payments journal has multiple columns.

General Journal: **If a transaction cannot be recorded in a special journal, the company records it in the general journal.** For example, if a company had special journals for only the four types of transactions listed above, it would record purchase returns and allowances in the general journal. Similarly, **correcting**, **adjusting**, **and closing entries are recorded in the general journal**. In some situations, companies might use special journals other than those listed above. For example, when sales returns and allowances are frequent, a company might use a special journal to record these
transactions.

5.5. Self-Examination Questions

1. The basic principles of an accounting information system include all of the following except:

- **a.** cost-effectiveness.
- **b.** useful output.
- **c.** flexibility.
- **d.** periodicity.

2. Which of the following is *not* an advantage of computerized accounting systems?

- **a.** Data is entered only once in computerized accounting systems.
- **b.** Computerized accounting systems provide up-to-date information.
- **c.** Computerized accounting systems eliminate entering of transaction information.
- **d.** Computerized accounting systems eliminate many errors resulting from human intervention.

3. Two common subsidiary ledgers are:

- **a.** accounts receivable and cash receipts.
- **b.** accounts payable and cash payments.
- **c.** accounts receivable and accounts payable.
- **d.** sales and cost of goods sold.

4. A purchase of equipment on account is recorded in the:

- **a.** cash receipts journal.
- **b.** cash payments journal.
- **c.** purchases journal.
- **d.** general journal.

5. A purchase of equipment using cash is recorded in the:

- **a.** cash receipts journal.
- **b.** cash payments journal.
- **c.** purchases journal.
- **d.** general journal.

(Answers) 1:D, 2:C, 3:C, 4:C, 5:B

5.6. Glossary of Terms

General ledger -the principal ledger that contains all the balance sheet and income statement accounts.

Controlling Account- a summarizing account in the general ledger, which represents a summary of subsidiary accounts.

Subsidiary ledger - a group of accounts, which contain detail regarding a controlling, account.

Purchaser journal - a special journal for recording purchase of merchandise or other items on account.

Cash payment journal- a special journal for recording payments of cash for any purpose.

Sales journal - a special journal for recording sale of merchandise on account.

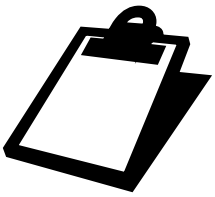
Cash Receipts journal- a special journal for recording receipt of cash from any source.

Chapter Six: Cash and Receivables

Dear students! In this chapter we will explore about the two significant assets for all companies. As a consequence, companies must pay close attention to their cash and receivables and manage them carefully. In this chapter you will learn about what activities should companies make about cash and receivables. Thus this chapter classified in two sections, i.e., cash and account receivable.

OBJECTIVES OF THE CHAPTER

After studying this chapter, you should be able to:



[a] Define cash

[b] Identify the with composition of cash

[c] Explain the objectives of cash management

[d] Prepare a bank reconciliation

[e] Understand the internal control of cash

[f] List the common classification of Receivables

[g] Explain internal Control procedures that apply to receivables

[h] Describe the nature of and the accounting for uncollectible

[i] Explain how receivables can be converted to cash before maturity.

SECTION ONE: CASH

Cash is the one asset that is readily convertible into any other type of asset. It also is easily concealed and transported, and is highly desired. Because of these characteristics, **cash is the asset most susceptible to fraudulent activities**. In addition, because of the large volume of cash transactions, numerous errors may occur in executing and recording them. To safeguard cash and to ensure the accuracy of the accounting records for cash, effective internal control over cash is critical.

6.1. Meaning of Cash

Cash includes money on deposit in banks and other items that a bank will accept for immediate deposit. Money on deposit in banks includes checking and saving accounts. Other items such as ordinary checks received from customers, money orders, coins and currency and petty cash also

are included as cash. Banks do not accept postage stamps, travel advances to employees, notes receivable or post-dated checks as cash. The following are some of the characteristics of cash:

a) Cash is used as medium of exchange
b) Cash is the most liquid asset
c) Cash is mostly affected by business transactions
d) Cash is used to measure the value of other assets
e) Cash is mostly exposed to embezzlements

6.2. Management of Cash

Cash management refers to planning, controlling and accounting for cash transactions and cash balances. Efficient management of cash is essential to the survival and success of every business organization. Managing cash requires planning wisely so that there will not be excess cash held on hand at any point in time; or there is no shortage of cash at any point in time to meet the business's needs.

Activity

Question 1: Define cash as it is used for accounting purpose.....

.....

Question 2: Which of the following items should not be included as cash?

a) Ordinary checks
b) Post-dated checks
c) Cash deposited in saving accounts
d) Postage stamps
e) Deposits in checking accounts

6.3. Internal Control of Cash

The need to safeguard cash is crucial in most businesses because cash is mostly exposed to embezzlement. Firms address this problem through the internal control system. An internal control system is a set of policies and procedures designed to protect assets, provide accurate accounting records and evaluate performances. In other words, **Internal control** consists of all the related methods and measures adopted within an organization to safeguard its assets, enhance the reliability of its accounting records, increase efficiency of operations, and ensure compliance with laws and regulations.

A sound internal control system for cash increases the likely hood that the reported values for cash are accurate.

Internal control for cash should include the following procedures:

a) The individuals who receive cash should not also disburse (pay) cash

b) The individuals who handle cash should not access accounting records

c) Cash receipts are immediately recorded and deposited and are not used directly to make payments.

d) Disbursements are made by serially numbered checks, only upon proper authorization by someone other than the person writing the check

e) Bank accounts are reconciled monthly.

The following are the most common elements of cash control and managements: bank account system, petty cash fund, voucher system, change fund, and cash short and over.

6.4. Control of Cash through Bank Accounts

Bank accounts are one of the most important means of controlling cash that provide several advantages such as:

- Cash is physically protected by the bank,
- A separate record of cash is maintained by the bank,
- And customers may remit payments directly to the bank.

If a company uses a bank account, monthly statements are received from the bank showing beginning and ending balances and transactions occurring during the month including checks paid, deposits received, and service charges. These monthly statements (reports) received from the bank are called ***bank statements***. Bank statements generally are accompanied by checks paid and charged to the accounts during the month, debit and credited memos, which inform the company about changes in the cash accounts. For a bank, the depositor's cash balance is a liability, the amount the bank owes to the firm. Therefore, a debit memo describes the amount and nature of decrease is the company's cash accounts. A credits memo indicates an increase in the cash balance of the depositor that it has with the bank.

6.4.1. Reconciliation of Bank and Book Cash Balances

Monthly reconciling of the bank balance with the depositor's cash accounts balance is essential cash control procedure. To reconcile a bank statement means to verify that the bank balance and the accounting records of the depositor are consistent. The balance shown in a monthly bank statement seldom equals the balance appearing in the depositor's accounting records. Certain transactions recorded by the depositor may not have been recorded by the bank and vice versa.

The most common examples that cause disparity between the two balances are:

a) **Outstanding checks**:
   Checks issued and recorded by the company, but not yet presented to the bank for payment.

b) **Deposits in transit**:
   Cash receipts recorded by the depositor, but not reached the bank to be included in the bank statement for the current month.

c) **Service charges**:
   Banks often charge a fee for handling checking accounts. The amount of this charge is deducted by the bank form bank balance and debit memo is issued for the depositor.

d) **Charges for depositing NSF- checks**:
   NSF stands for "Not Sufficient Funds." When checks are deposited in an account, the bank generally gives the depositor immediate credit. On occasion, one of these checks may prove to be uncollectible because the maker of the check does not have sufficient funds in his or her account. In such a case, the bank will reduce the depositor's account by the amount of this uncollectible item and return the check to the depositor marked "NSF".

e) **Notes collected by bank**:
   If the bank collects a note receivable on behalf of the depositor, it credits the depositor's account and issues a credit memorandum for the depositor.

When the depositor prepares bank reconciliation, the balances shown in the bank statement and in the accounting records both are adjusted for any unrecorded transactions. Additional adjustments may be required to correct any **errors** discovered in the bank statements or in the accounting records.

6.4.2. Steps in Preparing Bank Reconciliation

A bank reconciliation is a schedule prepared by the depositor to bring the balance shown in the bank statement and the balance shown in the depositor's accounting into agreement.

The steps to prepare a bank reconciliation are:

a) The deposits listed on the bank statement are compared with the deposits shown in the accounting records. Any deposits not yet recorded by the bank are deposits in transit and should be added to the balance shown in the bank statements.
b) The paid and received checks from the bank are compared with the check stubs. Any checks issued but not yet paid by the bank are outstanding checks and should be deducted from the balance reported in the bank statements.
c) Any credit memorandums issued by the bank that have not been recorded by the depositor, are added to the balance per depositor's record.
d) Any debit memorandums issued by the bank that have not been recorded by the depositor are deducted from the balance per depositor's record.
e) Any errors in the bank statement or depositor's accounting records are adjusted.
f) The equality of adjusted balance of statement and adjusted balance of the depositor's record is compared.
g) Journal entries are prepared to record any items delayed by the depositor.

6.4.3. Illustration of Bank Reconciliation

The January bank statement sent by Awash Bank to JORJO Company shows Br. 5,000.17. Assume also that on January 31, 2016, the Cash account of JORJO Co. shows a balance of Br. 4,262.83. The accountant of JORJO Company has identified the following items:

1. A deposit of Br. 410.90 made after banking hours on Jan. 31 does not appear on the bank statement.
2. Two checks issued in January have not yet been paid by the bank:

Check No. 301	Br. 110.25
Check No. 342	607.50

3. A credit memorandum was included in the bank statement, which was for proceeds from collection of a non-interest bearing note receivable from MAN company Br. 524.74.

4. Three debit memorandums accompanied the bank statement: Fee charged by bank for handling collection of notes receivable Br.5; a check of Br. 50.25 received from a customer, JORJO company, and deposited by JORJO company was charged back as NSF; and service charge by bank for the month of January amounts to Br. 12.00.
5. Check No. 305 was issued by JORJO Company for payment of telephone expense in the amount of Br. 85 but was erroneously recorded in the cash payments journal as Br. 58.

The January 31 bank reconciliation for JORJO Company is shown below:

Jorjo Company

Bank Reconciliation

January 31, 2016

Balance per bank statement, Jan. 31,2016		**Br. 5,000.17**
Add: Deposit of Jan. 31 not recorded by bank		410.90
Subtotal		Br. 5,411.07
Deduct: outstanding checks:		
No. 301	Br. 110.25	
No. 342	607.50	717.75
Adjusted cash balance		Br. 4,693.32
Balance per depositor's record, Jan. 31,2016		**Br. 4,262.83**
Add: Note Receivable collected by bank		524.74
Subtotal		Br. 4,787.57
Deduct: collection fee	Br. 5.00	
NSF check of Ron Co.	50.25	
Service charge	12.00	
Error on check stub No. 305	27.00	94.25
Adjusted cash balance		Br. 4,693.32

The following are journal entries related to the bank reconciliation.

Jan. 31	cash	524.74	
	Notes Receivable		524.74
	To record collection of Note Receivable collected by bank		

Jan 31	Miscellaneous Expense	17.00	
	Accounts Receivable-RON Co.	50.25	
	Utilities Exp.	27.00	
	Cash		94.25
	To record bank service charges, NSF check and error in recording Check No. 305		

Activity

Question 1: Briefly explain the basic purpose of a bank reconciliation.....

.....

Question 2: Define the following terms related to the accounting for cash:

a) Outstanding checks

.....

.....

b) Deposit in transit

.....

.....

c) NSF- check

.....

.....

Question 3: Which of the reconciling items necessitate an entry in the depositor's accounts?

a) Deposit in transit

b) Outstanding checks

c) Note collected by bank

d) Bank service charge

6.5. Petty Cash Fund

Petty cash fund, which is part of the total cash balance, is used to handle many types of small payments such as employee transportation costs, purchase of office supplies, purchase of postage stamps, and delivery charges. Many businesses find it convenient to make minor expenditures instead of writing checks. The petty cash amount various from Br. 50 or less to more than Br. 1,000, which will cover small expenditures for a period of two or three weeks.Thus, petty cash fund is the small fund used to make payment for small expenditures. There are three steps involved in the operation of the petty cash.

1. Establishing the petty cash
2. Making payment from the petty cash.
3. Replenishing (reimbursing) the petty cash.

1) Establishing the petty cash: In establishing the petty cash fund, the first step is to estimate the amount of cash needed for disbursement of relatively small amounts during certain period, such as week or a month and appointing the ***petty cash custodian***, the one who is responsible for the operation of the petty cash fund and for making disbursements from the petty cash fund. Checks payable to the petty cash fund custodian will be issued.

Petty cash.....xx
Cash in bank.....xx

No entry will be made to the petty cash account unless the petty cash fund is changed (increased or decreased).

2) Making payment from the petty cash: Petty cash receipt: The employee who request for payment and the petty cash custodian will sign on it. The petty cash custodian will make payment for the specified employee who request disbursement.

Dear Students! No journal entry will be made at the time of disbursement (payment) from the petty cash fund.

3) Replenishing (reimbursing) the petty cash: When the money in the petty cash fund reaches a minimum level the fund is replenished (reimbursed). Replenishing the petty cash fund restores to its original amount. The request for this is initiated by the petty cash custodian. The custodian will provide the summery of the petty cash payment with the petty cash receipt to the treasurer. Then the treasurer approves the request and check is prepared to restore the fund to its

established amount. Journal entry will be made to restore the petty cash fund to previously established amount and to record all expenditures.

Example: If "X" company desires to establish a $100 fund on August 1, the entry will be

August 1/	Petty cash	100	
	Cash in bank		100

Assume that on August 31, the petty cash custodian request check number 3 for $87. The fund contains $13 cash and petty cash receipt for postage expense $44, freight in, $38 and miscellaneous expense, $5. The entry to record the replenishment on August 31 will be:

August 31/	Postage expense	44	
	Freight in	38	
	Miscellaneous expense	5	
	Cash in bank		87

6.6. Voucher System

One method to control cash disbursements is a voucher system. **A voucher** is a special form, which contains relevant data about a liability and its payment.

In a voucher system, a voucher is prepared for each expenditure and approved by the designated officials. Each approved voucher represents liability and recorded in a voucher register, which is similar to purchases journal. Those registered vouchers are filed according to their payment date in an unpaid vouchers file. The vouchers and supporting documents then are sent to the treasure or other official is the finance department before issuing checks. When the checks are signed, the paid vouchers are recorded in a check register which is similar to cash payments journal. Those paid vouchers are filed in paid vouchers file according to their serial number for future reference.

6.7. Change Fund

Some businesses that receive cash directly from customers should maintain a fund of currency and coins in order to make change (such as changing Birr 100 in to 2 of Birr 50 or 10 of Birr 10). This fund, which is part of the total cash balance, is called change fund. A change fund is established by issuing a check to the bank and transferring the cash to the custodian. The issuance of a check to establish a change fund is recorded by debiting cash on hand and crediting cash or voucher payable. Once a change fund is established, there will be no change in its balance unless there is a decision by management to increase or decrease the fund balance.

6.8. Cash Short and Over

In handling cash receipts from daily sales, a few errors in making changes will occur. These errors may cause a cash shortage or overage at the end of the day. The account cash short and over is debited if there is shortage and credited if there is overage. At the end of the period if the account had a debit balance, it appears in the Income statement as miscellaneous expense; if it has a credit balance, it is shown as miscellaneous revenue.

For example, assume that the total cash sales recorded during the day amounts to Br. 12,420. However, the cash receipts in the cash register drawer (actual cash count) total Br. 12,415.

The following entry would be made to adjust the accounting records for the shortage in the cash receipts:

Cash Short and Over	5.00	
Cash		5.00

To record a Br. 5.00 (Br. 12,420 – 12,415) Shortage in cash receipts for the day

Activity

Question 1: The petty cash account has a debit balance of Br. 200. At the end of the accounting period, there is Br. 160 in the petty cash fund along with petty cash receipts totaling Br. 40. Should the fund be replenished as of the last day of the period? Why?.....

.....

.....

Question 2: In what order are vouchers ordinarily filed

A) In the unpaid voucher file

B) In the paid voucher file

.....

Question 2: In which section of the Income statement would a credit balance in cash short and over be reported?

.....

.....

SECTION TWO: RECEIVABLES

In this section, we emphasize on how companies account for and report receivables. Most of the companies sell goods and services on credit in order to earn more profits. Receivables represent claims for money, goods, services, and non-cash assets from other firms

The term **receivables** refers to amounts due from individuals and companies. Receivables are claims that are expected to be collected in cash. The management of receivables is a very important activity for any company that sells goods or services on credit. Receivables are important because they represent one of a company's most liquid assets. For many companies, receivables are also one of the largest assets

6.9. Internal control over receivables

The principles of internal control that are discussed in chapter 5 are required by organizations to safeguard their assets from any kind of error and misconduct. These control procedures should apply on receivables because they are one of the asset elements for the organization. For example, the individual responsible for sales should be separate from the individual accounting for the receivables and approving credit. By doing so, the accounting and credit approval functions serve as independent checks on sales. Separation of responsibility for related functions reduces the possibility of errors and misuse of funds.

Adequate control over Accounts Receivable begins with the approval of the sales by a responsible company official or the credit department, after the customer's credit rating has been reviewed. Likewise, adjustments of Account Receivable, such as for sales return and allowance, and sales discount, should be authorized or reviewed by a responsible party. Effective collection procedure should also be established to ensure timely collection of receivables and to minimize losses from uncollectible accounts.

6.10. Classification of Receivables

The relative significance of a company's receivables as a percentage of its assets depends on various factors: its industry, the time of year, whether it extends long-term financing, and its credit policies. To reflect important differences among receivables, they are frequently classified as (1) accounts receivable, (2) notes receivable, and (3) other receivables.

Accounts receivable are amounts customers owe on account. They result from the sale of goods and services. Companies generally expect to collect accounts receivable within 30 to 60 days. They are usually the most significant type of claim held by a company.

Recognizing accounts receivable is relatively straightforward. A service organization records a receivable when it provides service on account. A merchandiser records accounts receivable at the point of sale of merchandise on account. When a merchandiser sells goods, it increases (debits) Accounts Receivable and increases (credits) Sales Revenue.

The seller may offer terms that encourage early payment by providing a discount. Sales returns also reduce receivables. The buyer might find some of the goods unacceptable and choose to return the unwanted goods.

To review, assume that Jordache Co. on July 1, 2016, sells merchandise on account to Polo Company for $1,000, terms 2/10, n/30. On July 5, Polo returns merchandise worth $100 to Jordache Co. On July 11, Jordache receives payment from Polo Company for the balance due. The journal entries to record these transactions on the books of Jordache Co. are as follows

July 1	Accounts Receivable—Polo Company	1,000	
	Sales Revenue		1,000
	(To record sales on account)		
July 5	Sales Returns and Allowances	100	
	Accounts Receivable—Polo Company		100
	(To record merchandise returned)		
July 11	Cash ($900 2 $18)	882	
	Sales Discounts ($900 3 .02)	18	
	Accounts Receivable—Polo Company		900
	(To record collection of accounts receivable)		

Notes receivable represent claims for which formal instruments of credit are issued as evidence of the debt. The credit instrument normally requires the debtor to pay interest and extends for time periods of 60–90 days or longer. Notes and accounts receivable that result from sales transactions are often called **trade receivables**.

Other receivables include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable. These do not generally result

from the operations of the business. Therefore, they are generally classified and reported as separate items in the balance sheet.

On the other hand, receivables can be broadly classified into Trade Receivables and No-trade Receivables. ***Trade Receivables*** describe amounts owed to the company for goods and services sold in the normal course of business. Non-trade Receivable arise from many other sources, such as advance to employees, interest receivables, rent receivables and loan to affiliated companies. Unless we indicate otherwise, we will assume that all receivables in this unit are trade receivables.

As we have seen earlier, Account Receivable refers to amounts due from customers for credit sales. These receivables are supported by sales invoices or other documents rather than any formal written promises. Such Account Receivables are normally expected to be collected within relatively short period, such as 30 or 60 days. They are classified on the balance sheet as a current asset. On the other hand, Notes Receivable refers to amounts that customers owe, for which a formal, written instrument of credit has been issued. Notes are usually used for credit periods of more than sixty days and for transactions of relatively large value. Notes may also be used in settlement of an open account and in borrowing or lending money.

Activity

Question 1: Why is Account Receivable classified as a current asset?

……
……

Question 2: Why is segregation of duties required for related activities related to receivables?

……
……

6.11. Characteristics of Notes Receivable

A claim supported by a note has some advantages over a claim in the form of an Account Receivable. By signing a note, the debtor recognizes the debt and agrees to pay according to the terms listed. A note is therefore a strong legal claim if there is a court action.

A promissory note is a written promise to pay a sum of money on demand or at a definite time. It is payable to the order of a person or firm or to the bearer or holder of the note. The person or

firm that makes the promise signs it. The one to whose order the note is payable is called the ***payee***, and the one making the promise is called the ***maker***.

Notes have several characteristics that affect how they are recorded and reported in the financial statements. The characteristics are described in the following paragraphs: -

- ***Due Date***

The date a note is to be paid is called the **Due Date or Maturity date**. The period of time between the issuance date and the due date of a short-term note may be stated in either days or months. When the term on a note is expressed in days, the maturity date is the specified number of days after the note's date. As an example, a five-day note dated January-1 matures and is due on January-6. A 90-day notes dated March-10, matures on Jun-8. This due date, June-8, is computed as below: -

Term of the Note----------90

Days in March----------31

Minus the date of the note----------10

Days remaining in March----------21

Add days in April----------30

Add days in May----------31

82

Number of days remaining to equal 90-days

(90 – 82 = 8)----------8

Therefore, Due date is June-8.

The period of a note is sometimes expressed in months. When months are used, the note matures and is payable in the month of its maturity on the same date of the month as its original date

A three-month note dated March-10, for instance, is payable on June-10.

- ***Interest Computation***

Interest is the cost of borrowing money for the borrower. It is the profit from lending money for the lender. The interest rate on notes is normally stated in terms of per year, regardless of the actual period of time involved.

The formula for computing interest is as follows: -

Interest =	Principal (Face Amount of the Note)	X	Annual interest Rate	X	Time

To illustrate the formula, the interest on a Br. 10,000, 12%, 60 day note is computed as:-

Br. 10,000 X 12% X 60/360 = 200

N.B. To simplify interest computations for notes with periods expressed in days, it is common to treat a year as having 360 days.

- ***Maturity Value***

The amount that is due at the maturity or due date is called the maturity value. The maturity value of a note is the sum of the face amount and the interest. In the above example, the maturity value is Br. 10,200 (which is Br. 10,000 face amount plus Br. 200 interest)

I.e. $\boxed{MV = FV + I}$ where MV= Maturity value

FV = Face value

I = Interest

6.12. Accounting for Notes Receivable

Notes Receivable are usually recorded in a single note Receivable account to simplify record keeping. We need only one account because the original notes are kept on file. This means the maker; rate of interest, due date, and other information can be learned by examining the actual note.

To illustrate the recording of the receipt of a note, assume that on January-10, Nile Co. sales merchandise on account to Tana Co. and receive a Br. 5,000, 90-day, 12% promissory note.

This transaction is recorded as: -

Jan. 10. Notes Receivable ----------5000

Sales----------5000

The maker of the note usually honors the note and pays it in full. The entry required to record the receipt of cash by Nile Co. from Tana Co. is as follows:

April-10	Cash	5150	
	Notes Receivable		5000
	Interest Revenue (500 X 12/100 X 90/360		150

Companies can sometimes accept a note for an overdue customer as a way of granting a time extension on a past-due account Receivable. To illustrate, assume that a 60-day, 10% note dated September 5, 2016 is accepted by Awash Co. in settlement of the account of Happy co, which is past due and has a balance of 10,000. The entry to record the transaction is as follows:

September 5	N/R	10, 000	
	A/R		10,000
	Received a note to settle account		

Recording a dishonored note

When a note's maker is unable or refuses to pay at maturity, the note is dishonored. The act of dishonoring a note doesn't relieve the maker of the obligation to pay. The payee should use every legitimate means to collect. But how do companies report this event? The balance of the Notes Receivable account normally includes only those notes that have not matured. When a note is dishonored, we therefore remove the amount of this note from the Notes Receivable account and charge it back to an Accounts Receivable from its maker. Assume for instance Nile Co., holds a Br. 1000, 12%, 30-day note of Ato Zemen. At maturity, Zemen dishonored the note. Nile Co. records this dishonoring of its N/R, on Oct. 25, as follows:

Oct.25,	A/R Ato Zemen	1010	
	N/R		1000
	Int. Rev.		10
	To record dishonored note & interest of 1000 X 12% X 30/360 =10		

The above entry records interest of Br. 10, which has been earned, even though the note has been dishonored.

End-Of-Period Interest Adjustment

When notes receivable are outstanding at the end of an accounting period, accrued interest is computed and recorded. For example, on December 20, 2016, Nile Co. accepted a Br. 2000, 60-day, 12% note from a customer in granting an extension of a past-due account. Assuming that the accounting period ends on Dec. 31, the entries to record the receipt of the note, accrued interest, and payment of the note at maturity are shown below: -

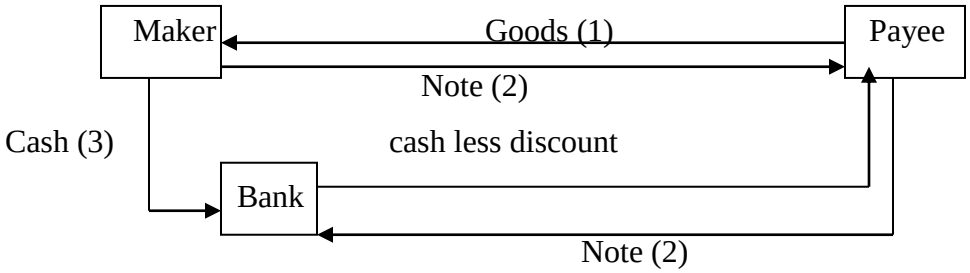
Dec. 19.	N/R	2000	
	A/R- Customer-X		2000
	Received note in settlement of A\R		
Dec. 31.	Interest Receivable	8	
	Int. Revenue		8
	Adjusting entry for ace need Interest, Br. 2000 X 12% X 12/360 = 8		
Feb. 17.	Cash	2040	
	N/R		2000
	Int. Rec		8
	Int. Revenue		32
	Received payment of note & interest at maturity		

The adjusting entry above on Dec. 31, 2016, was required to show the interest earned for the period on the Income Statement.

6.13. Converting Receivables to cash before Maturity

Sometimes, companies convert receivables to cash before they are due. Reasons for this include the need for cash or a desire not to be involved in collection activities. Converting receivable is usually done either (1) by selling them, or (2) by using them as security for a loan. The topic of using notes as security for a loan will be discussed in future courses. Notes Receivable can be converted to cash by discounting them at a financial institution such as a Bank. The process has three steps as indicated in the following diagram. In the first step, the maker receives goods, service or cash from the payee in exchange for the note. In the second step, the payee discounts

the note with a bank and receives the maturity value of the note less a discount (a fee) charged by the bank. In the third step, the maker pays the bank at the maturity of the note.



Notes Receivable are discounted with or without recourse. When a note is discounted without recourse, the bank assumes the risk of a bad debt loss and the original payee doesn't have a contingent liability. A contingent liability is an obligation to make a future payment if and only if an uncertain future event occurs. A note discounted without recourse is like an outright sale of an asset. If a note is discounted with recourse and the original maker of the note fails to pay the bank when it matures, the payee of the note must pay for it. This means a company discounting a note (an endorser) with recourse has a contingent liability until the bank is paid. A Co. should disclose contingent liabilities in the accompanying notes to its financial statements.

To illustrate, assume that a 90-day, 12%, Br. 20,000 N/R from Hiwot Co. dated Jan.1, 2016 is discounted at the payee's bank on February 12, 2016 at the discount rate of 15%. The steps to determine the **proceeds** (-the amount to be received by the payee from the bank upon discounting) are as follows:

Step 1 – Determine the maturity date & maturity value.

MD = April –1 & MV = FV + I = 20,000 + [20,000 X 12% X 90/360]

= 20,600

Step 2 – Determine the Bank Discount (***Bank discount*** is an interest that is charged by the bank and is computed based on the maturity value of the note for the discount period. ***Discount Period*** is the time the bank must hold the note) before it becomes due.

- Bank Discount = MV X DR X DP where MV = Maturity value (20,600)

  DR = Discount Rate (15%)

DISCOUNT = 20,600 X 15% X 48/360 DP = DISCOUNT PERIOD (FROM FEBRUARY 12 TO APRIL 1)

= <u>412</u>

Step 3- Determine proceed (proceed is the amount of cash paid to the endorser after deducting discount)

i.e. proceed = MV – D

= 20,600 – 412 = 20188

Step 4 – Record the necessary journal entry at the date of discount. (Here, record interest revenue which is the excess of proceeds from the face value or record interest expense when the proceed is less than the face value of the note)

Feb 12.	Cash	20,188
	N/R	20,000
	Interest Receivable	188.00

Discounted Br. 20,000, 90-day, 12% note at 15%

The length of the discount period and the difference between the interest rate and the discount rate determine whether interest expense or interest revenue will result from discounting.

When a discounted Notes Receivable is dishonored, the bank notifies the endorser and asks for payment if there is no statement that limits the responsibility of the endorser. In some cases, the bank may charge a protest fee of notifying the endorser that a note has been dishonored. The entire amount paid to the bank by the endorser, including the interest and protest fee, should be debited to the A/R of the maker. For example, assume that the maker, Hiwot Co, dishonored the above discounted note at maturity. The bank charges a protest fee of Br. 25. The endorser's entry to record the payment to the bank is as follows:

April 2.	A/R Hiwot Co	20,625
	Cash	20, 625

Paid dishonored, discounted note

Activity

Question 1: ABC Co. issued a 60-day, 12% note for Br. 40,000, dated February-12, to XYZ Company an account.

a) Determine the due date of the note
b) Determine the maturity value of the note
c) Present entries required to record the following
    - Receipt of the note by the payee.
    - Receipt by payee of payment of the note at maturity.

Question 2. Record the following transaction in the account of ABC Company

May-1. Received a Br. 15,000, 60-day, 12% note from XYZ Company on account.

May-21. Discounted the note at Dessie Bank at 14%

June-30. The note is dishonored, paid the bank the amount due on the note plus a protest fee of Br. 30.

July-20. Received the amount due on the dishonored note plus interest for 20-days, at 12% on the amount charged XYZ Company on April-30.

6.14. Accounting for uncollectible Accounts Receivable

When credit is extended, some amount of uncollectible receivables is generally inevitable regardless of the care taken in granting credit and the control procedures used. The operating expense incurred because of the failure to collect receivables is called Uncollectible Accounts Expense or Bad Debts Expense or Doubtful Accounts Expense.

When does an account as a note become uncollectibles? There is no general rule for determining when an account receivable becomes uncollectible. The fact that a debtor fails to pay an account receivable according to a sales contract or fails to pay a note on the due date does not necessarily mean that the account receivable will be uncollectible. The debtor's bankruptcy is one of the most significant indications of partial or complete uncollectibility. Other indications include the closing of the customer's business and the failure of repeated attempts to collect.

There are two methods of accounting for uncollectible receivables. The allowance method, which provides an expense for uncollectible receivables in advance of their write-off (removal from the ledger) and the direct write-off method, which recognizes the expense only when accounts receivable is judged to be worthless. We will discuss each of these methods next.

6.14.1. Allowance Method

The allowance method of accounting for bad debts matches the expected loss from uncollectibles A/R against the sales they helped produce. We must use expected losses since management cannot exactly identify the customers who won't pay their bills at the time of sale. This means at the end of each period the allowance method requires us to estimate the total bad debts expected to result from that period's sales. An allowance is then recorded for this expected loss. This method has two advantages over the direct write-off method:

(1) Bad debt expense is charged to the period in which the related sales are recognized, and
(2) A/R is reported on the Balance Sheet at the estimated amount of cash to be collected.

The allowance method estimates bad debt expense at the end of each accounting period and records it through an adjusting entry. To illustrate this method, assume the A/R account has a balance of Br. 50,000 and based on careful study of the experience of other companies, Nile Co. estimates that a total of Br. 2000 will be uncollectibles.

This estimated expense is recorded through the following adjusting entry.

Dec. 31	Uncollectibles Accounts Expense	2000	
	Allowance for Doubtful Accounts		2000
	To record estimated bad debts		

The amount Br. 2000 is an estimated reduction in A/R; but it cannot be credited to specific customer accounts or to the A/R controlling account. Instead, a contra asset account entitled Allowance for Doubtful Accounts is credited.

As with all periodic adjustments the above entry serves two purposes. First, it reduces the value of the receivable to the amount of cash expected to be realized in the future. This amount, which is Br. 48,000 (Br. 50,000 – Br. 2,000), is called the Net Realizable value of the receivables.

Second, the adjusting entry matches the Br. 2000 expense of uncollectibles account with the related revenues of the period.

6.14.2. Write-off to the Allowance Account

When specific accounts are identified as uncollectibles, they are written-off against the Allowance for Doubtful Accounts. Assume after spending some time trying to collect from Shalla Co., Nile Co. decides that Shalla's Br. 200 accounts receivable is uncollectible and makes the following entry to writ-it off.

Jan. 25	Allowance for Doubtful Accounts	200	
	A/R-Shalla Co.		200
	To write-off uncollectible accounts.		

Note two aspects of this entry and its related accounts

	Before Write-off	After Write-off
A/R	50,000	49,800
Less Allowance for D. a/cs	2,000	1,800
Net Realizable Value	48,000	48,000

Neither total assets nor net income are affected by the Write-off of a specific account. But both total assets and net income are affected by the recognized bad debts expense for the year in the adjusting entry.

6.14.3. Recovery of Uncollectibles Accounts

When a customer fails to pay and the account is written-off as uncollectibles, his or her credit standing is jeopardized. To help restore credit standing, a customer may later choose to voluntarily pay all or part of the amount owed. A company makes two entries when collecting an account previously written-off. The first is to reverse the original write-off and reinstate the customer's account.

For example, assume the amount written-of in the preceding entry is later collected on February 15.

On Feb. 15- The entries to record this recovery are:

Feb. 15- A/R Shalla Co. 200

Allowance for Doubtful Accounts 200

To reinstate accounts previously written-off

Feb. 15- Cash 200

A/R-Shalla Co. 200

To record full payment of account

6.14.4. Estimating Uncollectibles

The allowance method of accounting for bad debts requires an estimate of bad debts expense to prepare the adjusting entry at the end of each accounting period. How does a company estimate bad debts expense? There are two common methods. One is based on the Income Statement relationship between bad debts expense and sales. The second is based on the Balance Sheet relationship between A/R and the Allowance for Doubtful Accounts. Both methods require an analysis of past experience.

a. Estimating Based on Sales

Accounts receivable are created by credit sales. The amount of credits sales during the period may therefore be used to estimate the amount of uncollectible accounts expense. The amount of this estimate is added to whatever balance exists in Allowance for Doubtful Accounts. To illustrate, assume Wonji Co. has credit sales of Br. 500,000 in 2016. Based on past experience and the experience of other Cos, Wonji Co. estimated 0.007% of credit sales are uncollectible. Using this prediction, the adjusting entry for uncollectible accounts at the end of the period, 2016 is as follows.

Dec. 31 Uncollectibles Accounts Exp. (500,000 X 0.007%) 3500

Allowance for Doubtful Accounts 3500

To record estimated Uncoll. Exp.

This entry doesn't mean that the Dec. 31, 2016, balance of Allowance for Doubtful Accounts will be Br. 3500. A Br. 3500 balance results only if the account had a zero balance prior to

posting the adjusting entry. For example, assume that Allowance for Doubtful Accounts has a credit balance of Br. 1000 before adjustment. Now, what will be the balance of Allowance for Doubtful Accounts be at the end of 2016? It will be Br. 4500. If there had been a debit balance of Br. 500 in the Allowance for Doubtful Accounts before the year-end adjustment, and the amount of adjustment. would still have been Br. 3500. What will have been the end balance of Allowance for Doubtful Accounts at the end of 2016?

b. Estimate Based on Analysis of Receivables

The longer an A/R remains outstanding, the less likely that it will be collected. Thus, we can base the estimate of uncollectibles accounts on how long the accounts have been outstanding. For this purpose, we can use a process called Ageing receivables which examines each A/R to estimate the amount of uncollectibles. Receivables are classified by how long they are past their due date. Then, estimates of uncollectibles are made assuming the longer an amount is past due the more likely it is to be uncollectible. After the outstanding amounts are classified and analyzed in the Aging schedule the expected balance for the Allowance for Doubtful Accounts will be estimated. Let's assume the amount estimated is Br. 5000. So, do you think this is the adjustment amount required for the current period? NO!

Because, this estimated amount is the expected balance of the Allowance for Doubtful Accounts after adjustment rather than the current year provision for Uncollectible Accounts Expense. Therefore, to determine the current year provision we must take in to account the balance before adjustment in the Allowance for Doubtful Accounts. To illustrate, assume there is as credit Balance of Br. 1300 in the allowance account before adjustment. The amount to be added to this balance is therefore Br. 3800 (B.r 5000 – Br. 1200) and the adjustment entry is as follows:

Dec. 31	Uncollectible Accounts Expense	3800	
	Allowance for Doubtful Accounts		3800
	To record Uncollectible expense.		

Alternatively, if the Allowance for Doubtful Accounts had an unadjusted debit balance of Br. 700, then the required adjustment is Br. 5700. (Br. 5000 + 700) and the adjustment entry is as follows:

Dec. 31. Uncollectible Accounts Expense.....5700

Allowance for Doubtful Accounts.....5700

To record Uncollectible expense.

6.14.5. The Direct- Write-Off Method

The Direct Write-off method of accounting for bad debts records the loss from an uncollectible A/R at the time it is determined to be uncollectible. No attempt is made to predict uncollectible accounts expense. Bad debt expense is recorded when specific accounts are determined to be worthless. If Wonji Co. uses a direct write-off method and determines on Feb. 20, it can't collect from a customer- Home Co.- Br. 500. The entry to write-off the customer's account is as follows

Feb. 20 Uncollectible Accounts Expense..... 500

A/R- Home Co.....500

To write-off Uncollectible accounts

Sometimes an amount previously written off is later collected. This can be due to factors such as continual collection efforts or the good fortune of a customer. If the account of Home Co. that was written-off directly to Bad Debit Expense is later collected in full, the following two entries record this recovery.

Mar. 5 - A/R- Home Co..... 500

Uncollectible Accounts Expense..... 500

To reinstate account

Mar. 5 - Cash..... 500

A/R- Home Co..... 500

To record full payment of account

If the recovery is in the year following the writ- off, there is no balance in the Uncollectible Accounts Expense account related to the previous year's write-off and no other write-offs are expected. So the credit portion of the entry recording the recovery can be made to a Bad Debts Recoveries revenue account.

To conclude this part companies must weigh at least two principles when considering use of the direct write-off method: (1) Matching principle and (2) Materiality principle.

Activity

Question 1: Record the following transactions in the accounts of ABC Company, which uses the allowance method of accounting for uncollectibles receivables.

Sep. 5- Sold merchandise on account to XYZ Company Br. 5000

Oct. 20- Received Br. 3000 from, XYZ Company and Writes-off the remainder owed on the sale of September 5 as uncollectibles.

Dec. 10- reinstated the account of XYZ Company that had been written-off on October-20 and received Br. 2000 cash in full payment.

6.15. Summary

1. Cash includes only those items immediately available to pay obligations.
2. The objectives of cash management are accurate accounting for cash transactions, the prevention of losses through theft or fraud, and maintaining adequate cash balances.
3. The bank reconciliation adjusts the cash balance per book and the cash balance per bank statement for any unrecorded items such as outstanding checks and bank service charges.
4. Bank reconciliation produces the correct amount of cash to be included in the balance sheet at the end of the month.
5. A company may use a petty cash fund to make small payments that occur frequently, as payment by check would cause delay and excessive expense of maintaining records.
6. One of the best systems for establishing control of cash payments is the use of a voucher system.
7. Receivables are money claims against other entities, including people, business firms and other organizations. These receivables as other assets of the business organization need to be properly handled otherwise they might be exposed for different type of error and fraud.
8. Based on the nature of the account, there are different accounting treatments required for recording transactions made on credit and for the related risk of uncollectibles that arise when customers default to make payment according to their agreement. The common methods used to treat uncollectibles accounts in the book of the payee are the allowance method and the direct-write-off method.
9. If a company selects the allowance method to treat uncollectibles, estimation is required either based on sales or analysis of receivables.

6.16. Self-Examination Questions

Short answer questions

1. In general terms, in which section does cash, appear on the balance sheet?
2. Explain some measures that strengthen internal control over cash receipts and payments.
3. What is the basic control feature in a voucher system?
4. List two items often encountered in reconciling a bank account that may cause cash per the bank statement to be larger than the balance of cash shown in the depositor's accounting records.

Work Out Questions

1. Shown below is the information needed to prepare a bank reconciliatiofor MITE company at December 31.
    a) At December 31, cash per the bank statement was $ 15,981; cash per the company's records was $ 17,445.
    b) Two-debit memorandum accompanied the bank statement: service charges for December of $ 24, and a $ 600 check drawn by RAMI marked 'NSF'.
    c) Cash receipts of $ 4,353 on December 31 were not deposited until January.
    d) The following checks had been issued in December but were not included among the paid checks returned by the bank: no. 620 for $ 978, no. 630 for $ 2,052, and no. 641 for $ 483.

Required:

i) Prepare a bank reconciliation at December 31

ii) Prepare the necessary journal entry or entries to update the accounting records based on the reconciliation.

2. JORJO Company maintains its checking account with the Commercial Bank. The company is ready to prepare its December 31 bank reconciliation. The following data are available:

a) The November 30 bank reconciliation showed the following:

1) Cash on hand (held by JORJO company for day to day minor expenses), Br. 400 (included in JORJO's cash account)
2) Deposit in transit, Br. 2,000, and
3) Checks outstanding: N0. 121 Br. 1,000
   No. 130 2,000
   No. 142 3,000

b) Bank Statement, December 31:

• Balance, December 31		Br. 67,600
• Deposits:	188,500	
• Checks: No. 130, Br. 2,000; N0. 142, Br. 3,000; N0. 143 – 176, Br. 191,000		(196,000)
• Note collected for JORJO company (including Br. 720 interest)		16,720
• NSF check, customer Binda		(250)
• Bank service charges		(20)
• Balance, December 31		Br. 76,550

Required:

i. Determine deposit in transit and checks outstanding
ii. Prepare the December 31 Bank reconciliation
iii. Based on your bank reconciliation, give all journal entries that should be made at December 31.

3. Prepare journal entries to record the following transactions entered in to by MN Company during the year 2016.

September 1- Received a Br. 10,000, 12%, 60-day note from KK Co. as full settlement of his open account.

October 20- Sold merchandise on account to GY Co. for B.r 25,000 by receiving a 90-day, 10% note.

October 31- Received full payment from KK Co. for notes received on September 1.

December 31- Record the adjusting entry required for accrued interest from October 20. Transaction. (assume that the Accounting period ends on December 31.)

4. Nazareth cosmetics Co. is undecided about which base to use in estimating uncollectibles accounts. On December 31, 20X2, the balance in Account Receivable was Br. 800,000 and net credit sales amounted to Br. 1,500,000 during 20X2. An aging analysis of the account receivable indicated that Br. 12,000 in accounts receivable are expected to be uncollectible. Past experience has shown that about ½ of 1% of net credit sales eventually are uncollectibles.

Prepare the adjusting entries to record estimated bad debt expense using the

(1) Percentage of sales basis, and

(2) The percentage of receivable basis under each of the following independent assumptions

a) Allowance for Doubtful Accounts has a credit balance of Br. 2000 before adjustment.

b) Allowance for Doubtful Account has a debit balance of Br. 600 before adjustment

5. The FM Company uses the allowance method for estimating uncollectibles accounts. Prepare journal entries to record the following transactions.

January 02- Sold merchandise to Nile Co. for Br. 30,000, term n/15.

February 15- Received Br. 20,000 from Nile Co. on account.

April 20- Written-off as uncollectible the remaining balance of Nile Co. account when the business declared bankruptcy.

June 1- unexpectedly received a check for Br. 6000 from Nile Co.

6.17. Glossary of Terms

Account Receivable: - A claim against a customer for services rendered or goods sold on credit.

Aging the receivable: - The process of analyzing the account receivable and classifying them according to various age groupings, with the due date being the base point for determine age.

Allowance method: - A method of accounting for uncollectible receivables, whereby advance provision for the uncollectibles is made.

Bank reconciliation: a schedule that explains the difference between the balance of cash shown in the bank statement and the balance of cash shown in the depositor's records.

Cash management: planning, controlling, and accounting for cash transactions and cash balances.

Cash: money on deposit in banks and other items that a bank will accept for immediate deposit.

Current asset: - Cash or other assets that are expected to be converted to cash or sold or used up, usually within a year or less, through the normal operations of business.

Direct write-off method: - A method of accounting for uncollectibles receivables, whereby an expense is recognized only when specific accounts are judged to be uncollectible.

Dishonored note receivable: - A note that the maker fails to pay on its due date.

Notes Receivable: - A written promise to pay by the maker, representing an amount to be received by the payee.

Petty cash: small amount of cash, which is used to make small payments that occur frequently.

Uncollectibles accounts Expense: - The operating expense incurred because of the failure to collect receivables.

Voucher system: an accounting system designed to provide strong internal control over cash disbursements.

Voucher: a written authorization used in approving a transaction for recording and payment.

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