UNITYUNIVERSITY

College of Business, Economics & Social Sciences
Department of Accounting & Finance

Module for:
Fundamentals of Accounting I

Pre- Requisite: None

Course Title: Fundamentals of Accounting I

Course Number: ACFN_____

Dear students well come to unity university. This is your first accounting course. The course deals with the meaning of business, importance of accounting for business, the relevance and types of standards used in the accounting profession, the accounting system and its application in capturing business events for a merchandising and service giving enterprises, and accounting for cash and receivable.

Let me tell you a secret, to be successful in accounting courses the short cut is to understand this course well. If you are truly determined to do so be sure you are laying a strong base to easily understand the subsequent advanced courses. To be successful in this course give special attention and more effort for the first two chapters. Thechapter opens a door for you to clears with the fundamental concept of accounting and its application.

Course Objectives

The course has the general objective of introducing students to the basics of accounting and reporting of financial activities of business organizations as per International Financial Reporting Standards. 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

Grading

- Attendance 5%
- Assignment(Individual and Group).....15%
- Test 25%
- Final Exam 50%
- Total..... 100%

Text Books

- J. Weygandt, D. Kemmel and D. Kieso,(2012), ***Accounting Principles:*** 10th Edition, John Wiley and Sons, inc. (ISBN 13 978-0-470-53479-3.
- Kieso, D. E., Weygandt, J. J., & Warfield, T. W. (2016). Financial Accounting, IFRS Edition, New York: John Willey & Sons.

Additional Materials for Reading

- S. Warren, M.Reeve and E. Duchac (2009), ***Accounting***: 23th Edition, South-Western Cengage Learning, ISBN 13: 978-0-324-66296-2.
- Principles of Accounting I for distance education
- Commercial code of Ethiopia
- Any Accounting books published as per IFRS

Individual assignments

Instructions: - Record business transactions for:

i. A service business
ii. A Merchandising business

Specific Activity

- Prepare charts of account for your business
- prepare a three column general ledger account and open each account by writing the name and number of the account on the first line of the ledger card.(record opening balances if you have any)
- Write your one month events (Transactions) on a paper and journalize them chronologically.
- Post each journal entry to the appropriate account in your ledger
- Prepare trial balance at the end of the month

Team Assignment

- Instructions

  Complete the accounting cycles for a services giving and a merchandising business.

  Due date (12^{th} week) and (6^{th} week for summer)

Specific activity

- Complete the 10 column work sheet.
- Journalize and post the adjusting and closing entry.
- Prepare the basic four financial statements on the last day of your monthly fiscal
- Prepare a post closing trial balance on the first day of the following fiscal period

CHAPTER ONE

INTRODUCTION TO ACCOUNTING AND BUSINESS

Overview of Chapter 1

The future story highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information.

The purpose of this chapter is to show you that accounting is the system used to provide useful financial information. The core objectives and content of Chapter 1 are as follows.

1.0. Learning Objectives:

After completing this chapter the students should be able to:

- Understand the meaning of accounting
- Explain the main difference between bookkeeping and accounting
- Explain the nature and classification of business
- Identify the users and uses of accounting.
- Identify fields of accounting
- Understand the accounting profession
- Explain accounting standards and the measurement principles.
- Explain the monetary unit assumption and the economic entity assumption
- Analyze the effects of business transactions on the accounting equation.
- Understand about the four financial statements and how they are prepared.

Session 1(Hr 1and2)

Topic:- Nature Accounting and of Businesses

Session learning objective:

After completing this lesson you should be able to:

- Understand the meaning of accounting
- explain the main difference between bookkeeping and accounting
- Explain the nature and classification of business

1.1. Definition of Accounting

Thus, **accounting** can be defined as an information system that **provides reports to users** about the **economic activities** and condition of **a business**. Accounting is a "language of business," through it businessescommunicated with information users.

1.1.1. Activities of Accounting

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

The first activity in the accounting process is identification of the **economic events relevant to a particular business**. Purchase of school bus by Unity University, the provision of telephone services by Ethio Telecom and Sale of food and beverages by Sheraton Hotel are examples of business events.

Once identified, the economic events are recorded. Recording consists of keeping a **systematic**, **chronological diary of events**, measured in monetary units. In recording, economic events are also classified and summarized. **(That will be discussed in chapter 2 of this module)**

Finally, the identified and recorded data are prepared in a standardized way and **communicated** to the interested users by means of **accounting reports** called **financial statements**. The statements accumulate and aggregates information resulting from similar transactions as one amount.By so doing the accounting process simplifies a multitude of

transactions and makes a series of activities understandable and meaningful.

Communicating economic events to users also requires the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses**, **meaning**, **and limitations of reported data**.

Dear students, at this point, the explanations about financial statements seem confusing and complex. But by the end of this course, you'll be able to easily understand, analyze, and interpret them.

1.2. Overview of Business Organization and Accounting

1.2.1. Meaning of business in the Accounting Context

A business is an organization which is engaged in **converting basic resources** (inputs), such as raw materials, labor (Physical and Mental effort of employees) into **goods** (cloths, tables, computers and Automobiles) and **services** (transportation, banking, Education and health care services) for **sale on profit** to customers. Businesses come in all sizes, that ranges from a small local commodity shop like Kedir Shop to big multinational businesses like Pepsi cola which sales its products throughout the world.

The objective of businesses is to earn profit. Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the in-puts used to provide the goods or services. In this module, we focus on businesses operating to earn a profit. However there are also not-for- profit organizations such as hospitals, churches, and government agencies which, convert inputs into goods and service for free delivery or at cost recovery to the society without profit intention. These organizations will be fully addressed in your advanced course known "**Accounting for Governments and NFP organization**".

For accounting purposes, each business organization or **entity** has an existence separate from its owner(s), creditors, employees, customers, and

other businesses. This separate existence of the business organization is known as the **business entity concept**. Thus, in the accounting records of the business entity, the activities of each business should be kept separate from the activities of other businesses and from the personal financial activities of the owner(s).

1.2.2. Forms and Types of Business Organizations in Ethiopia

There are three forms of business organizations: **single-proprietorships, partnerships, and corporations** as briefly explained below:

There are three different legal forms of business organization: those are

1. **Sole Proprietorship**: -is a business owned and managed by single individual.

Advantages:

- Easy to establish the business
- Requires relatively small starting capital
- It is least regulated by government
- relatively long life
- No profit sharing

Disadvantages:

- Limited capital to finance business operation
- Unlimited liability the owner is responsible to pay the debt of the business even from his personal asset in case the business unable to meet its liability)

2. **Partnership:** - is business organization established by two or more persons.

Advantages:

- Easier and less expensive to establish than corporation
- Are not highly regulated by government
- More capital and managerial skill than a single proprietor ship
- Mutual Agency, sharing of responsibility and representing the business

Disadvantages:

- Limited life
- Unlimited liability (the partners are responsible to pay the debt of the business even from their personal assets in case the business unable to meet its liability)
- Conflict between partners throughout operating the business.
- Relatively short life, can be dissolved because of partners disagreement

3. **Corporation:** - is a business organized as a separate legal entity under state corporation law with ownership divided into transferable shares of stock.

Advantages:

- Long life
- Limited liability
- Can raise huge amount of capital to finance business operation

Disadvantages:

- Double taxation
- Highly regulated by government
- Difficulty of controlling management, because ownership and management is divorced in corporation.

According to **their type of activities or nature of operations**, business organizations are also classified in to three main types:

1. **Service Rendering/giving Businesses**: - are business organizations that are predominantly engaged in rendering of services to customers for the purpose of maximizing profit.

   Examples: Hotels, restaurants, cafeterias, bars, transport and communication services, professional firms like consultations by accountants, lawyers, engineers etc.
2. **Merchandising businesses**: - is profit seeking businesses, which are engaged in purchasing and reselling of merchandises.

   Examples:Super-markets, boutiques, garment and shoe shops, drug stores, stationary shops, auto spare parts, importers, exporters etc.
3. **Manufacturing businesses**: - are business organizations that are primarily involved in the conversion of raw materials and parts in to finished goods; and sale their finished goods to merchandising enterprises and consumers. Sometimes, they sale goods to other manufacturing firms, which utilize the goods as raw materials for production activities. **Examples**: Cement factories, sugar factories, soap factories, textile factories, paper factories, etc.

1.3. The Role of Accounting for Business

Accounting is often called "**the language of business**." Because it ***communicates*** so much of the information that **owners, managers, and investors** need to evaluate a company's financial performance. These people are all stakeholders in the business—they're interested in its activities because they are affected by the business. In fact, the **purpose** of accounting is to **help stakeholders** make better business **decisions** by providing them with financial information. Obviously, no one tries to run an organization or make investment decisions without having accurate and timely financial information. It is the accountant who prepares this information.

More importantly, accountants make sure that stakeholders understand the **meaning**of financial information, and they work with both individuals and organizations to help them use financial information to deal with business problems.

Actually, collecting all the numbers is the easy part—today, all the accountant have to do is start up your accounting software. The **hard part** is analyzing, interpreting, and communicating the information. Now a day's, **accountants are required**, to present everything clearly and effectively in a way that has a **predictive role** to potential investors and decision makers from every business discipline.

In any case, accounting is defined as the process of **measuring and summarizing** business activities, **interpreting** financial information, and **communicating** the results to management and other decision makers.

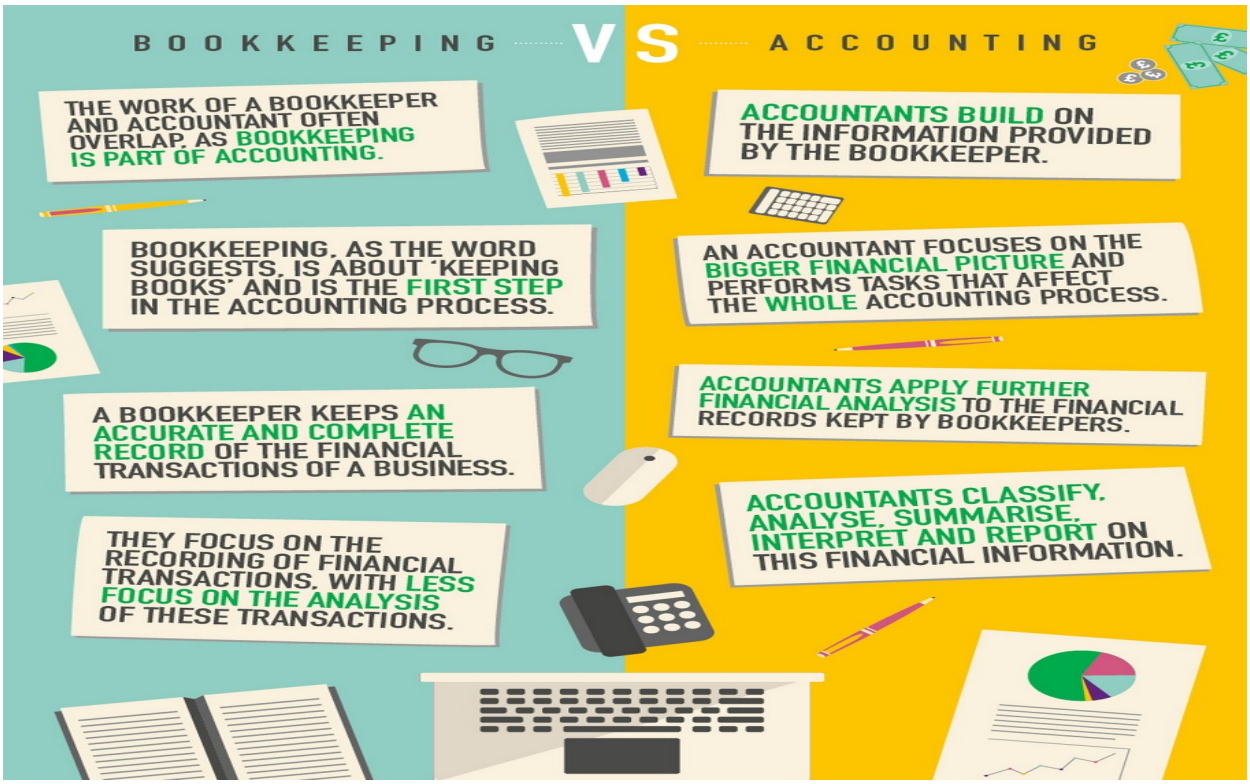
1.4. Book Keeping Vs Accounting

Accounting and Book keeping is to closely related activities. Both involves in recording business transactions. Record keeping is the only task to bookkeepers, but one of the tasks to accountants.Unlike bookkeeping the accounting process involves in a more detailed and advanced professional activities, of designing the information system, analyzing and interpreting the information of accounting. More over few days recording experience is enough for being book keeper but being an accountant requires several years in-depth study and working experience.

In general, Bookkeeping refers to the art of recording, in a prescribed and systematic way, the economic activities of an organization. It is routine and clerical in nature. Accounting, on the other hand, goes beyond bookkeeping and is concerned with

- ***Designing*** accounting and reporting systems
- ***Recording*** economic activities
- ***Preparing*** reports and statements

- ***Interpreting*** reported information and
- ***Reviewing*** records and reports for their accuracy.



Synopsis of Lecture

- Accounting are identifying, recording, and communicating economic activities.
- Bookkeeping refers to the art of recording.
- Accounting refers to the art of recording, reporting, and interpreting economic events.
- Accounting is a language of business.
- A business is an organization which is engaged in rendering service or producing a product for profit motive.
- Businesses can be categorized on the bases of ownership and activity.
- Based on ownership business are categorized into sole proprietorship, partnership and corporation.

- Based on activity Businesses are categorized into service giving, Merchandising and manufacturing.
- A business is an organization which is engaged in rendering service or producing a product for profit motive
- Businesses can be categorized on the bases of ownership and activity.
- Based on types of ownership business are categorized in to sole proprietorship, partnership and corporation.
- Accounting is a language of business.
- Accounting are identifying, recording, and communicating economic activities.
- Bookkeeping refers to the art of recording where as Accounting refers to the art of recording, reporting, and interpreting economic events.

Wrap-up discussion questions

- Distinguish between service and merchandising business
- Distinguish between bookkeeping and accounting company
- Explain accounting and its basic activity.
- Distinguish between service and merchandising business
- Distinguish between bookkeeping and accounting company
- Explain accounting and its basic activity

Next day's Assignment

Read about fields of accounting

Session 2 (Hr 3 and 4)

Topic:- Fields of Accounting

Secession learning objective

- Identify fields of accounting
- Identify the users and uses of accounting.

- Understand the accounting profession

Reading Text:

1.5. Fields of Accounting

Accountants typically work in one of the two major fields, namely**Management accountants** and **financial accountants. These basic categories farther decomposed in to various fields which are maintained under the title "the Accounting Profession" below.**

Managerial Accounting

Managerial accounting plays a key role in **helping managers** carry out their responsibilities. Because the information that it provides is intended for use by people who perform a wide variety of jobs, the format for reporting information is flexible. Since the reports are intended to **internal users** they are **not obliged** to follow a uniform set of accounting standards and are **tailored** to the **needs** of individual managers. The **purpose** of such reports is to supply **relevant, accurate, timely information** in a format that will aid managers in making decisions. In preparing, analyzing, and communicating such information, accountants work with individuals from all the**functional areas** of the organization—human resources, operations, marketing, and finance.

Financial Accounting

Financial accounting is responsible for preparing the organization's financial statements. Namely**income statement**, the **statement of owner's equity**, **the statements of financial position,** and **the statement of cash flow.** The statements summarizes a company's past performance and evaluates its current financial condition. The **purpose** of the report is to give **reliable, relevant** and **up-to-date** information which

serves to all **external users**. In preparing financial statements, **adherence to** uniform set of accounting standards is **mandatory**. The statements are **general purpose**in nature and are not address the specific requirements of individual users. I.e one type of income statement is prepared to serve different users like investors, banks, government etc.

1.6. The Profession of Accounting

Why is accounting such a popular major and career choice? First, there are a lot of jobs. In recent years, in our country Ethiopia, the demand for accountants highly increased because of the increase in number of various businesses, the introduction of different tax laws like VAT, the change in accounting standard- IFRS, the emergence of different multinational organization and the related reporting requirements, etc.

Accounting is also hot because it is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the turmoil over toxic (misstated) assets at many financial institutions. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society. Finally, recent internal control requirements dramatically increased demand for professionals with accounting training.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients.

A major portion of public accounting involves **auditing**. In auditing, an independent accountant, such as a chartered accountant (CA) or a

certified public accountant (CPA), examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position. Analysts, investors, and creditors rely heavily on these "audit opinions," which CAs and CPAs have the exclusive authority to issue.

- **Taxation** is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies.
- A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to providing support services for major marketing projects and merger and acquisition activities.

Many accountants are entrepreneurs. They form small- or medium-sized practices that frequently specialize in tax or consulting services.

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as Unity University or Commercial Bank of Ethiopia (CBE). In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, and tax planning and preparation. You might also be a member of your company's internal audit team. In response to corporate failures, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

Alternatively, many accountants work for not-for-profit organizations, such as the Mekodoniaya Merja, International Red Cross or performing arts organizations.

Governmental Accounting

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, tax authorities, law enforcement agencies, and corporate regulators all employ accountants. There is also a very high demand for accounting educators at colleges and universities and in governments.

Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future. The job of forensic accountants is to catch the perpetrators of theft and fraud occurring at companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.

1.7. Users of Accounting Information

Users of financial information are categorized in to two, i.e., internal **users** and **external users**.

1.7.1. Internal Users

Internal users of accounting information are **managers** who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. Financial information show, for example, whether the company did or didn't make a profit, whether cash is adequate to make pay dividend, whether the company affords pay raise to employee, etc. They also furnish other information that managers and owners can use in order to take corrective action.

1.7.2. External Users

External users are individuals and organizations **outside** a company who are **not directly** involved in running and organizing the business want financial information about the company for their own purpose. External users include investors, creditors, government agencies and others

Investors and Creditor

Investors and creditor are the two most common types of external users. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company. **Creditors** such as bankers and suppliers use accounting information to evaluate the risks of granting credit or lending money.

If you lend money to a friend to start a business, wouldn't you want to know how the business was doing? Investors and creditors furnish the money that a company needs to operate, and not surprisingly, they feel the same way. Because they know that it's impossible to make smart investment and loan decisions without accurate reports on an organization's financial health, they study financial statements to assess a company's performance and to make decisions about continued investment.

Government Agencies

Businesses are required to furnish financial information to a number of government agencies like taxing authorities and regulatory agencies. T**he authorities** want to know whether the company complies with tax laws. **Regulatory agencies** want to know whether the company is operating within prescribed rules.

Other Users

A number of other external users have an interest in a company's financial statements. **Customers** are interested in whether a company will continue to honor product warranties and support its product lines. **Labor unions** want to know whether the companies have the ability to pay increased wages and benefits to union members.

NB: **In general the information needs of internal users are supplied by both Financial and Managerial accounting. Whereas the information needs of external users are satisfied only by financial accounting**.

Synopsis of Lecture

- Accounting generates information that brings a difference on the decision making of both internal and external users.
- Internal Users are individuals within an organization or business entity that need accounting information of the business for the affairs of the business.
- External Users are those individual or institutions inside or outside an economic entity who/which need accounting information about that entity for their own affair.
- In dealing with a business accounting plays an important role in displaying operating results of businesses, in analyzing and rating financial conditions, and in predicting their futurity.

- Managerial accounting generates information for internal users where as financial accounting generates information mainly for external users.
- The four basic category of the accounting profession are, public accounting, private accounting, governmental accounting and forensic accounting.

Wrap-up discussion question

- Why is the profession of accounting required?
- Explain the users of accounting information.
- Which of the above fields of the accounting profession of study attracts you? Why?
- What are the factors that increase the demand for accountants?

Next day's assignment

Read about accounting standards

Session 3 (Hr 5 and 6)

Topic: The Accounting principles, standards, and Assumptions

Secession Learning Objectives:

- Explain accounting principles and standards
- Explain various assumptions and concepts of accounting

1.8. Accounting Principles and an Overview of International Financial Reporting Standard

Accounting is often called the language of business through which a business house communicates with the outside world. In order to make this language intelligible and commonly understood by all, it is necessary that it

should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

1.8.1. Accounting Principles

Accounting principles have been defined as “the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exist”.

In short, accounting principles are guidelines to establish standards for sound accounting practices and procedures in reporting the financial status and periodic performance of a business. These principles can be classified into two categories (i) Accounting conventions; and (ii) Accounting concepts (assumptions).

Accounting Conventions: The term ‘convention’ denotes custom or tradition or practice based on general agreement between the accounting bodies which guide the accountant while preparing the financial statements. It is a guide to the selection or application of a procedure.

Accounting concepts are defined as basic assumptions on the basis of which financial statements of a business entity are prepared. They are used as a foundation for formulating various methods and procedures for recording and presenting the business transactions. In this unit, we will discuss some of these universally accepted principles: Business Entity concept, Monetary Unit Assumption, Periodicity assumption, and the going concern assumption are covered under the headings of basic assumptions and Measurement principles, Revenue recognition principle, Expense recognition and full disclosures are discussed under the heading of basic principles.

Basic Assumptions/Concepts are the following:

a) Business Entity Concept (Separate Entity concept)

According to this concept, business is treated as an entity separate from its owners. It is treated to have a distinct accounting entity which controls the resources of the concern and is accountable thereof. Accounts are kept for a business entity as distinguished from the person(s) owning it. All transactions of the business are recorded in the books of the business from the point of view of the business.

Transactions are also recorded between the owner and the business, for instance, when capital is provided by the owner, the accounting record will show the business as having received so much money and as owing to the proprietor. This concept is based on the sense that proprietors entrust resources to the management and the management is expected to use these resources to the best advantage of the firm and to account for the resources placed at its disposal. Hence, in accounting for every type of business organization, be it Sole-proprietorship or partnership or Corporation, business is treated as a separate accounting entity.

The failure to recognize the business as a separate accounting entity would make it extremely difficult to evaluate the performance of the business since the private transactions would get mixed with business transaction. The overall effect of adopting this concept is:

- Only the business transactions are recorded and reported and not the personal transactions of the owners.
- Income or profit is the property of the business unless distributed among the owners.
- The personal assets of the owners or shareholders are not considered while recording and reporting the assets of the business entity.

b. Monetary Unit Assumption (Money Measurement concept)

It states that all business activities (events) are recorded in terms of money (-Birr, Dollar, Pound or any other currency). **Money measurement concept** holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms. Thus, only such transactions and events which can be interpreted in terms of money are recorded. Events which cannot be expressed in money terms do not find place in the books of account though they may be very important for the business. Non-monetary events like, death, dispute, sentiments, efficiency etc. are not recorded in the books, even though these may have a great effect. Accounting therefore, does not give a complete account of the happenings in a business or an accurate picture of the conditions of the business. Thus, accountinginformation is essentially in monetary terms and quantified. The system of accounting treats all units of money as the same irrespective of their time dimension. This has created doubts about the utility of the accounting data, leading to the introduction of inflation accounting.

C. Going Concern Assumption

Most accounting methods rely on the **going concern assumption—that the company will have a long life**. Despite numerous business failures, most companies have a fairlyhigh continuance rate. As a rule, we expect companies to last long enough to fulfill theirobjectives and commitments.

d. Periodicity Assumption

To measure the results of a company's activity accurately, we would need to wait until it liquidates. Decision-makers, however, cannot wait that long for such information. Users need to know a company's performance and economic status on a timely basis so that they can evaluate and compare companies, and take appropriate actions. Therefore, companies must report information periodically. The **periodicity** (or **time period**) **assumption**implies that a company can divide its economic activities into

artificial time periods. These time periods vary, but the most common are monthly, quarterly, and yearly

Basic Principles: the following are also the basic principles

There are four basic **principles of accounting**to record and report transactions: **(1) measurement, (2) revenue recognition, (3) expense recognition, and (4) full disclosure**. We look at each in turn.

1. Measurement Principles

The most commonly used measurements are based on historical cost and fair value. Selection of which principle to follow generally reflects a trade-off between relevance and faithful representation.

- ***Historical Cost.*** IFRS requires that companies account for and report many assets and liabilities on the basis of acquisition price. This is often referred to as the **historical cost principle**. Cost has an important advantage over other valuations: **It is generallythought to be a faithful representation of the amount paid for a given item.**

  For example, assume that Alem Business Center purchased land for Br. 500,000, on January 2016 and initially reports it in its accounting records at 500,000. But what does the company do if, by the end of the year, the fair value of the land has increased to 650,000? Under the historical cost principle, it continues to report the land at 500,000. It is a reliable report since it is supported by business document, but it is not relevant for decision making since it does not represent the fact on the land i.e Br. 650,000.
- ***Fair Value.*** **Fair value**is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value is therefore a market-based measure (exit price).Recently, IFRS has

increasingly called for use of fair value measurements in the financial statements. **The IASB believes that fair value information is more relevant to users than historical cost.**

2. Revenue Recognition Principle

Revenue refers to increases in economic benefits during the accounting period in the form of **enhancements of assets or decreases of liabilities** that result in increases in equity, other than those relating to contributions from equity participants. *When the company satisfies the performance obligation, it should recognize revenue.*

3. Expense Recognition Principle

Expenses refers to decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. Expenses should be recognized in the period in which they are incurred.

4. Full Disclosure Principle

In deciding what information to report, companies follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user. Often referred to as the **full disclosure principle**, it recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs.

1.8.2. Overview of International Financial Reporting Standard (IFRS)

Meaning of IFRS

The term 'IFRSs' has both a narrow and a broad meaning. Narrowly, **IFRSs** refers to the new numbered series of pronouncements that the IASB is issuing, as distinct from the International Accounting Standards (IASs) series issued by its predecessor. More broadly, IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB and IASs and Standards Interpretation Committee

(SIC) interpretations approved by the predecessor International Accounting Standards Committee

Definitions

- The **International Financial Reporting Standards,** usually called the IFRS, are standards issued by the IFRS foundation and the International Accounting Standards Board (IASB) to provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
- IFRS are the rules to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external
- IFRS are standards designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries IFRS are the consequences of growing international shareholding and trade and are particularly important for companies that have dealings with in several countries
- Are the rules to be followed by accountants to maintain books of accounts which is
    - Comparable,
    - Understandable
    - Reliable and relevant as per the users (internal and external)
- IFRS is a single set of high quality, understandable and enforceable global accounting standards, which is a “Principle based” set of

standards that are drafted logically and are easy to understand and apply.

Financial reporting can generally classified into two:

- **General purpose financial reporting** is a type of reporting which, aims to provide useful financial information about the reporting entity to primary users **who cannot enforce** the reporting entity to provide information directly to them.
- **Special purpose financial reporting** is a type of reporting that responds to the requirements of users that have the authority to require the reporting entity to provide the information that they need for their purposes directly to them. Examples include:
  - prudential regulation reporting requirements
  - tax reporting requirements

International Financial Reporting Standards (IFRS) are Designed for general purpose financial reporting by profit-oriented entities that might be found to be appropriate for not-for-profit activities too

- Focused on information needs of (primary users) **existing and potential investors, lenders and other creditors who have no authority to require information from the entity**
  - information to enable primary users to make their **own assessments** of the reporting entity's **prospects for future net cash inflows**
  - as a basis for their decisions to **buy, hold, sell** equity and debt instruments or to provide a loan or to require settlement of a loan

1.8.3. Overview of Financial Reporting Requirements in Ethiopia and AABE

Ethiopia announced official adoption of IFRS as established by IASB. Accordingly, the Accounting and Auditing Board of Ethiopia has

established as per the council of ministers regulation no. 332/2014. AABE is an autonomous governing organ to promote high quality reporting of financial and reporting entities and to regulate the accounting and auditing profession of Ethiopia.

Accordingly AABE has required reporting entities in Ethiopia to fully comply with all the requirements of IFRS applicable in their circumstances. For smoothing the process of adoption, AABE has established the following three phase IFRS implementation road map under its four year strategic plan running from the year 2016-2020.

Phase I: Significant Public Interest Entities (PIEs)-primarily financial institutions and federal public enterprises –are required to adopt IFRS standards from calendar year 2017, with reporting under IFRS starting in 2018.

Phase II: Other PIEs-including ECX members–and private companies that meet the PIE thresholds criteria and IPSAS for Charities and Societies are required to report under IFRS by the end of 2019.

If at least two of the following requirement is fulfilled the company satisfied PIE qualitative thresholds and it falls into phase II category:

1. >50 million annual Turnover/ Sales
2. > 100 Employees
3. > 100 million Total Asset
4. > 100 million total liability

Phase III: Small and Medium-Sized Entities (SMEs) are required to follow IFRS for SMEs, a simplified self-contained standard, by the end of 2020.

If at least two of the following requirement is fulfilled the company falls into phase III category:

1. Between 1 million – 50 million annual turnover/ Sales
2. Between 10 – 100 employees
3. Between 2 million - 100 million Total Asset
4. Between 2 million – 100 million Total Liability

1.9. The Basic Accounting Equations

Assets are the resources a business owns. If you noticed, in any organization you will find property such as a building, land, and furniture etc., such properties owned by the business are referred to as Assets. To acquire these assets, businesses may get money from two sources, investment made by owners or the amounts borrowed from creditors. Therefore both owners and creditors have a claim over the resources of the business. The claim or the right of owners is referred to as equities, where as the claim of creditors' referred to as liabilities. As a result we can express the relationship of asset liability and equity as an equation as follows.

Asset	**=**	**Liability**	**+**	**Equity**

Economic resources = Claims over the resources

Asset = Equities

This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and equity.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. The equation provides the **underlying framework** for recording and summarizing economic events.

NB; If the amounts of two of the three elements of the accounting equation are known, we can solve amount of three third one using the equation. To illustrate, assume that a business has a total asset of Br.50,000 and a total liability of Br. 20,000, the owners equity as follows

Asset= Liability + Owners Equity

Equity = Asset – Liability (Br. 50,000- 20000) = 30,000

Let's look in more detail at the categories in the basic accounting equation.

Assets

As noted above, **assets** are resources that a business controls and uses its assets in carrying out its activities of production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. Assets include cash, tables, chairs, cash register, etc. the further classification of assets will be discussed in chapter two.

Liabilities

Liabilities are claims against assets, those resulted from borrow money and purchase merchandise on credit. Liabilities result in payables of various sorts. For instance a company may purchase supplies on credit results Accounts Payable, Borrowing money from bank results notes payable, having unsettled salary of employees results Salary Payable etc. the supplier, the bank and the employees who owes money are a company are its creditor and have the first claim against the assets before owners.

Equity

The ownership claim on a company's total assets is **equity**. It is equal to total assets minus total liabilities. Since the assets of a business are claimed by either creditors or shareholders and the creditors have prior claim over the owners, equity is "left over" after creditors' claims are satisfied. Thus owner's equity is often referred to as **residual equity.**

Equity of a sole propitiator and a partners business comes primarily from the investment made by owners. Then this equity subsequently increased whenever there are revenuesgenerated from sales of merchandise, performing services, renting property, and lending money etc.Withdrawals

made owners and payments for business expenses like salary, rent, electricity etc decreases equity owners.

Equity = Owners' investment + Revenue – (Expense + withdrawals)

Equity of a corporation business generally consists of share capital—ordinary and retained earnings. Share capital is funds obtained by selling ordinary shares to investors. Whereas retained earnings is obtained from the composition of three items i.e revenue, expanse and dividends.

Equity = Share capital ordinary + Retained Earnings

Retained Earning = Revenue-(Expense + Dividend)

Therefore the equity of corporate business presents the equity obtained from owners investment separately from the equity obtained from operating activity.

Revenue is The gross inflow of economic benefits during a period arising in the course of ordinary activities when those inflows result in increases in equity, other than increases relating to contributions from equity participants.For instance Unity University generates revenues by selling educational service where as Shewa Supermarket generates revenue by selling goods. In general revenue is an income generated from sales of a product or a service.

Expenses are the cost of assets consumed or services used in the process of earning revenue. For example Unity University incurred expenses while using office and classroom equipments and paying salary to employees in the process render educational service. Expenses results a gross **decrease in equity that result from operating the business.**

Dividend is the distribution of cash or other assets to shareholders. It is similar to owners' withdrawal in the case of a proprietor and a partnership business. Dividend reduces retained earnings.

In summary, the principal sources (increases) of equity are investments by shareholders and revenues from business operations. In contrast,

reductions (decreases) in equity result from expenses and withdrawals or dividend.

1.10. Business Transaction

Transactions (**business transactions**) are a business's economic events recorded by accountants. All transactions have an effect on the components of an accounting equation. Transactions may be external or internal. **External transactions** involve economic events between the company and some outside enterprise. For example, payment of monthly electric Bill, purchase of Computers, and sale educational service to students are external transactions. **Internal transactions** are economic events that occur entirely within one company in between different working departments. The releases of teaching supplies like markers, from the store to departments, to be used for teaching are internal transactions for Unity University.

Companies carry on many activities that do not represent business transactions. For examples hiring employees, answering the telephone, talking with customers, and placing merchandise orders. Although most of these activities lead to business transactions: like employees will earn wages (payment transaction), and suppliers will deliver ordered merchandise (purchase transaction), they are not transactions by themselves.

As a result companies must analyze each activities and event to find out whether it affects the accounting equation or not. If it does, the company will record the transaction.Each transaction must have a dual effect on the accounting equation. i.e., if an asset is increased, there must be a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in equity.

Synopsis of lecture

- A single set of high quality, understandable and enforceable global accounting standards, called IFRS.
- IFRS should be properly followed to enhance, comparability, understandability, reliability and relevance of financial reports to users.
- The two main assumptions of accounting are **monetary unit assumption** and the **economic entity assumption**.
- Fair Value principle dictates that an asset or liabilities should be reported at the current price received to sell an asset or to settle a liability.
- The three elements of the accounting equation are Assets, Liabilities and Owners equity.
- Every business transaction as a dual effect on the elements of the accounting equation.

Wrap-up Discussion Question

- Explain the difference between cost and fair value measurement principles.
- Explain the term accounting equation.
- The interrelation between Accounting equation and double entry book keeping system
- Using the concept of accounting equation, compute the missed figure for the following
    a. Asset =? , Liability = Br. 100,000, Equity = br.80,000
    b. Asset = Br. 250,000, Liability = Br. 160,000, Equity=?
    c. Asset = ? Liability + equity = Br. 450,000
    d. at the end of the accounting period December 2016, Selam company has assets of Br. 500,000 and liability of Br. 300,000. How much will be the amount of owners equity on December 2017, assume that asset is increased by Br. 90,000 and liability is decreased by Br. 50,000 during year 2010.

Next day's Reading Assignment

Read about transaction analysis and financial statement of sole proprietor business.

Secession 4 and 5 (Hr 7, 8, 9 and 10)

Topic: Business Transaction and Financial Statements

Session Learning Objective

- Analyze the effects of business transactions on the accounting equation.
- Understand the four financial statements and how they are prepared

Reading Assignment Discussions

Discussion Issue: effects of transaction on the accounting equation

Question from Reading: Formulate different kinds of events to change, asset, and liability and owners equity.

1.11. Analysis of Business Transaction

The term transaction analysis refers to an activity of specifying the effects of a particular transaction on the components of the accounting equation. All transactions regardless of their type and nature require to be analyzed. To demonstrate the way to analyze business transaction, we will review the business activities of Melkam Internet Café and expand the impact of transactions on the basic accounting equation. To make it clear we will use the extended form of the accounting equation. The detailed (long) form of a basic accounting equation is referred to as extended an accounting equation.As you see from the following format the extension is made for the owners Equity section only.

The expanded accounting equation

Asset= Liability + Owners' investment + Revenue – (Expense + withdrawals)

Illustration I Analysis of business transactions of Melkam Internet Café,

TRANSACTION 1 - INVESTMENT BY OWNER: Melkam decided to start a business that gives a photocopy and internet service, named Melkam Internet Café around Unity University. On August 1, 2016, she has invested Br. 45,000 cash in a bank account opened by the name of the business. This transaction results in an equal increase in both assets and equity.

Basic Analysis:-

- The asset "cash" is increases by Br. 45,000, and Equity identified as "owner's investment" increases by Br.45,000.

Equation Analysis:-

Assets	**=**	**Liabilities**	**+**	**Owner's Equity**
Cash		**=**	**Owners Capital**	
Tran 1	**+Br. 45,000**		**+ Br. 45,000**	
Bal Br.	**45,000**		**45,000**	**Initial Investment**

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in equity (in this case, initial investment) is indicated, because investments made by owner's do not represent revenues (we will see it later), and they are excluded in determining net income.

NB:

- What if Wt. Melkam has personal assets like house, personal bank account etc., obviously it is excluded from the analysis. This assumption goes in line with separate Entity concept that will be discussed later.

TRANSACTION 2 - PURCHASE OF EQUIPMENT FOR CASH: on August 2, Melkam purchases computer and photocopy machine for Br. 20,000 cash. This transaction is resulted an equal increase and decrease in total assets. So there is no change on the balance of total asset, except the composition of assets.

Basic Analysis:-

- The asset "Cash" is decreases by Br. 20,000, and asset "Equipment" increases by Br.20,000.

Equation Analysis:-

Assets	**=**	**Liabilities**	**+**	**Owner's Equity**
	Cash	**+ Equipment**	**=**	**Owners Capital**
Bal.	**45,000**			**45,000**
Tran 2	**-20,000**	**+20,000**		**-**
Bal Br	**25,000**	**20,000**		**45,000**

As you see from the above analysis, after the second transaction, the company will has less cash and more equipment. As a result purchase of the equipment changes the components of assets, but it does not change the total asset.

Observe also that total assets are Br.45, 000 and total Owner's equity, is a Br.45,000. This means that each transaction always leaves the basic accounting equation in balance.

NB:,

- What if Melkam purchases washing machine for her personal use. It is not business transaction and not to be included in the analysis.

TRANSACTION 3 - PURCHASE OF SUPPLIES ON CREDIT: August 10,Melkam purchases different stationary materials and cleaning supplies

for Br. 2,500 from Hibir Trading. The supplies are to be used by the business. Melkam is agreed to pay the bill next week.

Basic Analysis:-

- The asset "Supplies" increases by Br. 2,500, and liability "Accounts Payable" increases by Br. 2,500.

Equation Analysis:-

Assets				**Liabilities**		**Owner's Equity**
	Cash	**Supplies**	**Equipment**	**Accounts Payable**		**Owners Capital**
Bal.	**25,000**	**-**	**20,000**	**-**		**45,000**
Tran 3		**+2,500**		**+2,500**		**-**
Bal	**33,500**					**45,000**
Br.	**0**	**2,500**	**20,000**	**2,500**		**0**

Asset of the business increase as a result of the above transaction because more stationary and cleaning supplies are available now for future consumption.

on the other hand the above purchase made on account (a credit purchase). All purchases made on credit increase liabilities. As a result Melkam Internet Café's liability increases by the amount due from Hibir Trading.

Total assets are now Br. 47,500 i.e (33,500 + 2,500 + 20,000.) This total is matched by a Br. 2,500 creditor's claim and a Br. 45,000 ownership claim.

NB:,

- What if Melkam also purchases cleaning supplies on account for her personal use? It is not to be considered in the analysis as it constitutes personal liability.

TRANSACTION 4 - SERVICES PERFORMED FOR CASH: during the first month of operation Melakm Internet Café received Br. 8,500 cash for

internet and photocopy service provided to customers. This transaction results in an equal increase in both assets and equity.

Basic Analysis:-

- The asset "Cash" increases by Br. 8,500, and Equity identified as "owner's capital" increases by Br.8,500. This increase is resulted from sales of a service.

Equation Analysis:-

Assets				**Liabilities**		**Owner's Equity**		
	Cash	**Supplies**	**Equipment**	**Accounts Payable**		**Owners capital**		**Revenue**
Bal.	**25,000**	**2,500**	**20,000**	**2,500**		**45,000**		
Tran 4	**+8,500**							**+8,500**
Bal Br.	**33,500**	**2,500**	**20,000**	**2,500**		**45,000**		**8,500**
	0	**2,500**	**20,000**	**2,500**		**0**		**0**

As it is clearly shown in the above analysis, the receipts of cash increase the balance of asset as the same time the balance of Owner's Equity for the amount of revenue earned. But this increase in equity is quite different from the one which was analyzed on transaction one above. As a result, it is necessary to clearly specify the source of increase in equity as owner's investment or revenues generated from day to day operation.

NB : - Businesses might generate revenue from different operating activities they have engaged in. Different titles are used for various sources of revenue. Revenue from providing services is recorded as fees earned. Revenue from the sale of merchandise is recorded as sales. Other examples of revenue include rent, which is recorded as rent revenue, and interest, which is recorded as interest revenue

TRANSACTION 5 – PAYAMENT FOR ACCOUNTS PAYBLE:- August 15, Melkam pay cash of Br. 1,200 for the partial settlement for purchase of supplies made on transaction 3. The transaction results an equal decrease in asset and liability.

Basic Analysis:-

- The asset "Cash" decreases by Br. 1,200, and Liability, "accounts payable" decreases by Br. 1,200.

Equation Analysis:-

Assets				**=**	**Liabilities**		**+**	**Owner's Equity**		
	Cash	**+**	**Supplies**	**+**	**Equipment**	**=**	**Accounts Payable**	**+**	**Owners capital**	**+**	**Revenue**
Bal	**33,500**								**45,000**		
Br.	**0**		**2,500**		**20,000**		**2,500**		**0**		**8,500**
Tran 5	**-1,200**						**-1,200**				
Bal	**32,300**								**45,000**		
Br.	**0**		**2,500**		**20,000**		**1,300**		**0**		**8,500**

As you see from the above analysis, payment of liability reduces the cash balance of the company. After the transaction the total amount that the company has to pay (liability) is reduced to Br. 1,300 i.e, (Br. 2500- 1,200)

After the above transaction the total asset on the left hand side of the accounting equation of Br. 54,800 is exactly equal with the sum of total liability and equity found on the right hand side of the accounting equation.

NB:- Remember that the above transaction has no effect on supplies that were bought on transaction 3.

TRANSACTION 6 - SERVICES PERFORMED FOR CASH AND CREDIT: on August 20, Melkam performs Br. 6,000 photocopy service for customers. The company receives cash of Br. 2,000 from customers, and it bills the balance of Br. 4,000 on account. This transaction results in an equal increase in assets and equity.

Basic Analysis:-

- The asset “Cash” and “Account receivable” increases by Br. 2,000, and Br. 4,000 respectively. Whereas Owner’s equity on the right side the equation by br. 6,000.

Equation Analysis:-

Assets					**=**	**Liabilities**	**+**	**Owner’s Equity**		
	Cash	**+**	**Account Rec.**	**+Supp.**	**+**	**Equip.**	**=**	**Accounts Payable**	**+**	**Owners capital**	**+**	**Reve.**
Bal	**32,300**					**20,000**				**45,000**		
Br.	**0**			**2,500**		**0**		**1,300**		**0**		**8,500**
Tran 6	**+2,000**		**+4,000**									**+6,000**
Bal.	**34,300**		**4,000**	**2,500**		**20,000**		**1,300**		**45,000**		**14,500**

As you see from the above transaction, Melkam recognizes Br. 6,000 in revenue when it performs the services. Out of it Br. 2,000 is received in Cash and the remaining br. 4,000 is to be receive after few days i.e Account Receivables. This Accounts Receivable represents customers’ promise to pay Br. 4,000 to Melkam internet Café in the future. When it is received later, Melkam will increase Cash and decrease Accounts Receivable (see Transaction 8).

TRANSACTION 7 - PAYMENT OF EXPENSES: Melkam internet Café pays the following expenses in cash during August: Salary of employees Br. 2,800, Monthly rent Br. 3,200, and Utilities Br. 750. These payments result in an equal decrease in assets and equity.

Basic Analysis:-

- The asset “Cash” decreases by Br. 6,750, and “Owner’s equity” decreases by Br. 6,750 because of the following specific expenses. i.e. Salary Expense, Rent Expense and Utilities Expense.

Equation Analysis:-

Assets	**=**	**Liabilities**	**+**	**Owner’s Equity**

	Cash	Account +Recei.	+Supp.	+Equip.	=	Account Payable	Owners +Capital	+Reve	-Expense	
Bal Br.	34,300	4,000	2,500	20,000		1,300	45,000	14,500		
Tran 7	- 6,750								-2,800	Salary
									-3,200	Rent
									-750	Utility
Bal Br.	27,550	4,000	2,500	20,000		1,300	45,000	14,500	6,750	

After the analysis of the above transaction, the two sides of the equation is still balance at Br.54,050. Three lines are required in the analysis to list each expenseseparately.

NB;

- Businesses by their side also consume service of other business and individuals in the process of producing products and services to customers. For instance Melkam Internet Café should hire employees, and consumes electric power to render internet service. This consumption creates expenses. Unlike revenues, Expense decreases the balance of owner's equity.

TRANSACTION 8 - RECEIPT OF CASH ON ACCOUNT: Melkam receives Br. 2,200 in cash from customers who had been billed for services (in Transaction 6).

Basic Analysis:-

- The asset "Cash" increases Br. 2,200, and the asset "Account Receivable" decreases Br. 2,200

Equation Analysis:-

Assets	=	Liabilities	+	Owner's Equity				
Cash	Account +Recei.	+Supp.	+Equip.	=	Account Payable	Owners +Capital	+Reve	-Expense

Bal Br.	**27,550**	**4,000**	**2,500**	**20,000**	**1,300**	**45,000**	**14,500**	**6,750**		
Tran 8	**+2,200**	**-2,200**								
Bal.Br.	**29,750**	**1,800**	**2,500**	**20,000**	**1,300**		**45,000**	**14,500**	**6,750**	

NB:

- Note that the collection of an account receivable for services previously billed and recorded does not affect both revenue and equity. Melkam already recorded this revenue (in Transaction 6) and should not record it again. On the other hand the above transaction does not change the total asset, but it changes the composition of the asset.

TRANSACTION 9 – OWNER'S DRAWINGS: The Melkam Withdraws Br. 2,500 from the business for her personal use. This transaction results in an equal decrease in assets and equity.

Basic Analysis:-

- The asset Cash increases Br. 2,500, and owner's equity decreases Br. 2,500

Equation Analysis:-

	Assets				**=**	**Liabilities**	**+**	**Owner's Equity**				
Tran.	**Cash**	**Account +Recei.**		**+Supp.**	**+Equip.**	**=**	**Account Payable**	**Owners +Capital**	**+Reve**	**-Expense**	**Owner's -Drawi**	
Bal.Br.	**29,750**	**1,800**		**2,500**	**20,000**		**1,300**	**45,000**	**14,500**	**6,750**		
Tran 9	**-2,500**										**-2,500**	
Bal.Br.	**27,250**	**1,800**		**2,500**	**20,000**		**1,300**	**45,000**	**14,500**	**6,750**	**2,500**	

Look, the Owner's drawing reduces equity but this reduction is totally different from the reduction resulted because of expenses. The reason is

expenses are the costs incurred or resources consumed for the running of run the day to day business activity, where as drawing is an amount of capital consumed for owner's personal use or non business activity.

NB: don't confuse drawings with those personal transactions excluded from the transaction analysis of the business. The essence here is not including the Melkam's personal transaction in to the analysis of the business transaction, but rather it is inclusion of the change in asset (cash) and equity which accompanies her cash withdrawal in to the accounting equation.

- **Summary of Transactions analysis**

From the above nine transaction analysis students are required to clearly understand the following basic points.

i. Each business transaction should be analyzed in terms of its effect on:
   a. the three component of the basic accounting equation
   b. the specific item within each component

ii. After each transaction, the left hand side of the equation must always be equal with the right hand side of the equation.

iii. The owner equity is increased by the amount invested by owners and is decreased by withdrawals by owners. Moreover the owner's equity is increased by revenues and decreased by expenses.

NB: The above basic points are commonly applicable to all transaction analysis. **Illustration 1**summarizes the August transactions of Melkam Internet Café to show their cumulative effect on the basic accounting equation. Then tabular summery of the analyzed transactions is required.

Transaction summery used to display the effects of all those transactions occurred during the month on the two sides of the basic accounting equation using a tabular format.

Illustration 1.2 Transaction Summery of Melkam Internet Café

Tabular Summery of Transactions

Asset					Liability	Owner's Equity				
Tran. No.	Cash +	Accounts Receivable	+Supplies	+Equipment	=Account Payable	+Owners Capital	+Revenue	- Expense	- Drawing	
1	Br.45,000					45,000				Initial Inv.
2	-20,000			20,000						
3			2,500		2,500					
4	+8,500						8,500			Serv. Rev.
5	-1,200				-1,200					
6	+2,000	4,000					+6,000			Ser. rev.
7	-6,750							2,800		Salary Exp.
								-3,200		Rent Exp.
								-750		Utilities Exp.
8	+2,200	-2,200								
9	-2,500								-2,500	Drawing

Bal.	**27,250**	**+1,800**	**+2,500**	**+20,000**	**=1,300**	**+45,000**	**+14,500**	**-6,750**	**-2,500**	
Total Assets	**Br. 51,550.**			**Total Liability and Equity**					**Br. 51,550.**	

Look, the information contained clearly shows you the applicability of those basic points of transaction analysis presented above.

Dear students, the above analysis are the simplest way to understand the basics of accounting. More over it is the critical step to deal smoothly with the essence of whole recording activity which you will learn in the following chapters. So please take sufficient time to do and review it until you are certain about and capable enough to:

- Analyze the effects of each transaction on the accounting equation
- Identify the name specific item affected within the component names
- Keep the accounting equation in balance

1.12. Financial Statement

After transactions have been recorded and summarized, reports are prepared for users. The accounting reports providing this information are called financial statements. These statements provide a company's history quantified in money terms. The financial statements most frequently provided are the following.

1. **Statement of profit or Loss and Other comprehensive income** presents the summery of revenues and expenses to determine the resulting net income or net loss for a specific period of time. Such as a month or a year.
2. A **statement of owner's equity** summarizes the changes in owner's equity for a specific period of time. Such as a month or a year.
3. A **statement of financial position** (sometimes referred to as a *balance sheet*) reports the assets, liabilities, and equity of a

company at a specific date. Usually at the close of the last day of a month or a year.

4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time. Such as a month or a year.

NB:

- The income statement, statements of Owner's equity, statement of cash flows, and comprehensive income statement holds financial information of a particular period, whereas the statement of financial position is for a point in time.

1. Statement of Profit or Loss and Other Comprehensive Income

The income statement reports the success or profitability of the company's operations over a specific period of time. Investors and creditors use this statement to determine and predict the profitability and future cash inflows of a particular business. It is prepared from the data appearing in the revenue and expense columns of**Illustration 1.3.1**. The statement has two parts i.e the heading and the body part. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement. The main body reports those revenue and expense items with their respective balances for the specific period.

The income statement lists revenues followed by expenses and then, shows net income (or net loss). **Net income** results when revenues exceed expenses, whereas **net loss** results when expenses exceed revenues. IFRS does allow an alternative statement format in which the information in the income statement can be combined and presented as a single statement with the comprehensive income statement referred to as a **statement of comprehensive income**.NB:- As discussed earlier income statement do not include investment and drawings made by owners, even though both investment and drawing affects owner's equity.

Illustration 1.3. Financial Statements of a Sole Proprietor Business

Illustration 1.3.1.Statement of profit or Loss and Other comprehensive income

Melkam Internet Café

Statement of profit or Loss and Other comprehensive income

For the Month ended August 30,2016

Revenues			
			Br. 14,500
	Service Revenue		**0**
Expenses			
		Br.	
	Salary Expense	**2,800**	
	Rent expense	**3,200**	
	Utilities Expense	**750**	
	Total Expense		**6,750**
	Net Income		**7,750**

Illustration 1.3.2 Statements of Owner's Equity

Melkam Internet Café

Statements of Owner's Equity

For the Month ended August 30,2016

Owners capital August 1,			**Br. 0**
		Br.	
Add	**Investments**	**45,000**	
Add	**Net income**	**7,750**	**52,750**
			52,750
Less	**Drawing**		**2,500**
	Owner's capital August 30,		**50,250**

Illustration 1.3.3. statements of Financial Position

Melkam Internet Café

Statements of Financial Position

For the Month ended August 30,2016

Asset

Equipment	**20,000**
Supplies	**2,500**
Accounts Receivable	**1,800**
Cash	**27,250**
Total Asset	**51,550**
Equity and Liability	
Owners Equity	
Melkam Capital	**50,250**
Libilities	
Accounts Payable	**1,300**
Total Equity and liabilities Br.	**51,550**

Illustration 1.3.2. Statements of Cash Flow

Melkam Internet Café

Statements of Cash Flow

For the Month ended August 30,2016

Cash Flows from operating activity	
Cash receipts from revenue	**Br. 12,700**
Cash payment for Expenses	**-7,950**
Net cash provided by operating activity	**4,750**
Cash flows from investing activity	
purchase of equipment	**-20,000**
Cash flows from Financing activity	**-20,00**

		0
	Investment by owner	**Br. 45,000**
	Drawing by owner	**-2,500**
	Net increase in Cash	**42,500** / **27,250**
	cash at the beginning of the month	**0**
cash at the end of the month		**27,250**

2. Owner's Equity Statement

The owner's equity statement reports the changes in owner's equity for a specific period of time. It is prepared after the income statement because the amount of net income or net loss of the period is necessary for the preparation of the statement.

Owner's equity statement is prepared before the balance sheet, since the amount of owner's equity at the end of the period is necessary for the preparing balance sheet. Because of this, the statement of owner's equity is often viewed as the connecting link between the income statement and balance sheet.

Data for the preparation of the owner's equity statement come from the owner's equity columns of the tabular summary of illustration 1.3.2

As you see from the illustration owner's equity for Melkam Internet Café is affected by three instances during the reporting month. (1) The original investment of Br. 45,000, (2) the revenue and expenses that resulted in net income of Br. 7,750 for the month, and (3) owner's withdrawal of Br. 2,500 by the owner.

Like income statement Owners Equity statement has two parts, i.e the heading and the main body. The heading is summers the name of the business, the type of statement and the reporting period with in three lines. Whereas the main body starts with the beginning balance of owners equity (which is zero at the start of the business), and ends up with the ending

balance of owner's equity. Investment and net income are added to whereas, Drawing and Net loss if any are deducted from the beginning Owners Equity to determine the balance for equity at the end of a particular period.

NB: Net income and net Loss are mutually exclusive; they never appear together for any particular reporting period.

3. Statement of Financial Position

Statement of financial position reports the assets, liabilities, and equity at a specific date. The asset and liability amounts are taken from the last line of the tabular summary of **illustration1.12.1** of. Melkam's Capital as of August 30, 2016, is taken from the statement of owner's equity on **illustration 1.3.3**

The statements of financial position have two parts, i.e the heading and the main body. The main body lists assets at the top followed by equity and liability. Total assets must equal total equity and liabilities. For the current case of Melkam Internet café there is only one liability, i.e Accounts Payable, on its statement of financial position. But in most cases, there will be more than one liability. When two or more liabilities are involved, the proper order of listing is as follows.

Liabilities

Notes payable	Br. XXX	
Accounts Payable		XX
Salary and Wages payable		XX
Total Liabilities		XXX

4. Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing activities, (3) its financing activities, (4) the net increase or

decrease in cash during the period, and (5) the cash amount at the end of the period.

As you see in Melkam Internet café's statement of cash flows in **Illustration 1.3.4** cash is increased by Br, 27,250 during the period. This is resulted because of the net effect of a Br.4,750 increase in the Net cash provided by operating activity, a Br. 8,000 decrease from investing activity and a Br. 42,500 increase of cash flow from financing activities.

NB: Investing activities pertain to investments made by the company, not investments made by the owners. Any ways don't worry about the statements of cash flow the course Financial Accounting I gives you the full detail.

- Most students do not consider the heading of financial statements as a necessary section. But it is important to distinguish one finical statement from the other. Without heading financial reports cannot gives complete information.
- Similarly most students' give less attention for the necessity of underlings while preparing financial statement. Proper underlinings are the ultimate indicators for sub totals and final or the grand total of a particular statement. As a result please don't hesitate to make single underline under subtotal and double underline under final totals.

1.12.1. Financial Statements and their Interrelationships

The preparation of the financial statements for Melkam Internet café has been finalized. Now it is the time to show you the interrelationship between the statements.

- Net income determined by the income statement, Br, 7,750 is used in the statements of owner's equity to determinate ending balance of owner's equity.

- The figure for ending equity Br. 50,250, in the statements of owner's equity is used by statements of financial position for the determination of the balance for total liability and equity.
- The cash balance Br. 27, 250 shown in the statements of financial position to reconcile the ending cash balance determined in the statements of cash flow.

Synopsis of Lecture

- Transaction analysis refers to an activity of specifying the effects of a particular transaction on the components of the accounting equation.
- Statement of profit or Loss and Other comprehensive income presents the summery of revenues and expenses of the entity for a specific period of time.
- The owner's equity statement reports the changes in owner's equity for a specific period of time.
- The statement of cash flows provides information on the cash receipts and payments of the entity for a specific period of time.
- Statement of financial position reports the assets, liabilities, and equity at a specific date.

Wrap-up Discussion Question

- Explain the necessity of analyzing business transaction.
- Explain the interrelationship among financial statements

Exercise: - Use an accounting equation and show the effects of the following transaction on the components of the equation.

-purchase of supplies for cash Br. 200

-Sales of service on credit Br. 3000

- Purchase of equipment on credit Br. 5,000

- Payment of cash as a full settlement Br. 5000

SELF-EXAMINATION QUESTION

1. A profit-making business that is a separate legal entity and in which ownership is divided into shares of stock is known as a:
   A. Sole proprietorship C. Partnership
   B. Single proprietorship D. Corporation
2. The properties owned by a business is called:
   A. Asset C. Stockholders' equity
   B. Liability D. Owner's Equity
3. If the total asset increased by Br. 20,000 during the year and liability increased by Br. 12,000 during the same year, the amount and direction(increase or decrease) of the year's change in owner's equity is:
   A. Br. 32,000 increase C. Br. 8,000 increase
   B. Br. 32,000 decrease D. Br. 8,000 decrease
4. A list of Asset liability and owners equity at the specific date is:
   A. Statement of owners equity C. Statements of Cash flow
   B. Statements of financial potion D. Income statement
5. If revenue was Br. 45,000, expenses were Br. 17,500 and owner's withdrawal were Br. 10,000, the amount of net income or net loss was:
   A. Br. 45,000 net income C. Br. 37,500 net loss
   B. Br. 32,000 net income D. Br.2,500 net loss

ILLUSTRATIVE PROBLEM

The assets and liabilities of White dry cleaners on December 1, 2016 of the current year are as follows: Cash Br.1,000, Accounts Receivable, Br.2,200, Supplies Br. 850, Equipment Br. 3,500, Land Br. 11,450. Accounts Payable, Br 4,030. A white dry cleaner is a sole proprietor owned and managed by W/o Mihret. Currently the building, and delivery truck, are being rented, pending expansion to new facilities. Another company at wholesale rates

of does the company work of dry cleaning. Business transactions during December are summarized as follows.

1. Received cash from customers for dry cleaning service Br. 4,928.
2. Paid creditors on account Br. 1,755.
3. Received cash from W/o Mihret as additional investment Br. 3,700.
4. Paid rent for the month Br. 1,200.
5. Charged customers for dry cleaning service delivered on account Br.1,025.
6. Purchased supplies on account, Br. 245
7. Received cash from customers on account Br. 2,000
8. Received a monthly bill for electricity for the month December(To be paid on January 2, Br. 1,635,
9. Paid the following: Wages expense, Br. 850, Truck Expense, Br. 250, Utilities Expense, Br.325, miscellaneous expense.Br. 75
10. W/o Mihret the owner withdraws cash Br. 1,800 for her personal use.
11. Determined by taking an inventory count, the cost of supplies used during the month Br. 115.

Required:

a. Insert the beginning balances to the appropriate account using the following tabular headings.

Asset					Liability	Owner's Equity			
Tran. No.	**Cash +**	**Accounts Receiv**	**+Supplies**	**+Equipment**	**=Account Payable**	**+Owners**	**+Revenue**	**- Expense**	**-Drawing**

		able				**Capital**			

b. Analyze the above transactions and Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:
c. Prepare financial statements for the business for the month of December 31, 2016.

CHAPTER TWO

ACCOUNTING CYCLE FOR SERVICE-GIVING BUSINESS

Overview of Chapter 2

As you recall from Chapter 1, we have analyzed business transactions of Melkam Internet café, in the way that displays their effects on the elements of the accounting equation. Then we have prepared a tubular summery the transactions and also the financial statements. This is so in this way because the business is small. But what if we are going to record transactions of large business like Unity University, Teklehaimanot Hospital or Ethiopian Airlines? These firms entertain 100 or 1000 folds of the monthly transactions of Melkam Internet Café within a single day. Do you think it seems practical and wise to analyze each and every transactions in the way we did before? **No**. Record transaction in this way would be impractical, expensive, and unnecessary. Though tabulation is a simple way to show you how transaction and their respective effects are captured in the basic accounting equation, it is not the formal system for recording business transactions at all. Instead, companies use a set of systematic procedures and records to keep track of transaction data more easily. This chapter introduces and illustrates the basic procedures used in the recording process and completion of accounting cycle.

2.0 Chapter Learning Objectives

After completing this chapter you should be able to:

- Explain what an account is and how it helps in the recording process.
- Define the term debits and credits and explain their role in the recording process
- Identify the basic steps in the recording process.
- Explain what a journal is and how it helps in the recording process.
- Explain what a ledger is and how it helps in the recording process.
- Explain what posting is and how it helps in the recording process.

- Prepare a trial balance and explain its purposes.

Session 6 (Hr. 11 and 12)

Topic: - The Recording Process

Session Learning Objectives:

- Explain what an account is and how it helps in the recording process.
- Define debits and credits and explain their role in the recording process
- Identify the basic steps in the recording process.
- Explain what a journal is and how it helps in the recording process.

Recording Assignment decision

- **Discussion Issue:-** self examination question and illustrative problems at the end of chapter one

2.1.The Recording Process

The recording process holds detailed discussions on the terminologies of the elements used in recording of business transactions. These are an account, the recording system and the proving process.

2.1.1. The Account

An **account** is an individual accounting record of increases and decreases in a specific asset, liability, or equity item. An **account** is a sub division of the three elements of the accounting equation For example; Melkam internet Cafe (the company discussed in Chapter 1) would have separate accounts for Cash, Accounts Receivable, Accounts Payable, Service Revenue, Salaries and Wages Expense, and so on.

2.1.2 Characteristics of an Account

The simplest (basic) form of an account consists of three parts: (1) an account title, (2) a left or debit side, and (3) a right or credit side. We use this form often throughout this course to explain basic accounting relationships. Illustration 2.1 shows the basic form of an account.

Illustration 2.1 Basic form of account.

Accounts Title

Debit	Credit

As you see from the figures the format looks like the letter “T”, as a result the simplest form of an account is referred to as a **T-account**

1. **Account Title**

The account title represents the name of the particular account which is written on the top of the account.

2. **Debits and Credits**

The term **debit** indicates the left side of an account, where as the term credit indicates the right side of the account. They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit.

The terms**debit** and **credit** repeatedly used in the recording of the increases and decreases of a particular account.

The act of entering an amount on the left side of an account is called **debiting**. Whereas making an entry on the right side is **crediting** the account.

The act of debiting or crediting by itself doesn’t represent an increase or a decrease in a specific account. Increase or decrease of an account is determined on the basis of account classification only.

2.1.3. Balance Side of an Account

Increasing side of an account is called balance side**.** An account shows a **debit balance side** if the total of the debit amounts exceeds the credits. An account shows a **credit balance side** if the credit amounts exceed the debits. Dear students’ illustration 2.1 shows you the recordings and the balance determination of an account. Beside the illustration also shows you how the account format sparely records increases and decreases in a particular account compared with tabular format dealt on Chapter 1). The data for the illustration is taken from Melkam Internet Café tabular summery of illustration 1.2.

Illustration 2.2 Tabular summary and account form for Melkam Internet Café Cash account

Account Form

Cash

Debit		**Credit**	
45,000		**20,000**	
	8,500		**1,200**
	2,000		**6,750**
	2,200		**2,500**
Bal.			
27,250			

Tabular Summery of Cash

Br.45,000
-20,000
+8,500
-1,200
+2,000
_6,750
_2,200
_-2,500
27,250

Look, the above two formats for your comparison. Every positive figure in the tabular summary represents an increase in cash and every negative figure represents a decrease in cash balance. **Notice also in the account form the increases and decreases in cash are recorded in a separate side. I.e the increases in cash is recorded as debits, and the decreases as credits.** There is no need to uses + or – signs in the account format.

Having increases on one side and decreases on the other reduces recording errors and helps in determining the totals of each side of the account as well as the account's balance side. The balance is determined by netting the two sides (subtracting one amount from the other). The account balance, a debit of Br. 27,250, indicates that Melkam Internet Cafe had Br. 27,250 more increases than decreases in cash. As a result cash has a debit balance side.

NB: For simplicity all accounts which, appear in the **left hand side** of the accounting equation has a **debit balance side**. Whereas all those accounts which appeared on the **right hand side** of the accounting equation has a **credit Balance side**.

2.1.4. The Rules of Debit and Credit in a double entry system

In Chapter 1, you have learned the effect of a transaction each transaction has a dual effect on the basic accounting equation and that maintains the accounting equation always in balance. Thisfactprovides the basis for the **double-entry system** in the formal records of transactions.

Under the double-entry system, the dual (two-sided) effect of each transaction is recorded in appropriate accounts as debits and credits. This system provides a logical method for recording transactions and helps to ensure the recording accuracy. If every transaction is recorded with equal debits and credits, the sum of all the debits to the accounts must equal the sum of all the credits.

The double-entry system for determining the equality of the accounting equation is much more efficient than the plus/minus procedure used in Chapter 1. On the following pages, we will illustrate debit and credit procedures in the double-entry system.

Rules of Debits and Credits for Asset, Liabilities and Owners Equity

In Illustration 2.2 above increases in Cash (an asset) were entered on the left side i.e debit, and decreases in Cash were entered on the right side i.e credit. Since assets are found on the left side of the basic accounting equation.

On the other hand increases in liabilities must be entered on the right or credit side, and decreases in liabilities must be entered on the left or debit side. It is therefore follows that increases and decreases in liabilities will have to be recorded **opposite**from increases and decreases in assets.

balance side or normal balance of an account is the side where the increaseing in the account is recorded. For instance **Asset accounts normally show debit balances.** That is, debits to a specific asset account should exceed credits to that account. Likewise, **liability accounts normally show credit balances**. That is, credits to a liability account should exceed debits to that account.

As it is discussed in Chapter 1 indicated, owner's equity has four subdivisions: Owner's Capital, drawing, revenues, and expenses. In a double-entry system, companies keep accounts for each of these subdivisions, as explained below.

Owner's capital has a credit balance side. Revenues increase equity, a revenue account use the same debit/credit rules as owner's capital account. As you know Drawing and Expenses decreases equity account, they have the opposite Debit/credit rules as owner's capital account. As a result they have a debit normal balance.

Knowing the normal balance in an account may help you to trace errors. For example, a **credit** balance in an **asset** account such as Equipment or a **debit** balance in a **liability** account such as Accounts Payable usually indicates an error.

Summary of Debit/Credit Rules

Illustration 2.3 shows a summary of the debit/credit rules and effects on each type of account. Study this diagram carefully. It will help you understand the fundamentals of the double-entry system.

Illustration 2.3 Summary of debit/credit rules

Accounting Equation	**Asset**		=	**Liabilities**		+	**Owners Equity**									
Account Classificatio	**Asset**		=	**Liability**		+	**Owners**		+	**Revenue**		-	**Expense**		-	**Drawing**	
	Dr	**Cr**		**Dr.**	**Cr.**		**Dr**	**Cr.**		**Dr.**	**Cr**		**Dr.**	**Cr.**		**Dr**	**Cr.**
Debit/Credit Rule	+	-		-	+		-	+		-	+		+	-		+	-

NB: in the above illustration, the plus sign represents an increase in an account where as minus sign represents a decrease in an account.

The information in the above table is summarized as follows.

Debit Credit

- Increase in asset - Decrease in asset

- Decrease in Liability - Increase in Liability
- Decrease in equity - Increase in equity
- Decrease in revenue - Increase in revenue
- Increase in Expense - Decrease in Expense

Synopsis of Lecture

- Account is a subdivision of the elements in accounting equation
- The simplest form of an account is referred to as a **T-account**
- The left side of an account is debit side and the right hand side of an account is credit
- Accounts with debit balances appear in the left column, and those with credit balances in the right column.
- The increasing side of an account is normal balance or balance side

Wrap-up discussion questions

- Describe how debits and credits rules are related with the accounting equation.
- Define the terminologies of debits and credits.
- Write the normal balance for the elements of the accounting equation.

Next day's assignment

Read about classification of accounts

Session 7 and 8 (Hr. 11, 12, 13 and 14)

Topic:- Classification of accounts

Session Learning Objective

- Understand classification of accounts
- Identify the basic steps in the recording process.
- Explain what a journal is and how it helps in the recording process.

Reading Assignment discussion

Discussion issues:

- Analyzing transaction
- Journalizing

2.1.2 Classification of Accounts

Accounts are classified in to five. Namly Assets, Liability, Equity, Revenue (referred to as income) and Expense. The first three are reported the statements of financial position accounts. So they are called financial Position accounts. Whereas the last two are called Income statement accounts and are called income statement accounts.

The simplified versions of the official account definitions provided by the FASB, using the IASB definitional structure, are as follows.

i. **Assets** :- A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The following three characteristics must be present for an item to qualify as an asset:

1. The asset must provide probable future economic benefit that enables it to provide future net cash inflows.
2. The entity is able to receive the benefit and restrict other entities' access to that benefit.
3. The event that provides the entity with the right to the benefit has occurred.

Assets have features that help identify them in that they are exchangeable, legally enforceable, and have future economic benefit (service potential). It is that potential that eventually brings in cash to the entity and that underlies the concept of an asset.

IFRS based Classification of assets :-International Financial Reporting Standard made asset classification as follows:

Property Plant and Equipments:- are asses held to be used in the production and supply of goods or services, for administrative purpose, or for rental to others. As per IAS 16 Property, plant, and equipment includes land,building structures (offices, factories, warehouses), and equipment (machinery, furniture, tools). PPEs also include Biological assets (Bearer Plants) and mineral recourses. Biological assets are Bearer plants that are used to produce agricultural products, like Rubber tree, Fruit tree, Sheep, Dairy cattle etc. Mineral Recourses and Mineral reserves used to produce such as oil, natural gas and mineral water etc.

Intangible Asset:- are identifiable assets, without physical existence, held for use in production and supply of goods or services, for administrative purpose or, for rental to others. (IAS 38). Intangible assets includes Brand, Copyrights, Trademarks, Trade secrets, Permits, Corporate intellectual property etc.

Noncurrent Asset Held for Sale:-is a PPE that are available for immediate sale in its present condition and its sale must be highly probable. In addition, the asset must be currently being marketed actively at a price that is reasonable in relation to its current fair value. For example a building in use by a business but the entity is committed to sale it on the moment the company gets buyers.(IFRS 5)

Inventories:- Are asset held for sale in the normal course of business or in the process of production for such sale or in the form of materials or supplies to be used in the production process or in the rendering of services. Harvested and stored biological assets held for sale is also categorized under inventories. (IAS2)

Biological Asset in Agricultural Activity and Agricultural Products:- assets point of harvest:- assets that are agricultural products growing on

bearer plant Example, Picked fruit, harvested sugar cane or wool on the sheep at point of harvest. (IAS41).

Investment Property:- Are properties held to earn rentals or for capital application or both rather than for use in production for use or for sale. For instance, holding a building or a land for rental purpose is an investment property.

Financial Asset:- is cash, an equity investment of another company (e.g., ordinary or preference shares), or a contractual right to receive cash from another party (e.g., loans, receivables, and bonds).(IAS 32 and IFRS 7)

NB: the above are detailed classification for the assets; you are required to read more about the classifications. However for the purpose of simplicity, assets generally are classified in to noncurrent and current asset. **Noncurrent assets** are assets that cannot be easily and readily converted into cash and cash equivalents. Non-current assets are also termed fixed assets, or long-term assets which serve an entity for a period more than one year. Noncurrent asset is reclassified in to three. These are PPEs, Mineral Recourses and Intangible Assets.

On the other hand **Current assets** are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle or within a year. This includes Cash, account receivable, inventory etc. The general classification is within the scope of the above asset category.

ii. **Liabilities.** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The following three characteristics must be present for an item to qualify as a liability:

1. A liability requires that the entity settle a present obligation by the probable future transfer of an asset on demand when a specified event occurs or at a particular date.

2. The obligation cannot be avoided.
3. The event that obligates the entity has occurred.

IFRS based Classification of Liabilities:-IFRS categorized liabilities as follows**:**

Financial liabilities:- a contractual obligation to deliver cash or another financial asset, obligation to exchange financial liabilities under unfavorable condition. Financial liability includes accounts payables, deposit liabilities, bond issued etc.(FRS 9 and IAS39)

Lease liability:- a present obligation arising from lease agreements. Lease an agreement whereby the leaser conveys to the lessee the right to use an asset for an agreed period of time in return for payment. (IAS 17).

Employee Benefit liability:- a present obligation incurred by an entity in exchange for service rendered by employees for the termination of employment. Employee benefits liability included, salary payable, Bonus payable, pension payable, severance pay.(IAS 19)

Income Tax liability:- A present statutory obligation to pay taxes to the government based on taxable profits(IAS12).

Provisions:- A provisionis a liability of uncertain timing or amount and sometimes referred to as an estimated liability. Common types of provisions are obligations related to litigation, warrantees or environmental damage etc.(IAS37).

Depending on the date of expected payment Liabilities can be classified in to Current and Noncurrent liabilities. This classification is within the framework of the above category,

Current liabilities are obligationswhich are expected to be settled within its normal operating cycle; or within 12 months after the reporting date.

Current liabilities include Accounts payables, salary payable, notes payables etc.

Non-current liabilities (sometimes referred to as long-termdebt) consist of an expected outflow of resources arising from present obligations that are not payable within a year or the operating cycle of the company, whichever is longer. Bonds payable, long-term notes payable, mortgages payable, pension liabilities, and lease liabilities are examples of non-current liabilities.

iii. **Equity**. A residual interest in the assets of the entity after deducting all its liabilities.

iv. **Income.** Increases in economic benefits that result in increases in equity (other than those related to contributions from shareholders). Income includes both revenues (resulting from ordinary activities) and gains.

v. **Expenses.** Decreases in economic benefits that result in decreases in equity (other than those related to distributions to shareholders). Expenses includes losses that are not the result of ordinary activities

2.2. The Recording System

Recording system is an accounting system used to capture (Record) continues track of business transaction.

Steps in the recording transactions

There are three basic steps in the recording process:

I. Analyze each transaction for its effects on the accounts.
II. Enter the transaction information in a *journal*.
III. Transfer the journal information to the appropriate accounts in the *ledger*.

I. Analyzing Business Transaction

Analyzing a business transaction is reviewing the information included in a particular business document and identifies the transaction effect on a particular account. Business documents are those source documents like Receipts, invoices, a check or a bill that provides evidence for the occurrence of the transaction.

The analysis of business transaction answers the following three questions.

i. Which accounts are affected? helps to identify the specific account affected by a particular transaction
ii. How are they affected? Helps to specify whether the identified accounts are increased or decreased due to the transaction.
iii. Which account is to be debited and which account is to be credited by how much.

NB; dear students this activity is a pre-stage for the recording activity. It helps to enhance the accuracy of the recording activity. The company then enters the transaction in the journal. Finally, it transfers the journal entry to the designated accounts in the ledger.

The steps in the recording process occur repeatedly. In Chapter 1, we have illustrated the first step, i.e transaction analysis, and in this chapter and the later chapters you will have more examples and advanced illustrations to practice the recording activity.

2.2.1. The Journal and Recording Transactions

The journal is a format used to record a transaction for the first time. The process of enteringa transaction from the source document in to a journal is called Journalizing. Companies uses a journal to 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.

Types of Journal

There are two types of Journal: **General journal** and the **Special journal**. General journal is the most basic form of Journal which is used to record all kinds of business transactions.

Whereas special journal is a journal used to record only as specific transaction type. For instance cash journal records only a transaction which involves cash receipt or payments, purchase journal records only purchase transaction only etc., for the matter of this course whenever *we* use the

term “journal” in this course, we mean the general journal, unless we specify otherwise.

Significances of recording transaction in a journal

The journal makes several significant contributions to the recording process:

1. It discloses the **complete effects of a transaction** in one place.
2. It provides a **chronological record** of transactions.
3. It helps **to prevent or locate errors** because the debit and credit amounts for each entry can be easily compared.

Illustration 2.3 Format for a General Journal

As shown inillustration2.3.below a general journal has a space for date, account titles and explanations, references, and two amount columns.

General Journal

Page No.

Date		**Descriptions**	**P/ R**	**Debit**		**Credit**	

Parts of a General Journal

Companies make separate journal entries for each transaction. 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.

Illustration 2.4 shows the technique of journalizing, using the first two transactions of Melkam Internet café. On August 1, Melkam invested Br. 45,000 cash to start the business and on August 2, Melkam purchased equipment for Br. 20,000 for cash. The number page 1 indicates that the company records these two entries on the first page of the general journal.

Illustration 2.4 Steps of journalizing

General Journal Page 1

Date		Account Title and Descriptions	P/R	Debit		Credit	
2016 Aug	**1**	**Cash**		**45,000**			
		Owner's capital				**45,000**	
		(Initial Investment)					
	2	**Equipment**		**20,000**			
		Cash				**20,000**	
		(purchase of equipment)					

Steps in Journalizing Transaction

1. Enter the date of the transaction in the Date column in the way it is shown on the above table
2. Enter the name of the account to be debited in the "Account Titles and Description," column and record its respective amount in the Debit column. As you see from the above table the account Cash is written bend to the extreme left end of the column, this is to indicate that the account is recorded on the left hand side or debited.
3. Enter the name of the account to be credited in the "Account Titles and Description," column of the Journal and record its respective amount in the Credit column. As you see from the above illustrations the account Owners capital is written bend to the right end of the column, this is to indicate that specific account is recorded on the right side or credited.
4. Include brief description of the transaction on the line below the credit account title. A space is left between journal entries. The blank space separates individual journal entries and makes the entire journal easier to read.

5. The column titled P/R. (which stands for Post 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.

NB:

- Dear student's as a beginner you might face difficulties in understanding while you have tried to journalize transactions. But don't worry, take it normal, what you are advised to do is continue with practicing until you develop the knowhow to identify accounts, and there balance sides to journalize them. Once you are able to journalize correctly and properly, the other recording activities are so simple for you. The base for financial reporting is the ability to journalize transactions properly. Note also that journal is the source document or the base for further activities on the recording process so please take time and record it properly and correctly.

Simple and Compound Entry

An individual record for debit or credit of a particular transaction is called journal entry. Journal entries for a transaction which involves only two accounts i.e one debit and one credit account is called simple entry. The journal entry on illustration 2.4 above is simple entries. Journal entries which involve more than two accounts for a transaction is called compound entry. To illustrate let us take transition 6 of Melkam Internet Café' of chapter 1. On August 20, Melkam performed a Br. 6,000 photocopy service to customers and receives cash of br. 2,000. Melkam billed the customer balance of Br. 4,000 on account. The compound entry is as follow

Illustration 2.5 Compound Journal Entry

Date		Account Title and Descriptions	P/R	Debit		Credit	
2016 Aug	**20**	**Cash**		**2,000**			
		Accounts receivable		**4,000**			
		Service fee				**6,000**	
		(Sales of service for cash and on account)					

NB; service fee is a revenue account.

Synopsis of Lecture

- Account is a place to record increases or decreases of in the element of a particular accounting equation.
- Asset, liability, owner's equity, revenue and expense are the five classification of an account.
- Assets are resources owned by a business and are classified in to current and noncurrent asset.

- The basic steps in the recording system are analyzing traction, recording transaction to a journal and post the journal to a ledger.
- Journalizing is a process of entering a transaction in to a journal**.**
- A journal is a general journal if it records all business transaction, where as it is a special journal if record is made specific transaction types only.
- a single record of the journal is called an entry

Warm-up Discussion

- What distinguishes PPE,s from current assets
- Discuss which activities need to be recorded and which do not. Any that have economic effects should be recorded in a journal.
- Analyze the effects of transactions on asset, liability, and equity accounts.
- Explain the term source documents and its role in the recording process.

Next day's assignment

- Read about posting business transactions

Session 9 and 10 (Hr.17, 18, 19 and 20)

Topic:- Posting Journal to a Ledger

Session Learning Objectives

At the end of these sessions, students are expected to:

- Explain what a ledger is and its role in the recording process.
- Explain what posting is and how it helps in the recording process.
- Prepare a trial balance and explain its purposes.

Discussion issues:

- Posting
- Preparation of trial Balance

2.2.2. The Ledger

The entire group of accounts maintained by a company is the **ledger**. The ledger keeps in one place all the information about changes in specific account balances. Companies may use various kinds of ledgers for each account. But every accountmust have at least one ledger calleda general ledger. A **general ledger** contains all the asset, liability, and equity accounts.

The ledger provides the balance in each of the accounts and keeps track of changes in these balances. For example, the Cash account shows the amount of cash available to meet current obligations. The Accounts Receivable account shows amounts due from customers. The Accounts Payable account shows amounts owed to creditors. Each account is numbered for easier identification.

Standard Form of Account

The simple T-account format of a ledger used in accounting course is often very useful for illustration purposes. However, in practice, the account format (three-column format) is appropriate and standardized for the formal posting process. The **three-column form of an account**has three money columns—debit, credit, and balance. The balance in the account is determined after posting each entry. Companies use the Postreference (P/R) columns to specifying the source document for each posting and for cross checking purpose. Illustration 2.6 shows a typical form, using assumed data from a cash account.

Illustration 2.6 Three-column form of account

Date		Explanation	P/R	Debit		Credit		Balance	

Posting

The process of transferring information from a journal to a ledger is called **posting**. This phase of the recording process accumulates the effects of those journalized transactions into the respective ledger accounts. Posting involves the following steps.

1. In the **ledger**, enter, the date and amount shown in the journal in the appropriate column of the account(s) debited,
2. Enter the journal page number in the post reference column of the account
3. Enter account number in the post reference column of the **journal**.
4. In the **ledger**, enter, the date and amount shown in the journal, in the appropriate column of the account(s) credited,
5. repeat step 2 and 3

Illustration 2.7 the following illustration shows you how to recording and post transactions.

On April 1, 2016, Ato Enkopa Bfikir established a House Finishing and Decor business, during the month of April Ato Enkopa completed the following business transactions.

April 1. Enkopa transferred cash of Br. 50,000 fromhis personal bank account to the account opened by the name of the business. He has Br. 175,000 left in his personal bank account and one residential house worth br. 980,000 around Gereji.

April 3. Paid office rent for the month, Br. 3,000.

April 8. Purchased a used truck for Br.60,000, paying Br. 20,000 cash and giving a note payable for the remainder.

April12. Purchased various equipments on account, Br. 10,000.

April 14. Purchased supplies for cash, Br. 3,200.

April 14. Paid for a one year property insurance premium Br. 2, 400.

April 18. Received cash for job completed, Br. 14, 800.

April 21. Paid creditor a portion of the amount owed for equipment on April 13 April, 15, 000.

April 23. Sent invoices to customers, of Br. 9,600 service delivered on account.

April 25. Received an invoice for truck expenses, to be paid in May Br.1,000.

April 26. Paid Telephone and electric expense of the month, Br. 650

April 27. Paid miscellaneous expenses, Br. 420.

April 27. Received cash from customers on account, Br. 4,000.

April 29. Paid salary and wages of employees for the month, Br. 6,400.

April 30. Ato Enkopa the owner withdrew cash for personal use, Br. 1,800.

Instructions:

i. Journalize the above transactions using the general journal
ii. Post the Journal in to a ledger
iii. prepare Trail Balance

Summary Illustration of Journalizing and Posting

i. Journalizing

Illustration 2.7.1 Journal entries of the above transactions

General Journal **Page 1**

Date		Account Title and Descriptions	P/R	Debit	Credit
2016 April	1	Cash		50,000	
		Enkopa Capital			50,000
		(Initial Investment)			
	3	Rent Expense		3,000	
		Cash			3,000
		(Payment For rent)			
	8	Truck		60,000	
		Cash			20,000

		Notes payable				40,000	
		(Purchase of Truck)					
	12	Office Equipment		10,000			
		Cash				10,000	
		(Purchase of Equipment)					
	14	Supplies		3,200			
		Cash				3,200	
		(Purchase of Supplies)					
	14	Prepaid Insurance		2,400			
		Cash				2,400	
		(Purchase of insurance coverage)					
	18	Cash		14,800			
		service fee				14,800	
		(cash received from customers)					
	21	Notes payable		15,000			
		Cash				15,000	
		(Cash Paid on account)					
	23	Accounts Receivable		9,600			
		Service Fee				9,600	
		(Provision of service)					
	25	Truck Expense		1,000			
		Accounts payable				1,000	
		(Payment for Truck Expense)					
	26	Utilities Expense		650			
		Cash				650	
		(payment for Light and telephone)					
	27	Miscellaneous Expense		420			
		Cash				420	
		(Payment for various Expenses)					
						Page 2	

	27	**Cash**		**4,000**			
		Accounts Receivable				**4,000**	
		(cash received on account)					
	29	**Salary Expense**		**6,400**			
		Cash				**6,400**	
		(Salary payment)					
	30	**Enkopa's Drawing**		**1,800**			
		Cash				**1,800**	
		(Withdrawal of cash)					

ii. Posting the Journal to a Ledger

Illustration 2.7.2. Posting the above journal to individual ledger accounts

Before posting a journal you need to prepare charts of account. This helps you to open a ledger by the name of each account.

Charts of Account

The list of all accounts used by the business with their account numbers is called Charts of account. The account number is the identification code given to each account. Depending on the size of the businesses, companies might code their accounts using two or more digits. In a two digit coding the first digit represents account classification and the second indicates the position of the account with in the classification. For instance is 13 is given to an account Supplies: it is to mean that supplies is an assets account listed third.

Here is the chart of account for Enkopa House Finishing and Décor.

Enkopa House Finishing and Décor

Charts of Account

Account Title	Account Number	Account Title	Account Number
Asset		**Owner's Equity**	
Cash	11	Enkopa's capital	31
Accounts Receivable	12	Enkopa's Drawing	32
Supplies	13	Income Summery	33
Prepaid Insurance	14	**Revenue**	41
Office Equipment	15	Service Fee	

Accumulated Depreciation – Equipment 15-1		**Expenses**	
Truck	16	Salary Expense	51
Accumulated Depreciation – Truck	16-1	Rent Expense	52
Liabilities		Utilities Expense	53
Notes Payable	21	Truck Expense	54
Accounts Payable	22	Miscellaneous Expense	55

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

The reference column **of a ledger** account appoints the journal page from which the transaction was posted. The explanation column of the ledger account is used infrequently because an explanation already appears in the journal.

Illustration 2.7.2 below displayed all the postings of the above journal.

iii. Posting the Journal to a ledger

Illustration 2.7.2 posting of the above journal to the respective general ledgers accounts

Cash
Account No.11

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	**1**		**Jp1**	**50,000**				**50,000**	
	3		**Jp1**			**3,000**		**47,000**	
	8		**Jp1**			**20,000**		**27,000**	
	12		**Jp1**			**10,000**		**17,000**	
	14		**Jp1**			**3,200**		**13,800**	

	14		Jp1			2,400		11,400	
	18		Jp1	14,800				26,200	
	21		Jp1			15,000		11,200	
	24		Jp1	2,000				13,200	
	26		Jp1			650		12,550	
	27		Jp1			420		12,130	
	27		Jp2	4,000				16,130	
	29		Jp2			6, 400		9, 730	
	30		Jp2			1,800		7, 930	

Accounts Receivables
Account No. 12

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	23		Jp1	9,600				9,600	
	27		Jp1			4,000		5,600	

Supplies
Account No. 13

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	14		Jp1	3,200				3,200	

Prepaid Insurance
Account No. 14

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	14		Jp1	2,400				2,400	

Office Equipment
Account No. 15

Date	Explanation	P/R	Debit	Credit	Balance

2016 April	14		Jp1	10,000				10,000	

Truck
Account No. 16

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	8		Jp1	60,000				60,000	

Notes Payable
Account No. 21

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	8		Jp1			40,000		40,000	
	21			15,000				25,000	

Accounts Payable
Account No. 22

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	25		Jp1			1,000		1,000	

Unearned Service Revenue
Account No. 23

Date		Explanation	P/R	Debit		Credit		Balance		
2016	25		Jp1			2,000		2,000		

Enkopa's Capital
Account No. 31

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	1		Jp1			50,000		50,000	

Enkopa's Drawing
Account No. 32

Date		Explanation	P/R	Debit		Credit		Balance	
2016	30		Jp2	1,800				1,800	

Service Fee
Account No. 41

Date		Explanation	P/R	Debit		Credit		Balance	
2016	18		Jp1			14,800		14,800	
	23		Jp1			9,600		24,400	

Salary Expense
Account No. 51

Date		Explanation	P/R	Debit		Credit		Balance	
2016	29		Jp2	6,400				6,400	

Rent Expense
Account No. 52

Date		Explanation	P/R	Debit		Credit		Balance	
2016	3		Jp1	3,000				3,000	

Utilities Expanse
Account No. 53

Date		Explanation	P/R	Debit		Credit		Balance	
2016	26		Jp1	650				650	

Truck Expense
Account No. 54

Date		Explanation	P/R	Debit		Credit		Balance	
2016	25		Jp1	1,000				1,000	

Miscellaneous Expense
Account No. 55

Date	Explanation	P/R	Debit	Credit	Balance

2016	**27**		**Jp1**	**420**				**420**	

2.2.3. Trial Balance

A **trial balance** is a list of accounts and their balances at a given time. It list accounts in the order in which they appear in the charts of account. Debit balances appear in the left column and credit balances in the right column.

The trial balance proves the mathematical accuracy and equality of the total debits and the total credits after posting. Under the double-entry system, this equality occurs when the sum of the debit account balances equals the sum of the credit account balances. **In addition, a trial balance is useful in the preparation of financial statements**.

The steps for preparing a trial balance are:

1. List the account titles and their balances.
2. Total the debit and credit columns.
3. Prove the equality of the two columns.

iii.Trial Balance

Illustration 2.7.3. Trial balance

Enkopa House Finishing and Decor
Trial Balance
For the month ended April30, 1016

Account Title	Debit Balance	Credit Balance
Cash	**7,930**	
Accounts Receivable	**5,600**	
Supplies	**3,200**	
Prepaid Insurance	**2,400**	
Office Equipment	**10,000**	
Truck	**60,000**	
Notes Payable		**25,000**
Accounts Payable		**1,000**
Unearned Service Revenue		**2,000**
Enkopa's capital		**50,000**

Enkopa's Drawing	**1,800**	
Service fee		**24,400**
Salary Expense	**6,400**	
Rent Expense	**3,000**	
Utilities Expense	**650**	
Truck Expense	**1,000**	
Miscellaneous Expense	**420**	
Total	**102,400**	**102,400**

The trial balance for Enkopa House Finishing and Décor as of April30, 2016, is shown in illustration 2.7.3.The balances of the accounts in the above trial balance is taken from the ledger balance of the individual ledger illustration 2.7.2. Before the preparation of a trial balance the individual account balance of each account of ledger must be determined. The trial balance prepared immediately after completion of posting is called unadjusted trial balance. The above trial balance is known as an unadjusted trial balance. This is to distinguish it from the adjusted trial balances that we will prepare in the next chapters.

Limitations of a Trial Balance

A trial balance does not guarantee freedom from recording errors, however. Numerous errors may exist even though the totals of the trial balance columns agree. For example, the trial balance may balance even when (1) a transaction is not journalized, (2) a correct journal entry is not posted, (3) a journal entry is posted twice, (4) incorrect accounts are used in journalizing or posting, or (5) offsetting errors are made in recording the amount of a transaction. As long as equal debits and credits are posted, even to the wrong account or in the wrong amount, the total debits will equal the total credits. **The trial balance does not prove that the company has recorded all transactions or that the ledger is correct.**

Locating Errors

In locating errors the first activity is to determine the amount of the difference between the two columns of the trial balance. After this amount

is known, the following steps are often helpful:

1. If the difference is Br. 10, Br.100, or Br.1,000, it may be addition error, re-add the trial balance columns.
2. If the difference is divisible by 2, scan the trial balance to see whether a balance equal to half the error has been entered in the wrong column.
3. If the difference is divisible by 9, it is a transposition and slide error while copying. Retrace the account balances to see whether they are incorrectly copied from the ledger. For example, if a balance was Br. 43 and it was listed as Br.34, a Br.9 error has been made. Reversing the order of numbers is called a **transposition error**.
4. If the difference is not divisible by 2 or 9, scan the ledger to see whether an account balance in the amount of the error has been omitted from the trial balance, and scan the journal to see whether a posting of that amount has been omitted.

Correction of Error

Occasional error in journalizing and posting transactions are unavoidable. Procedures used to correct error in the journal and ledger varies according to the nature of the error and the duration which it is discovered.

If an error in the journal is discovered before the entry is posted, the correction will be made by drawing a line through the error and insert the correct account or amount immediately above.

If an entry in the journal is recorded correctly, but incorrectly posted to wrong side, i.e debit as credit, it will be corrected by drawing a line through the error and posting the correct item above it.

If an error in the journal is discovered after it is posted to the ledger, it will be corrected by recording and posting correcting entries.

Procedures for Correcting Entries

Error **Correction procedure**

- Error in recording but not yet posted — Draw a single line through the error
- Correct recording but incorrect posting — Draw a single line through the error
- Incorrect journal entry is posted — Journalize and post correcting entry

Lecture Synopsis

- A group of account is called a ledger.
- The process of transferring a journal to a ledger is called posting.
- Determine the ending balance by netting the total debits and credits.
- List of all accounts with their account number is called charts of account
- List of all accounts with their account balance is called trial balance.
- A trial balance proves the mathematical accuracy of the recording process.
- Trial balance doesn't give an absolute prove about the accuracy of the recording process.
- An entry made to correct recording error is called correcting entry.

Next day's assignment

- Read about the procedures for completion of accounting cycle

Session 11 and (Hr. 21and 22)

Topic:- Posting Journal to a Ledger

Session Learning Objectives

At the end of these sessions, students are expected to:

- Explain and prepare work sheet.
- Record and post adjusting and closing entries
- Prepare post closing trial balance

2.3. Completing an Accounting Cycle for Service Giving Business

Dear students in the previous part of this section we have tried to learn how business transactions are recorded posted and preparing of trial balance. Now in this part we will try to complete the accounting cycle and to issue financial statement. Then some accounts are adjusted and we have also seen why and how to adjust accounts. Completion of the accounting cycle involves the following completion activities,

i. Preparation of work sheet(optional Step)
ii. Preparation of financial statements
    a. Income Statement
    b. Statements of Owners Equity
    c. Statements of financial position
iii. Record and post adjusting entries
iv. Record and post closing entries
v. Preparation of post closing trial balance

The following trial balance is taken from Enkopa House Finishing prepared for April 30, 2016. This trial balance is prepared by taking the ending balance of each ledger. Such trial balance is referred to as unadjusted trial balance. So, adjusting (updating) accounts are required before preparation of financial statement. Although issues of Adjusting accounts will be deeply discussed in chapter 3, the following are the reasons for adjustment

1. To record those events which are not journalized daily, for example daily consumption of supplies like a piece of paper
2. To record those costs, which expire with time and are therefore not recorded, for example prepaid insurance or rent
3. To record those items previously unrecorded, for example accrued salary

Using the following information perform the instructions ordered below.

Enkopa House Finishing and Décor

Unadjusted Trial Balance

For the month ended April30, 1016

Account Title	Debit Balance	Credit Balance
Cash	**7,930**	
Accounts Receivable	**5,600**	
Supplies	**3,200**	
Prepaid Insurance	**2,400**	
Office Equipment	**10,000**	
Truck	**60,000**	
Notes Payable		**25,000**
Accounts Payable		**1,000**
Unearned Service		**2,000**
Enkopa's Capital		**50,000**
Enkopa's Drawing	**1,800**	
Service fee		**24,400**
Salary Expense	**6,400**	
Rent Expense	**3,000**	
Utilities Expense	**650**	
Truck Expense	**1,000**	
Miscellaneous	**420**	
Total	**102,400**	**102,400**

Information for adjustments

- Supplies on hand April 30,2016 Br.1,200
- Insurance expired during April 30,2016 Br. 200
- Deprecation of for Truck April 30,2016 Br. 100
- Deprecation of office equipment for April 30,2016 Br. 150
- Revenue earned for April 30, 2016, Br.1,300
- Salary accrued but not yet paid Br. 1,250

Instructions:- using the above information perform:

i. Prepare work sheet
ii. Prepare of financial statements
a. Income Statement
b. Statements of Owners Equity
c. Statements of financial position
iii. Record and post adjusting entries
iv. Recording and posting closing entries
v. Prepare Post Closing trial balance
vi. Preparation of post closing trial balance

i. Work Sheet

Worksheet is a working_paper of an accountant. It showed the details of accounting works and adjustment to check their arithmetical accuracy before preparing financial statements.

It is a multi-columnar sheet of paper used in the accounting cycle to facilitate the work of making adjusting and closing entries and preparingfinancial_statements. It is a working paper, which helps the accountant to assemble all the ledger account balance and adjustment information together on one schedule.

The basic objective of a worksheet is to organize the information needed to prepare financial statement without recording and posting adjusting entries.

Worksheet is a working tool or a supplementary device for the accountant and not a permanent accounting record.

A worksheet generally contains eight to ten columns. A ten column work sheet contains the following five column heading. Each item needs two amount column, one for debit the other for credit.

- **Unadjusted Trial Balance**:-a trial balance shows the balance of all accounts after adjustment at the end of the accounting period.
- **Adjustments**:- Shows accounts that are adjusted as per the adjustment information.
- **Adjusted trial balance**:-a trial balance shows the balance of all accounts after adjustment at the end of the accounting period.
- **Income statement**:- shows all revenue and expense accounts extended from the adjusted trail balance.
- **Balance sheet**. Shows all asset, liability, and equity accounts extended from the adjusted trail balance.

Steps in preparing worksheet

Step 1 entering unadjusted trial balance
Step 2 enter adjustments in the adjustments column
Step 3 prepare adjusted balance using unadjusted trial balance and adjustments column
Step 4 Extend the adjusted trial balance to the appropriate financial statements
Step 5 Total the income statement column and compute net income or net loss
Step 6 Extend the amount of the net income to credit column or the net loss to the debit column of the balance sheet and equate the columns

Enkopa House Finishing and Décor										
Work Sheet										
For April 30,1016										
Account Title	**Unadjusted Trial Balance**		**Adjustment**		**Adjusted trail Balance**		**Income Statement**		**Balance Sheet**	
	Debit	**Credit**	**Debit**	**Credi**	**Debit**	**Credi**	**Debit**	**Credi**	**Debit**	**Credi**
Cash	**7,930**				**7,930**				**7,930**	
Accounts	**5,600**				**5600**				**5600**	
Supplies	**3,200**			**a)2,0**	**1200**				**1200**	
Prepaid	**2,400**			**b)200**	**2,200**				**2,200**	
Office	**10,00**				**10,00**				**10,00**	
Accumulated Depreciation				**d)100**		**100**				**100**
Truck	**60,00**				**60,00**				**60,00**	
Accumulated				**c)150**		**150**				**150**
Notes		**25,00**				**25,00**				**25,0**
Accounts		**1,000**				**1,000**				**1,00**
Salary				**g)**		**1250**				**1,25**

Unearned		2,000	e)1,30			700				700
Enkopa's		50,00				50,00				50,0
Enkopa's	1,800				1800				1,800	
Service fee		24,40		e)1,3		25,70		25,7		
Salary	6,400		g)1,25		7,650		7,650			
Rent	3,000				3,000		3,000			
Utilities	650				650		650			
Truck	1,000				1000		1,000			
Miscellaneou	420				420		420			
Supplies			a)2,00		2000		2,000			
Insurance			b) 200		200		200			
Deprecation			c,d)		250		250			
Total	102,4	102,4	5,400	5,400	103,9	1037	15,17	2570	88,73	7820
Net income							10,53			10,5
Total							25,70 0	25,7 00	88,73 0	88,7 30

Illustration 3.7 shows you how to prepare worksheet

a. Statements of profit or loss and other comprehensive income

Enkopa House Finishing and Décor
Statements of profit or loss and other Comprehensive
For April 30,1016

Revenues		
Service Revenue		**Br. 25,700**
Expenses		
Salary Expense	**Br. 7,650**	
Rent expense	**3,000**	
Utilities Expense	**650**	
truck expense	**1,000**	
Miscellaneous expense	**420**	
supplies expense	**2,000**	
insurance expense	**200**	
Depreciation Expense	**250**	
Total Expense		**15,170**
Net Income		**10,530**

b. Owners Equity Statement

Enkopa House Finishing and Décor
Statements of Owner's Equity
For April 30,1016

Owners Capital January 1,	**50,000**	
Add Net income	**10,530**	
sub total		**60,530**
Less Drawing	**1,800**	
Owner's capital August 30,	**58,730**	

c. Statements of Financial Position

Enkopa House Finishing and Décor

Statements of Financial Position

For April 30,1016

Asset			
Non Current Asset			
Property,			
Truck	**60,00**		
Accumulated depreciation on truck	**150**		
		59,850	
Equipment	**10,00**		
Accumulateddepreciation on	**100**		
		9,900	
Total PPE's		**69,750**	
Current Asset			
Prepaid Insurance		**2,200**	
Supplies		**1,200**	
Accounts Receivable		**5,600**	
Cash	**7,930**		
Total Current			**16,930**
Total Asset		**86,680**	
Liability and Equity			

Owners equity			
Enkopa.'s			**Br. 58,730**
Liabilities			
Accounts Payable	**1,000**		
Salary	**1,250**		
Unearned	**700**		
Notes Payable		**25,000**	
Total Liability		_____	
Total Equity and liabilities		**Br. 86,680**	

vii. Recording Adjusting Entry

Adjusting Entry

201	**3**	**Supplies Expense**		**200**			
		Supplies				**200**	
		(Adjustment of supplies)					
	3	**Insurance Expense**		**200**			
		Prepaid Insurance				**200**	
		(Adjustment of insurance)					
	3	**Deprecation Expense**		**150**			
		Accumulated Dep.Truck				**150**	
		(Recognition of Deprecation)					
	3	**Deprecation Expense**		**100**			
		Accumulated Dep.Equip				**100**	
	3	**Unearned Revenue**		**1,30**			
		Service revenue				**1,30**	
		(Adjustments of unearned					
	3	**Salary Expense**		**1,25**			
		Salary Payable				**1,25**	
		(Recording Accrued Salary)					

vi. Recording Closing Entry

Closing Accounts

The revenue, expenses, and drawing 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 included in the permanent capital (Retained Earnings) account through closing entry. The balances must also be removed from the temporary accounts and transferred to permanent account so that will be ready for use in accumulating data for the following account period. Both of these goals are accomplished by a series of entries is called closing entries. Closing entries transfer the balances of temporary accounts to the owner's capital account.

The closing process involves the following four steps:

1. **Revenue** account balances are transferred to an account called **Income Summary**by debiting each service fee and crediting Income Summary for the total revenue.

2. **Expense** account balances are transferred to an account called **Income Summary**by crediting each expense account for its balance and debiting Income Summary for the total expenses.

3. The balance of **Income Summary** (net income or net loss) is transferred to the **owner's capital** account by debiting Income Summary for its balance and crediting the owner's capital account

4. The balance of the **Owner's Drawing** account is transferred to the **Owner's Capital** account debiting the owner's capital account for the balance of the drawing account and crediting the drawing account .

In the case of a net loss, Income Summary will have a debit balance after the firsttwo closing entries. In this case, credit Income Summary for the amount of its balanceand debit the owner's capital account for the amount of the net loss.Closing entries are recorded in the journal and are dated as of the last day of theaccounting period. In the journal, closing entries are recorded immediately followingthe adjusting entries. The caption, **Closing Entries,** is often inserted above the closing entriesto separate them from the adjusting entries

Closing Entries

Date		Account Title and Descriptions	P/R	Debit		Credit	
201	3	Service Fee		25,70			
		Income Summery				25,70	
		(Closing revenue					
	3	Income Summery		15,17			
		Salary Expense				7,650	
		Rent Expense				3,000	
		Utilities Expense				650	
		Truck Expense				1,000	
		Miscellaneous				420	
		Supplies Expense				2,000	
		Insurance Expense				200	
		Depreciation					
		(Closing Expense					
	3	Income Summery		10,,5			
		Owner's Capital				10,53	
		(Closing income					
	3	Owner's Capital		1,800			
		Owner's Drawing				1,800	
		(Closing Drawing					

A post-closing trial balance is prepared after the closing entries have been posted. Thepurpose of the post-closing (after closing) trial balance is to verify that the ledger is inbalance at the beginning of the next period. The accounts and amounts should agreeexactly with the accounts and amounts listed on the statements of financial position at the end of the period.

Enkopa House Finishing and Decor

Post Closing Trial Balance

For the month ended April30,1016

Account Title	Debit Balance	Credit Balance
Cash	7,930	
Accounts Receivable	5,600	
Supplies	1,200	
Prepaid Insurance	2,200	
Office Equipment	10,000	
Accumulated		100
Truck	60,000	
Accumulated		150
Notes Payable		25,000
Accounts Payable		1,000
Salary Payable		1250
Unearned Service		700
Enkopa's Capital		58,730
Total	86,930	86,930

2.1 The adjusting process-accrual vs. cash basis of accounting

2.2 Preparing a worksheet

2.3 Preparing financial statements from a worksheet

2.4 Adjusting and closing entries

Post-closing trial balance

Wrap-up Discussion Questions

- Explain the difference between journalizing and posting
- Explain the function of post reference column in the recording process.
- Why is posting necessary?
- Explain the purpose of preparing trial balance and its limitation.
- Explain the difference between per closing and post closing trial balance.

SELF-EXAMINATION QUESTIONS

1. a debit signify
    a. an increase in an asset account
    b. a decrease in an asset account
    c. An increase in a liability account
    d. an increase in the owner's capital
2. the type of account with the normal credit balance is:
    a. Asset
    b. Drawing
    c. A revenue
    d. An expense
4. the current asset category will include
    a. cash
    b. Accounts receivable
    c. Supplies on had
    d. all of the above
5. the receipt of cash from customers in payments of their accounts would be recorded by a
    a. debit to cash, credit to accounts receivable
    b. Debit to accounts receivable, credit to cash
    c. Debit to accounts payable, credit to accounts payable
    d. debit to accounts payable, credit to cash
6. the form listing the balances and the titles of accounts in the ledger on a given date is the:

a. Income statement
statement
b. statements of Financial position
c. retained earning
d. trial balance

ILLUSTRATIVE PROBLEM

Simret Abera, MD. has been practicing as a pediatrician for three years. During June, she has completed the following transaction.

June 1, Paid office rent for June Br. 6,000

2, Purchased equipment on account Br. 20,000

5, Received Cash on account from patients Br. 10,000

8, Purchased X-Ray film and other supplies on account Br. 450

9, One of the items of equipment purchased on june2 was defective. it was returned with the permission of the supplier, who agreed to reduce the account fot the amount charged for the item, br. 200

12, paid cash to creditors on account, 7,600

16, Sold X-Ray film to another doctor at coat, as an accommodation, receiving cash, Br. 500

17, Paid cash for renewal of a 2-year property insurance policy, Br, 1,800

20, Discovered that the balance of cash, and accounts payable as of june1 were overstated by br 160. A payment of that amount to a creditor in May had not been recorded. Journalize the Br. 160 payments as of June 20.

23, Paid cash for laboratory analysis Br. 2,450

27, Paid cash from the business's bank account for personal and family expenses br. 3,200

30, Recorded the cash received in payments of service to patients during June Br.13,700

30, Paid salaries of receptionists and nurses Br. 8,000

30, Paid water and electric expense Br,1,200

30, Recorded fees charged to patients on account for services performed Br, 3, 800

30, Paid telephone expense Br. 800

30, Paid miscellaneous expense br. 600

Samrwit's Account titles, numbers, and balances as of June 1 are listed as follows: Cash, 11, Br, 3,123, Accounts receivables, 12, Br, 6,725, Supplies, 13 Br. 290, Prepaid Insurance, 14, Br. 365, equipment, 15, Br. 19, 745, Accounts Payable, 21, BR. 765, Samrawit's capital, 31,Br.29,483, Samrawit's drawing, 32,, Professional Fee, 41, Salary Expense, 51, rent expense, 53, Libratory Expenses, 55 utility Expense, 56 Miscellaneous Expense, 59

Instructions

1. Open a ledger of four-column accounts for Dr. Samrawit as of june1 of the current year. Enter the balances in the appropriate balance column and place a check mark (-) in the post reference column. (Please check the equality of the debits and credits before proceeding to the next instruction.
2. Record each transactions using general journal
3. Post the journal to the ledger, extending the month end balances to the appropriate balance columns after all posting is completed.
4. Prepare a trial balance of june30.

CHAPTER THREE

ADJUSTING ACCOUNTS

Chapter over View

In the previous two chapters chapter you have tried to understand the basic accounting equation, how to capture business transactions using an accounting equation and how to complete the accounting cycle for service. Dear students' while we are completing the cycle we have meinshined the necessity of adjusting accounts before preparing financial statements at the end of the accounting period In this chapter you will have the detail discussion about why and how accounts are adjusted.

Learning Objectives:

After completing this chapter the students should be able to:

- Explain the time period assumption.
- Explain the accrual basis of accounting.
- Explain the reasons for adjusting entries.
- Prepare adjusting entries for deferrals
- Understand the characteristics of accruals
- Prepare adjusting entries for accruals.
- Apply alternative treatments for deferrals
- Describe the nature and purpose of an adjusted trial balance.

Session 12(Hr. 23 and 24)

Topic:- Adjusting Accounts

Session Learning Objective

- Explain the time period assumption.
- Explain the accrual basis of accounting.
- Explain the reasons for adjusting entries.
- Prepare adjusting entries for deferrals

Reading Assignment discussion

Discussion issues:

- Adjusting accounts

3.1. Adjusting Accounts

The issue of Adjusting Accounts deals with the timing issue, the basics of adjusting entry and the preparation of adjusted trial balance and financial statement.

3.1.1 Timing Issues

As per periodicity assumption, the economic life of the business is divided into artificial time periods, i.e, **a month, a quarter, or a year**. An accountingperiod which covers less than a year is an**interim period** and a financial report prepared for it is an interim report. An accounting time period that covers one year or 12 months in length is called a fiscal year. A fiscal year usually begins with the first day of a particular month and ends 12 months later on the last day of a month. Many businesses use the calendar year (January 1 to December 31) as their accounting period. Periodicity assumption requires revenues and expenses be reported in the proper period.

3.1.2. The Revenue Recognition Principle

As per IFRS revenue is recognized when the performance obligation is satisfied partially or completely. The earning process goes in line with the satisfaction of a particular performance obligation. In a service company revenue is usually considered to be earned at the time the service is performed. Where as in a merchandising company revenue is considered to be earned at the time the goods are delivered. Dear students you will learn the detailed concepts and applications of revenue recognition principle in your **IntermediateFinancial Accounting I** course.

To illustrate, assume that Dr. Leul Dental Clinic delivers brass dental service on December 25, 2016 but the customer going to pay for it on January 25, 2017. Here revenue should be recognized on December 25 on the date service is performed rather than on January 25 cash is collected. At December 31, the clinic would report a receivable on its statement of financial position and revenue in its income statement for the service performed. This requires recording of the respective adjusting entry.

3.1.3. Accrual versus Cash- Basis of Accounting

Under the accrual basis, companies record transactions that change a company's financial statements **in the periods in which the events occur**. This means that revenues should be recognized in the period when service is performed and expenses should be recognized in the period when incurred. Whether or not cash is received or paid. Accrual bases of accounting adhere to revenue recognition principle. As you recalled from chapter one it is one of the assumption of IFRS.

The alternative for the accrual basis is the cash basis of accounting. Under cash-basis accounting, revenue is recognized when cash is received, when as expenses are recognized when cash is paid. The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. It fails to record revenue for a company that has performed services and expanse that has incurred until cash is transacted. As a result, the cash basis does not obey the revenue recognition principle.

3.2. The Basics of Adjusting Entries

At the end of the accounting period, many of the account balances in the ledger can be reported in the financial statements without change. For example, the balances of the cash and office equipment accounts are normally the amount reported on the balance sheet. Under the accrual basis, however, some accounts in the ledger require updating because of the following reasons:

4. To record those events which are not journalized daily, for example daily consumption of supplies like a piece of paper
5. To record those costs, which expire with time and are therefore not recorded, for example prepaid insurance or rent
6. To record those items previously unrecorded, for example accrued salary

The process of updating an account is called adjusting. The journal entries recorded to that update an account called adjusting entries. The entries are required each time when financial statement is prepared. Each adjusting entries affect at least one income statement account and one balance sheet account. Thus, an adjusting entry will always involve revenue or an expense account in one side and an asset or a liability account in the other side.

3.3. Classifications and types of Adjusting Entries

3.3.1 Classification of Adjusting Entries

Adjusting entries can be categorized in to three. These are:

i. Prepayments or Deferrals (prepaid expense or unearned revenue),
ii. Accruals (Accrued revenue or Accrued expense), or
iii. Estimates (Deprecation or amortization)

Types of Adjusting Entry

i. Prepayments (Deferrals)

To defer means to postpone or delay. **Deferrals** are expenses or revenues that are recognized at a date later than the point when cash was originally paid or received. Companies make adjusting entries for deferrals to record the portion of the deferred item that was incurred as an expense or recognized as revenue during the current accounting period. The two types of deferrals are prepaid expenses and unearned revenues.

Prepayments

1. **Prepaid Expenses**: Expenses paid in cash and recorded as assets before they are used or consumed.
2. **Unearned Revenues**: Revenues received in cash and recorded as liabilities before they are earned.

ii. Accruals

Accrual is the recognition of revenue or an expense that has arisen but has not yet been recorded. The word “accrue” means to accumulate or grow in size. An accrual is the recognition of revenue or an expense that has accumulated overtime but has not yet been recorded. In order to report the company’s financial position and results of operation, the accruals requires adjustments. The adjusting entries for accruals are used to record revenues earned and expenses incurred in the current period. There are two types of accruals in accounting. These are:

Accruals

1. **Accrued revenues:** Revenues for services performed but not yet received in cash or recorded.
2. **Accrued expenses:** Expenses incurred but not yet paid in cash or recorded.

iii. Estimates

Deprecation is an allocation of the cost of capital assets to expense over their useful lives**.**The capital assets included office Equipments, Trucks or Building etc. These items give long years service and their serving capacity will reduce as a passage of time through use. The cost of a particular asset is allocated to expense by the amount of estimated reduction in periodic service giving capacity. Here adjusting entries are required to recognise expenses resulted from usage of capital assets.

3.4. **Analyzing and Recording Adjusting Entries for Deferrals**

Prepaid Expenses

When expenses are prepaid, an asset account called “prepaid expense” is increased (debited) to show the service or benefit that the company will receive in the future. Examples of common prepayments are insurance, supplies, advertising, and rent.

Prepaid expenses are costs that expire either with the passage of time (e.g., rent and insurance) **or through use** (e.g., supplies). The expiration of these costs does not require daily entries, which would be impractical and unnecessary. Accordingly, companies postpone the recognition of such cost expirations until they prepare financial statements. At each statement date, they make adjusting entries to record the expenses applicable to the current accounting period and to show the remaining amounts in the asset accounts.

Prior to adjustment, assets are overstated and expenses are understated. Therefore, **an adjusting entry for prepaid expenses results in an increase (a debit) to an expense account and a decrease (a credit) to an asset account**.

Let’s look in more detail at some specific types of prepaid expenses, beginning with supplies.

Supplies

The purchase of supplies, such as paper and envelopes cleaning supplies, results in an increase (a debit) to an asset account. During the accounting

period, the company keeps using of the supplies purchased without making the respective record. At the end of the accounting period, the company counts the remaining supplies and deducts it from the unadjusted balance in the Supplies (asset) account to determine the used portion. Thenrecord an adjusting entry by debiting supplies expenses and crediting supplies account for the used portion.

Illustration: As you remember the transaction 3 Enkopa House finishing and Décor of chapter 2, the company purchased supplies costing Br. 3,200 on April 14,2016. The purchase was record by debiting the asset account supplies. This account shows a balance of Br.3, 200 in the April 30 trial balance. An inventory count at April 30 reveals that Br. 1,200 of supplies are remained on hand. This means the company consumed supplies costing br. 2,000. This reduces supplies and increase supplies expense by the amount consumed. As a result Enkopa needs to record this adjustment using adjusting entries. Illustration 3.1 presents the adjustments.

2016	**30**	**Supplies Expense**		**2,000**			
		Supplies				**2,000**	
		(Adjustments for supplies Used)					

After recording the adjusting entry it is posted to the appropriate accounts as follows.

Supplies

Account No. 13

Date		Explanation	P/R	Debit		Credit		Balance	
2016	**14**		**Jp1**	**3,200**				**3,200**	
	30	**Adjusting Entry**				**2,000**		**1,200**	

Supplies Expense

Account No. 53

Date	Explanation	P/R	Debit	Credi	Balance

2016	30	Adjusting Entry	Jp1	2,000				2,000	

NB: After adjustment, the asset account Supplies shows a balance of Br. 1,200, which is equal to the cost of supplies on hand at the statement date. In addition, Supplies Expense shows a balance of br. 2,000, which equals the cost of supplies used in April. **If Enkopa did not make the adjusting entry, April expenses are understated and net income is overstated by** Br. 2**,000. Moreover, both assets and equity will be overstated by** Br.**2,000 on the April 30 statement of financial position.**

Insurance

Companies purchase insurance to protect themselves from losses due to fire, theft, and unforeseen events. Insurance must be paid in advance, often for more than one year. The cost of insurance (premiums) paid in advance is recorded as an increase (debit) in the asset account **Prepaid Insurance**. At the financial statement date, companies increase (debit) Insurance Expense and decrease (credit) Prepaid Insurance for the cost of insurance that has expired during the period.

Illustration:as you recall in previous chapter discussion Enkopa paid Br. 2,400 for a one year insurance premium on April 14, 2016. The Company recorded the payment by increasing (debiting) Prepaid Insurance and decreasing (Crediting) Cash. Prepaid insurance shows a debit balance of Br.2,400 in the April 30, 2016 trial balance before adjustment. Insurance of Br. 200expires each month. The adjusting entry is recorded in illustration 3.2 as follows.

2016	30	Insurance Expense		200			
		Prepaid Insurance				200	
		(Adjustments for insurances					

The above adjusting entry is posted to appropriate accounts as follows.

Prepaid Insurance **Account No. 14**

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	14		Jp1	2,400				2,400	
	30	Adjusting				200		2,200	

Insurance Expense **Account No. 54**

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	30	Adjusting Entry	Jp1	200				200	

After posting the adjusting entry the asset Prepaid Insurance shows a balance of Br. **2,200**, this represents the unexpired cost for the remaining 11 months of coverage. On the other hand, the balance in Insurance Expense equals the cost of insurance expired during April. **If Enkopa does not make this adjustment, April expenses are understated by** Br. **200 and net income is overstated by** Br. **200. Moreover, both assets and equity will be overstated by 200 on the April 30 statement of financial position.**

3.5. Alternative Treatment of Prepaid Expenses and Unearned Revenues

In discussing adjusting entries for prepaid expenses and unearned revenues, we have illustrated transactions for which companies made the initial entries to statement of financial position accounts. In the case of prepaid expenses, the company debited the prepayment to an asset account. In the case of unearned revenues, the company credited a liability account to record the cash received in advance.

Some companies use an alternative treatment: i.e. (1) When a company prepays an expense, it debits an expense account instead of asset. (2) When it receives advance payment for future services, it credits the amount to a revenue account instead of liability. Companies prefer to use this alternatives if they think that prepayments are fully consumed in the period payment is made and delivery of service is completed in the same period advance collection is made. This alternative treatment of prepaid expenses and unearned revenues has the same effect on the financial statements as the procedures described in the chapter.

Prepayments initially recognized as expense

To illustrate, assume that on December 1, 2016 Fresh Corner acquired supplies of Br. 1,000 for cash. The company records prepayments initially as expanse and passes the following Journal entry

2016	**1**	**Supplies Expense**		**1000**			
		Cash				**1000**	
		(to record purchase of supplies as expense)					

As you see from the above illustration an expense account (supplies expense) recognized in advance. Here the company expects that it will use all the supplies purchased before December 31. If the supplies are used fully as expected there is no need for adjusting entry at the end of the accounting period.

But what if, a br. 200 inventory of supplies is left un-used at the end of the month December 31. If so adjusting entry is required to reduce the expense account (Supplies expense) and increase and asset account (Supplies) by the amount of the unused portion of supplies as follows.

2016 Dece	**31**	**Supplies**		**200**			
		Supplies expense				**200**	
		(to record supplies inventory)					

After recording the adjusting entry posting is made to the appropriate accounts as follows

supplies expense

Date		Explanation	P/R	bit		Credit		Balance	
2016	1		Jp1	1000				1,000	
	3	Adjusting	Jp			200		800	

Supplies

Date		Explanation	P/R	Debit		Credit		Balance	
2016	31	Adjusting Entry	Jp1	200				200	

After posting the asset account Supplies shows a balance of Br.200, which is equal to the cost of supplies on hand at December 31. In addition, Supplies Expense shows a balance of Br. 800. This is equal to the cost of supplies used between December 1 and December 31. Without the adjusting entry, expenses are overstated and net income is understated by 200 in the October income statement. Also, both assets and equity are understated by Br.200 on the December 31 statement of financial position.

Comparison of Adjustments of prepayments

Prepayments initially recorded as									
Asset						**Expense**			
	1	**Supplies**	**1000**			**Supplies**	**1000**		
		Cash		**1000**		**Cash**		**1000**	
To record purchase of supplies									
	2	**Supplies expense**	**800**			**Supplies**	**200**		
		Supplies		**800**		**Supplies**		**200**	
Adjustment at used portion						**Adjust at unused portion**			

Debit **Credit**

Dec 1,

Supplies

1,000				**Bal.**	**Br. 200**
	800	**Dec 31**			

supplies

Debit	Credit
Dec 1 - Dec 31 200	-

Supplies Expense

Debit	Credit
Bal. Br. 200	
Dec 1, -	

Dec.31 Bal. Br.800	

Supplies Expense

Debit	Credit
Dec1 1000	- 200 Dec31
Bal. Br. 800	

As you see from the above illustration the ending balance of supplies ledger under both treatments the same Br. 200 and also supplies expanse account shows an equal balance of in both cases. As a result the alternative treatment of prepaid expenses has the same effect on the financial statements as the procedures described in the chapter.

Unearned Revenue

When companies receive cash before performing service, they record a liability by increasing (crediting) Unearned Revenue. Advance collections for rent, magazine subscriptions, airplane tickets and tuition may result in unearned revenues. Unearned revenue represents the presence of performance obligation (liability) to deliver a service to particular customers. The company subsequently recognizes revenues when service is performed. But performance of service does not involve daily transaction. As a result the recognition of revenue delays until the date of adjustment. Then, the company makes an adjusting entry to record the revenue earned for services performed and the liability settled at the end of the accounting period. Typically, prior to adjustment, liabilities are overstated and revenues are understated. Therefore, as shown in Illustration 3.3, **the adjusting entry for unearned revenues results in a decrease (a debit) to a liability account and an increase (a credit) to a revenue account**.

Alternative Terminology: Unearned revenue is sometimes referred to as *deferred revenue*.

Illustration: As you remember from Illustration 3.3 of chapter 2 Enkopa received Br. 2,000 from clients in advance for the finishing service. Unearned Service Revenue shows a balance of Br.2, 000 in the April trial balance. Analysis reveals that the company performed Br.1, 300 services in April.

The liability (Unearned Service Revenue) is therefore decreased, and equity (Service Revenue) is increased by the amount.

	3	**Unearned service Revenue**		**1,300**			
		Service Revenue				**1,300**	
		(Adjustments for unearned					

Unearned Service revenue

Account No. 23

Date		**Explanation**	**P/R**	**Debit**		**Credit**		**Balance**	
2016	**25**		**Jp1**			**2,000**		**2,000**	
	3	**Adjusting**		**1,300**				**700**	

Service Revenue

Account No. 41

Date		**Explanation**	**P/R**	**Debit**		**Credit**		**Balance**	
2016 April	**18**					**14, 800**		**14,800**	
	2		**Jp1**			**9,600**		**24,400**	
	3	**Adjusting**				**1,300**		**25,700**	

After recording and posting adjusting entries the liability Unearned Service Revenue now shows a balance of Br.700 I.e the amount represents the remaining finishing services expected to be performed in the future. On the other hand Service Revenue shows total revenue recognized in April

26,600. **Without this adjustment, revenues and net income are understated by** Br. 1,300**. Moreover, liabilities are overstated and equity is understated by** Br. 1,300 **on the April 30 statement of financial position.**

Advance Collections Initially Recognized as Revenue

Unearned Revenue

Unearned revenues are recognized as revenue at the time services are performed. Similar to the case for prepaid expenses, companies may credit (increase) revenue account when they receive cash for future services.

To illustrate, assume that on December 1Birhana Selam Printing press received Br. 8,000 in advance to subscribe publishing service and expects to perform the services before December 31. As per this expectation the company records advance collection as revenues.

2016 Dece	**1**	**Cash**		**8,000**			
		Service fee				**8,00**	
		(to record advance collection)					

If the publication service is fully performed as expected there is no need for adjusting entry at the end of the accounting period.

But what if, a br. 1,800 worth subscription service is not yet performed on December 31. If so adjusting entry is required to reduce the revenue account (Service fee) and increase a liability account (unearned service fee) by the amount of the unfulfilled portion of supplies as follows.

2016 Decembe	**1**	**Service fee**		**1,800**			
		Unearned service fee				**1,80**	
		(to adjust advance collection)					

After recording the adjusting entry posting is made to the appropriate accounts as follows

Service fee

Date		Explanation	P/R	Bit		Credit		Balance	
2016	1		Jp1			8000		8, 000	
	31	Adjusting entry	Jp 2	1,800				6,200	

Unearned service fee

Date		Explanation	P/R	Debit		Credit		Balance	
2016	31	Adjusting Entry	Jp1			1,800		1,800	

The liability account Unearned Service fee shows a balance of Br.1,800. This equals the services that will be performed in the future. In addition, the balance in Service fee equals the services performed in December. Without the adjusting entry, both revenues and net income are overstated by Br. 1800 in the December income statement. Also, liabilities are understated by Br. 1,500, and equity is overstated by Br.1,500 on the December 31 statement of financial position.

Comparison of Adjustments of unearned revenue

Unearned Initially Recorded as:									
Liability					**Revenue**				
	1	**Cash**	**8,000**			**Cash**	**8,00**	
		Unearned serv.		**8,000**		**Service fee**		**8,00**
To record purchase of supplies									
	2	**Unearned serv. fee**	**6,500**			**Service fee**	**1,50**	
		Supplies		**6,500**		**Unearned**		**1,50**
Adjustment at performed portion					**Adjust at unperformed portion**				

Unearned service fee

Debit		Credit	
-		8,000	Dec 1
Dec 31	Bal.		Br.
	1,500		

Unearned service fee

Debit	Credit
-	- Dec 31 1,500
	Bal. Br. 1,500

Service fee

Debit	Credit
- Dec.31	- Dec 1
	Bal. Br.6,500

Service fee

Debit	Credit
- Dec 31	Dec1 8,000
	Bal. Br.6,500

NB: Dear student, under both treatments **service fee**, has a balance of Br. 6,200 and **unearned service fee** has a balance of Br. 1,800. As a result application of the treatments has the same effect on income statement and financial position statement.

NB: this alternative treatment for unearned revenue is not recommended by IFRS

Synopsis of lecture:

- As per periodicity assumption an accounting time period that covers a year in length or 12 months is called a fiscal year.
- The revenue recognition principle stats that revenue should be recognized in the period in which it is measured reliably.
- The principle of expense recognition is referred to as the matching principle.
- The journal entries that bring the accounts up to date at the end of the accounting period are called adjusting entries.
- Adjusting entries can be categorized in to three. i.e. ***Deferrals*** (prepaid expense or unearned revenue),***Accruals*** (Accrued revenue or Accrued expense), and ***Estimates*** (Deprecation or amortization)
    - Deferrals are expenses or revenues that are recognized at a date later than the point when cash was originally paid or received
    - Accrual is the recognition of revenue or an expense that has arisen but has not yet been recorded.

Wrap-up discussion Question

- Discuss the basic issues behind adjusting accounts
- describe what is meant by a fiscal year and a natural business year
- Explain the reasons for adjusting accounts
- Compare and contrast cash basis of accounting with that of accrual basis of accounting
- Identify the major types of adjusting entries

Next day's assignment

Read about adjustments for accruals

Session 13(Hr. 25 and 26)

Topic: - Adjusting Entries for Accruals

Session Learning Objectives

- Understand the characteristics of accruals

- Prepare adjusting entries for accruals.
- Apply alternative treatments for deferrals
- Describe the nature and purpose of an adjusted trial balance.

Reading Note

3.6. **Analyzing and Recording Adjusting Entries for Accruals**

Accrued Revenue

Revenues for services performed but not yet collected and recorded at the statement date are accrued revenues. Accrued revenues may accumulate (accrue) with the passing of time, as in the case of interest revenue. These are unrecorded because the earning of interest does not involve daily transactions. Companies do not record interest revenue on a daily basis because it is often impractical to do so. Accrued revenues also may resulted from services that have been performed but not yet billed or collected, as in the case of commissions and fees. These may be unrecorded because only a portion of the total service has been performed and the clients will not be billed until the service has been completed.

An adjusting entry records the receivable that exists at the statement of financial position date and the revenue for the services performed during the period. Prior to adjustment, both assets and revenues are understated. As shown inillustration 3.3, **an adjusting entry for accrued revenues results in an increase (a debit) to an asset account and an increase (a credit) to a revenue account**.

NB: For accruals, there may have been no prior entry, and the accounts requiring adjustment may both have zero balances prior to adjustment.

Illustration:during the month April Enkopa performed finishing services worth Br. 800 that were not billed to clients on or before April 30.

Because these services are not billed, they are not recorded. The accrual of unrecorded service revenue increases an asset account called Accounts Receivable. It also increases equity by increasing a revenue account, Service Revenue, as shown in illustration 3.4.

	3	**Accounts Receivable**		800				
		Service Revenue				800		
		(Adjustments for unearned						

Accounts Receivables Account No. 12

Date		Explanation	P/R	Debit		Credit		Balance	
2016	23		Jp1	9,600				9,600	
	3	Adjusting				4,000		5,600	
	30	Adjusting		800				6,400	

Service Revenue
Account No. 41

Date		Explanation	P/R	Debit		Credit		Balance	
2016	18					14, 800		14,800	
	2		Jp1			9,600		24,40	
	3	Adjusting				1,300		25,70	
	3	Adjusting				800		26,50	

After posting the adjusting entry the asset Accounts Receivable shows a balance of Br.6,400 i.e (9,600-4,000+ 800) on the other hand the updated balance of service revenue is 26,500, i.e (Br. 14,800 + 9,600 +1,300+ 800). **Without the adjusting entry, assets and equity on the statement of financial position and revenues and net income on the income statement are understated.**

Accrued Expenses

Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses. Salarypayables, rent payable, Interest payable, are common examples of accrued expenses.

Companies make adjustments for accrued expenses to record the obligations that exist at the statement of financial position date and to recognize the expenses that are applied to the current accounting period. Prior to adjustment, both liabilities and expenses are understated. Therefore an **adjusting entry has to be made that result in an increase (a debit) to an expense account and an increase (a credit) to a liability account**.

Illustration: Enkopa paid salaries and wages on April 25 for its employees' first two weeks of work. The next payment of salaries will not occur until May 10. As illustration 3.5 Shows, five working days salary of Br. 1,250 is remained unpaid and unrecorded in April (April 26–30).

Recording adjusting entries for accruals

2016	**30**	**Salary Expense**		**1,250**			
		Salary payable				**1,250**	
		(Recognition of Accrued					

As you see from the above table, the company accrued 5 days salary and record adjusting entries At April 30. The entry increases both an expense(salary expense) and a liability account (Salaries Payable). It also decreases equity by increasing an expense account, Salaries and Wages Expense.

Posting Adjusting entries

Salary payable
Account No. 24

Date		**Explanation**	**P/R**	**Debit**		**Credit**		**Balance**	
2016	**30**	**Adjusting Entry**	**Jp2**			**1,250**		**1,250**	

Salary Expense

Account No. 51

Date		Explanation	P/R	Debit		Credit		Balance	
2016 April	**29**		**Jp1**	**6,400**				**6,400**	
	3	**Adjusting**	**Jp**	**1,250**				**7,650**	

After posting the adjusting entry, the balance in Salaries and Wages Expense of Br.7,650 is the actual salary and wages expense for April. The balance in Salaries and Wages Payable of Br. 1,250 is the amount of the liability for salaries and wages Enkopa owes as of April 30. **Without the** Br.**1, 250adjustmentsfor salaries expense, the company understated expense by** Br. **1,200 and its liabilities by Br.1, 250.**

Deprecation

A company typically owns a variety of assets that have long lives, such as buildings, equipment, and motor vehicles. The period of service is referred to as the useful life of the asset. Because a building is expected to be of service for many years, it is recorded as an asset, rather than an expense, on the date it is acquired. As explained inChapter 1, companies record such assets **at cost**, as required by the historical cost principle. To follow the expense recognition principle, companies allocate a portion of this cost as an expense during each period of the asset's useful life.Depreciation is the process of allocating the cost of an asset to expense over its useful life.

The acquisition of long-lived assets is essentially a long-term prepayment for the use of an asset. An adjusting entry for depreciation is needed to recognize the cost that has been used (an expense) during the period and to report the unused cost (an asset) at the end of the period. An important point to understand here is that: **Depreciation is a concept of cost allocation, not a valuation concept.** That is, depreciation **allocates an**

asset's cost to the periods in which it is used. Depreciation does not attempt to report the actual change in the value of the asset.

Illustration 3.6, As per illustration 2.8 of chapter 2 Enkopa acquired equipment and Truck worth Br. 10,000 and Br. 60,000. Assume that depreciation on the equipment and truck is Br. 1,200 and 1,800 a year, or br. 100 and 150 per month respectively.

	3	**Depreciation Expense**		**250**				
		Accumulated depreciation-				**100**		
		Accumulated depreciation-Truck						
		(Adjustments for unearned						

Accumulated depreciation-equipment

Account No. 15-1

Date		**Explanation**	**P/R**	**Debit**		**Credit**		**Balance**	
2016	**30**	**Adjusting Entry**	**Jp1**			**100**		**100**	

Accumulated depreciation- Truck **Account No.**

Date		**Explanation**	**P/R**	**Debit**		**Credit**		**Balance**	
2016	**30**	**Adjusting Entry**	**Jp1**			**150**		**150**	

Depreciation Expense

Date		**Explanation**	**P/R**	**Debit**		**Credit**		**Balanc**	
2016	**30**	**Adjusting Entry**	**Jp1**	**250**				**250**	

Here rather than decrease (credit) the asset account directly, Enkopa credits Accumulated Depreciation—Equipment and accumulated depreciation on Truck account. Accumulated Depreciation is called a contra asset account. Such an account is offset against an asset account on the statement of financial position. **This account keeps track of the total amount of depreciation expense taken over the life of the asset.** To keep the accounting equation in balance, Enkopa increasing an expense account, Depreciation Expense.

The balance in the Accumulated Depreciation—Equipment and Accumulated Depreciation –Truck account will increase Br. 100 and 150 each month, and the balance in Equipment and truck remains Br, 10,000 and br. 60,000 respectively.

Statement Presentation

As indicated, Accumulated Depreciation—Equipment is a contra asset account. It is offset against Equipment on the statement of financial position. The normal balance of a contra asset account is a credit. A theoretical alternative to using a contra asset account would be to decrease (credit) the asset account by the amount of depreciation each period. But using the contra account is preferable for a simple reason: It discloses **both** the original cost of the equipment **and** the total cost that has been expensed to date. Thus, in the statement of financial position, Enkopa deducts Accumulated Depreciation—Equipment from the related asset account. The same procedure is made while presenting truck on the statements of financial position.

NB: All contra accounts have increases, decreases, and normal balances opposite to the account to which they relate.

Statement of financial position presentation of accumulated depreciation

Equipment	Br. 10,000

Less Accumulated Deprecations-Equipment	100
	Br.9,000

The Adjusted Trial Balance and Financial Statements

After a company has journalized and posted all adjusting entries, adjusted trial balance is prepared using updated balance of the ledger accounts. Adjusted trial balance shows the balances of all adjusted accounts, at the end of the accounting period. The purpose of an adjusted trial balance is to **prove the equality** of the total debit with the total credit after adjustment. The adjusted trial balance is the**basis for the preparation of financial statements**.

Synopsis of Lecture

- Adjusting entries should not involve debits or credits to cash.
- Adjusting entries for accruals will increase both a statement of financial position and an income statement account.
- Each adjusting entry affects one statement of financial position account and one income statement account.
- Adjusted trial balance is thebasis for the preparation of Financial Statements.

Warp-up Discussion Question

- Explain the why adjusted trial balance is necessary
- Identify the major difference between adjustments of deferrals with the alternative treatment
- Explain the consequences of the failure recording adjusting entries for accruals and deferral

SELF EXAMINATION QUESTION

1. Which of the following is correct when a company uses accrual bases of accounting
    a. Revenue is recognized only when cash is received
    b. Expense should be recorded in the period when cash is paid
    c. Revenue and expense relating for the period should be recognizes regardless of cash exchange
    d. revenue should be recognized in accrual bases and expenses on cash payment basis

2. An accrued expense was overlooked to be recorded when preparing income statement, the effect of this error is that
    a. Net income is not affected but liability is overstated
    b. Net income is overstated and liability is understated
    c. Net income as well as liability are overstated
    d. Net income as well as liability are understated
3. a staff salary remained unpaid as of the year end should be incurred by
    a. debiting salary accrued and crediting staff salary expense
    b. debiting staff salary expense and crediting salary accrued account
    c. Debiting prepaid salary and credit staff salary account
    d. debiting staff salary expense and crediting cash
4. Prepaid rent account has a balance of br. 9,800 at the beginning of the year, The company is agreed to pay br. 1,200 per month. assume the company is unable to make any payment for rent during the year, which of the following holds true at the end of the fiscal year?
    a. Prepaid rent has a balance of br. 4,800
    b. Accrued rent has a balance of Br. 9,800
    c. Prepaid rent has a balance of br. 9,800
    d. Accrued rent has a balance of Br. 4,800
5. Which of the following statements is *incorrect* concerning the worksheet?
    a. The worksheet is essentially a working tool of the accountant.
    b. The worksheet is distributed to management and other interested parties

c. The worksheet cannot be used as a basis for posting to ledger accounts.
d. Financial statements can be prepared directly from the worksheet before journalizing and posting the adjusting entries.

6. 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).
7. When a net loss has occurred, Income Summary is:
   a. Debited and Owner's Capital is credited.
   b. Credited and Owner's Capital is debited.
   c. Debited and Owner's Drawings is credited.
   d. Credited and Owner's Drawings is debited.
8. The closing process involves separate entries to close (1) expenses, (2) drawings, (3) revenues, and (4) income summary. The correct sequencing of the entries is:
   a. (4), (3), (2), (1)
   b. (3), (1), (4), (2)
   c. (1), (2), (3), (4)
   d. (3), (2), (1), (4)
9. The proper order of the following steps in the accounting cycle is:
   a. Prepare unadjusted trial balance, journalize transactions, post to ledger accounts, journalize and post adjusting entries.
   b. Journalize transactions, prepare unadjusted trial balance, post to ledger accounts, journalize and post adjusting entries.
   c. Journalize transactions, post to ledger accounts, prepare unadjusted trial balance, journalize and post adjusting entries.
   d. Prepare unadjusted trial balance, journalize and post adjusting entries, journalize transactions, post to ledger accounts.

ILLUSTRATIVE PROBLEM

The following unadjusted trial balance belongs to Liyou Consulting Firm for the fiscal year ended December 31, 2016.

Liyou Consulting Firm

Trial Balance

December 31,2016

Account Titles	**Debit**	**Credit**
Cash		12,500
Accounts Receivable		4,380
Supplies		1,330
Prepaid Insurance	3,600	
Equipment	50,000	
Notes Payable		20,650
Accounts Payable		17,400
Owner's Capital		26,460
Owner's Drawings	1500	
Service Revenue		19,620
Salaries and Wages Expense	6,120	
Rent Expense	4,200	
Miscellaneous Expense	500	
Total	**84,130**	**84,130**

Additional Data for Adjustment

1. Supplies on hand total Br. 500.

2. Depreciation is br. 5000 per quarter.

3. Interest accrued on 6-month note payable, issued September Br. 120.

4. Insurance expired during the period Br. 2,000

5. Services provided but unbilled at December 31 total br.2, 500

6. Salary Accrued but not yet paid br. 1,500.

Instructions

a. Enter the trial balance on a worksheet and complete the worksheet.
b. Prepare an income statement and owner's equity statement for December 31 and financial position statement as of December 31.
c. Journalize the adjusting entries from the adjustments columns of the worksheet.
d. Journalize the closing entries from the financial statement columns of the worksheet.
e. Prepare post closing Trial Balance

CHAPTER FOUR

ACCOUNTING FOR A MERCHANDISING BUSINESS

Chapter Overview

Dear students' in the previous two chapter i.e chapter 2 and 3, you have learnt about the accounting for a service giving business. In the completion of those chapters you are familiar with each activity undertaken in the recording process, adjusting, closing and completion of an accounting cycle as a whole. Having that in mined in this chapter you will learn about the overall accounting activities applicable for merchandising business. The recording process, completion of work sheet, the adjustment and closing activities will be discussed in detail. Dear student accounting activities for merchandising business is more or less similar with that of the service giving business except the presence of additional unique transactions, accounts and adjustments. What are those unique items? Grasp it from the chapter.

Learning Objectives:

After completing this chapter the students should be able to:

- Identify the differences between service and merchandising companies.
- Explain the recording of purchases under perpetual inventory and periodic system.
- Explain the recording of sales revenues under periodic and perpetual inventory system.
- Prepare charts of account for a merchandising business
- Complete the accounting cycle for a merchandising business

Session 14 (Hr. 27 and 28)

Topic:-Accounting for a Merchandising Business

Session Learning Objectives

- Identify the differences between service and merchandising companies.
- Explain the recording of purchases under perpetual inventory and periodic system.

Reading Assignment

Read about a merchandising business and identify the treatments of its unique transaction

4.1. Definition of a Merchandising Business

A merchandizing Businesses is a business that buy and sale Merchandise. The principal source of revenue for a merchandising business is sales of merchandise. The account used to record this revenue is **sales**. A merchandising business that sale to retailers is a **whole seller;** where as a merchandising business that sale to finale users or customers is called **retells**. Unlike service giving company merchandising companies has two major expenses. i.e **Cost of Goods sold** and **Operating expense**.

Comparisons of Merchandising and Service Company

Merchandising Service Giving

- Long operating cycle — Short Operating cycle
- has two major expenses — One major expense

Sales ..... X — Sales X

-Cost of Goods sold .....X- Operating Expenses.....X

Gross Profit .....,.....X — Net income..... X

Operating Expense..... X

Net Income X

4.2. Operating Cycle of Merchandising Businesses

The operations of a merchandising business involve the purchase of merchandise for sale (purchasing), the sale of the products to customers

(sales), and the receipt of cash from customers (collection). This overall process is referred to as the operating cycle.

Thus, the operating cycle begins with spending cash, and it ends with receiving cash from customers. When we compare it with service giving business, service giving business involves rendering of service to customers and receiving cash from customers. As a result the operating cycle of merchandising businesses is longer than service giving business.

Cost flow Assumption

Cost flow assumption is about the transfer of a particular cost from one cost object or item to another. The flow of costs for a merchandising company is as follows. Beginning inventory plus the cost of goods purchased is the cost of goods available for sale. As goods are sold, they are assigned to cost of goods sold and those goods which are not sold by the end of the accounting period represent, ending inventory.

4.3. Merchandising Inventory System

A system used in determining the cost of merchandise sold and the cost of merchandise on hand is called inventory system. Basically there are two inventory systems in practice, i.e **Periodic inventory system** and **perpetual inventory** system. Companies use one of the two systems to account for inventory costs

i. Periodic Inventory System

There is no continuous record of inventory items. I.e Purchase and sales of each inventory is not directly recorded to inventory account.

Company's which use periodic inventory system debited Purchase of merchandise to a purchase account instead of an inventory account

d. Transportation costs covered by the business is debited to **Transportation -in** account

e. Purchase return and allowance is credited to **Purchase Return and Allowance** account
f. Purchase discount is credited to **Purchase Discount** account
g. Sales revenue is credited to sales but no record is made on the reduction on inventory on hand due to sales
h. have a constant balance (the ending balance of the previous period)
i. require a physical inventory at least once per year to determine inventory balance
j. require a calculation of the of cost of goods sold
k. Preferred by companies which hold small volume and less costly items, like shops.

ii. Perpetual inventory system

l. There is a continuous record of inventory items. i.e records cost of each inventory purchase and sale directly to the inventory account

In a *perpetual system* the account Inventory will:

- be debited when there is a purchase of goods (there is no Purchases account)
- be debited when there is transportation cost(there is no transportation- in account)
- be credited when there is purchase returns (No purchase return and allowance account)
- be credited when there is purchase discount (No purchase Discount account)
- be credited for the cost of the items sold (and the account Cost of Goods Sold will be debited)
- have its balance continuously or perpetually changing because of the above entries

- Require a physical inventory to reconcile the actual inventory balance with that of the record.
- Prefers by merchandising businesses which holds high cost items like Gold jewelries, companies

The following illustration shows you how to apply the above inventory systems in recording purchase and purchase related transactions.

4.4. Recording Purchase and Purchase Related Transactions

Purchase related transactions include the recording of transportation cost, purchase return and allowance and purchase discount. The following illustration explains each item and how to record them using both periodic and perpetual inventory system.

Recording Purchase of Merchandise

Purchase is an account used to record purchase of goods for resale purpose. Purchase of merchandise can be made using cash or credit (on account). Purchase is an income statement account and has a debit normal balance. Companies record purchase when they receive the goods from the seller. The business document used as an evidence to record purchase transaction is **Purchase invoice**.

NB: A business documents gives full information about a particular transaction. The basic information included is date, amount and description of the transaction. Each transaction should be supported by a business document.

Illustration4.1 shows you how to record purchase and purchase related transaction using both periodic and perpetual inventory system as a compression.

Transaction1. January 2 Shewa Supermarket purchase of merchandise on account br. 10,000 from AlleBjimlla Plc. with terms 2/10 n/30. FOB shipping

A. Periodic Inventory system

Date		Account Title and	P/R	Debit		Credit	
2016	2	Purchase		10,000			
		Accounts				10,000	
		(purchase of merchandise)					

B. Perpetual inventory system

Date		Account Title and	P/R	Debit		Credit	
2016	2	Inventory		10,000			
		Accounts				10,000	
		(purchase of merchandise)					

When you compare the above two journal entries the second entry uses the account inventory to record purchase instead of the purchase account. It is the only difference between periodic and perpetual systems while recording purchase.

NB: when purchases are made for cash, in that case cash is credited instead of account payable and the other item remains the same.

Recording Cost of Transportation

The sales agreement should specify who the seller or the buyer will covers transportation costs. The terms of agreement is expressed as either FOB shipping point or FOB destination. FOB Shipping means that the seller places the goods free on board of the sellers place, and the buyer pays the freight costs. Conversely, FOB destination means that the seller places the goods free on board to the buyer's place of business, and the seller pays the

freight. When the buyer covers the transportation costs, these costs are considered as part of the cost of purchasing inventory.

Transaction 2. January 2. Shewa pays br. 800 to transport the merchandises purchased on January 2.

As you recall the term of agreement is FOB shipping, Shewa has to cover the fright cost and records the transaction as follows.

A. Periodic Inventory System

Date		Account Title and	P/R	Debit		Credit	
2016	1	Transportation-in		800			
		Cash				800	
		(Payment for fright charges)					

Transportation-in is an account used to record transportation costs when the buyer covers transportation cost. The other name of this account is freight- in. it has debit normal balance.

Perpetual inventory system

Date		Account Title and Descriptions	P/R	Debit		Credit	
2016	2	Inventory		800			
		Cash				800	
		(Payment for fright charges)					

NB; what if the Agreement is FOB destination, if so the transportation cost is covered by the seller as a result no record for transportation is maintained by Shewa Super Market.

Recording Purchase Return and Allowance

A purchases return involves actually returning merchandise that is damaged or does not meet the specifications of the order. The seller makes a price adjustment for the items returned, this is a purchases allowance. The sources document used to record purchase return allowance is debit memorandum prepared by the buyer and approved by the seller.

Transaction 3 Assume that on January 5, Shewa Supermarket returned merchandises costing Br. 2,000 to AlleBjimlla plc. The following record is to be kept by Shewa Super Market.

A. Periodic Inventory System

Date		Account Title and	P/R	Debit		Credit	
2016 Jan	5	Accounts Payable		2,000			
		Purchase return and Allowance				2,000	
		(Return of merchandise					

Purchase return and allowance is a contra account to purchase. This account is used to record purchase returns mad by the buyer and it has credit normal balance.

B. Perpetual inventory system

Date		Account Title and	P/R	Debit		Credit	
2016 Jan	5	Accounts Payable		2,000			
		Inventory				2,000	
		(Return of merchandise					

NB: as you see from the above record, the amount of purchase on January 2, I.e 10,000 now is decreased by Br. 2,000 because of the return. At the same time the amount owed to AlleBjimlla is also reduced by the same amount.

Recording Purchase Discount

The presence of purchase discount is expressed on credit terms.The terms that describe when payments for merchandise are to be made are called ***credit terms.*** In our case on transaction 1 above the credit term is expressed as 2/10, n/30. It is to mean that, 2% cash deduction is offered by Alle if Shewa pays its bill within 10 days, if not Shewa can pay the net(the full bill) within 30 days. Therefore 2/10 represents the discount period, where as n/30 represents the credit period. Alternatively a credit term can

be expressed as 2/10, n/Eom, it is to mean that 2% discount is allowed if paid within 10 days If not pay the invoice price at the end of the month in which the purchase made.

NB; if the term do not specify the discount period i.e n/30 0nly, this notifies the absence of discount as a result Shewa has to pay the full invoice within the credit period.

Transaction 4. January 12. Shewa paid cash for the full settlement of the merchandise purchased on January 2

Here the company is entitled to get 2% discount, since it paid within the discount period. As per January 1, Shewa owed br. 10,000, but as a result of merchandise return on January 5, the liability is reduced by Br. 2000. so the amount owed now is Br. 8, 000 out of which 2% is deducted and the amount of cash required to settle the liability is Br. 7,840(8,000-(0.02*8,000). the record is made as follows

A. Periodic Inventory System

Date		Account Title and	P/R	Debit		Credit	
2016 Jan	12	Accounts Payable		8,000			
		Purchase				160	
		Cash				7,840	
		(payment with discount)					

B. Perpetual inventory system

Date		Account Title and	P/R	Debit		Credit	
2016	12	Accounts Payable		8,000			
		Inventory				160	
		Cash				7,840	
		(payment with discount)					

What if Shewa makes payment on January 15, instead of January 12? Now no discount is given to Shewa as a result Accounts payable is debited and cash is credited for br. 8000.

NB: Both Purchases discount and purchase return and allowance are a contra accounts to purchases. As a result they have credit normal balance.

Summary of Purchase Transactions

Assume that Shewa Super market has an inventory balance of Br. 1,200 on December31, 2015, at the end of the previous accounting period. The following summery is to show you how the inventory system affects the company's inventory balance even though the transactions result similar effect on company's inventory.

Periodic Inventory System

Perpetual Inventory

Debit	**Credit**
Jan1, 1,500	
Bal. Br.1,500	

Inventory

Debit	**Credit**	
Jan1		
Jan2		
Jan 2 800	**2,000**	**Jan 5**
Bal. Br.10,140		

As you see from the above summery, the inventory account shows a balance of br. 1,500 under periodic system and Br. 10,140 under perpetual system. Br. 1,500 represents the beginning balance of inventory forwarded from the previous year. This is because periodic system does not capture any event that changes the inventory balance. Unlike periodic system perpetual inventory system keeps a continuous record of all events that affects inventory account. As a result an up to date balance of inventor is presented in perpetual inventory system

NB: Based on the discussion we made above, you are clear about the unique accounts of merchandising business. These are purchase, purchase discount, purchase return and allowance, transportation in and inventory. The first four accounts only belong to the periodic inventory system the last belongs to both periodic and perpetual system

Synopsis of Lecture

- Sales of merchandise is the principal source of revenue for a merchandising business.
- Perpetual or periodic inventory system is used to record merchandizing inventory
- Perpetual means a continuous record of inventory and determine up-to-date balance of inventory on hand and cost of goods sold.
- Accounts unique to a merchandising business are purchase, purchase discount, purchase return and allowance and transportation in.
- purchase discount, and purchase return and allowance are contra accounts to purchase,

Warp-up discussion questions

- Explain the basic difference between periodic and perpetual inventory systems
- Discuss the concept of cost flow assumption
- Identify the normal balances of the unique accounts for a merchandising business

Next day's assignment

- Read about sales related transactions

Session 15 (Hr. 29 and 30)

Topic:-Recording Sales and sales related transaction

Session Learning Objectives

- Explain the recording of sales revenues under periodic and perpetual inventory system.

4.5. Recording Sales and Sales Related Transaction

Sales related transactions include the recording of transportation cost, Sales Return and Allowance and Sales Discount. The following illustration explains each item and how to record them using both periodic and perpetual inventory system.

Recording Sales of Merchandise

Sales are an account used to record the total amount charged from customers for merchandise sold. It is equivalent to the account Service Revenue we used in chapter 2 to record amount charged for service delivered. Sales is a revenue account and has a credit normal balance.

Sales may be made on credit or for cash. A business document should support every sales transaction, to provide written evidence of the sale. Cash register tapes provide evidence of cash sales. A sales invoice, provides support for a credit sale.

Illustration 4.2, Sales of merchandise on account and related transactions using both periodic and perpetual inventory systems.

Transaction 1 On January 4 Shewa Super Market sold merchandise on account to Melo Café Br. 4,500, terms 1/15, n/45. FOB Destination. The cost of merchandise sold is Br. 3,000

Shewa record this transaction as follows using Periodic and perpetual inventory system

a. Periodic

Date		Account Title and	P/R	Debit		Credit
2016	4	Accounts Receivable		4,500		
		Sales				4,500

		(Sales of Merchandise on				

As you see from the above record if Shewa uses a periodic inventory system, makes only one journal entry is required each sales transaction by increasing both Accounts Receivable and sales accounts. No record is made for cost of goods sold. As a result the inventory account does not show the balance of inventory on hand.

b. Perpetual

Date		**Account Title and**	**P/R**	**Debit**		**Credit**
2016	**4**	**Accounts receivable**		**4,500**		
		Sales				**4,500**
		(Sales of Merchandise on				

Date		**Account Title and**	**P/R**	**Debit**		**Credit**
2016 Jan	**4**	**Cost of Goods Sold**		**3,000**		
		Inventory				**3,000**
		(to record cost of				

As you see from the above tables, in the case of perpetual system. Shewa makes two entries for each sale. The first entry records the sale. The seller increases (debits) Cash (or Accounts Receivable, if a credit sale), and also increases (credits) Sales Revenue. The second entry records the cost of the merchandise sold.The seller increases (debits) Cost of Goods Sold, and also decreases (credits) Inventory for the cost of those goods. As a result, the Inventory account will show at all times the amount of inventory that should be on hand.

NB: Cost of Merchandise Sold the cost of merchandise sold is the cost of the merchandise sold to customers.

Recording Transportation Costs

As you recall from the previous discussion of illustration 1 above, the agreement now is FOB destination so the transportation cost is covered by the seller i.eShawa Super market.When the seller pays the freight charges, it is considered as selling expenses.

Transaction 2 January 4 Shawa paid Br. 400 to transport the items sold to Melo Cafe

a. Periodic

Date		Account Title and	P/R	Debit		Credit
2016 Jan	4	Delivery Expense		3,000		
		Cash				3,000
		(to record payment of transportation)				

b. perpetual

The same as periodic system

Look the record for transportation cost in the two inventory systems is similar. Because delivery expense is an expanse account which do not affect inventory account.

The other name for delivery expense is transportation out or freight out. It has debit normal balance and classified an expense incurred to sale more or it is selling expense.

Recording Sales Return and Allowance

Merchandise that is returned to the vendor due to defect in the product or the wrong item shipped is referred to as a**sales return**. A price reduction made by the seller for the goods returned called sales allowance. The seller makes a price adjustment for the items returned called sales allowance. It has a debit normal balance. The business document used to support sales return and allowance is a credit memorandum.

Transaction 3. January 6 Shewa Super Market received merchandise returned Br. 500. The cost of merchandise returned is br. 300. Shewa record the transaction as follows.

a. Periodic

Date		Account Title and Descriptions	P/R	Debit		Credit
2016 Jan	**6**	**Sales return and allowance**		**500**		
		Accounts				**500**
		(receipt of Merchandise				

The periodic inventory system records only the reduction in sales revenue. No entry is required to record the change on inventory balance due to the return.

b. Perpetual

Date		Account Title and	P/R	Debit		Credit
2016 Jan	**6**	**Sales return and allowance**		**500**		
		Accounts				**500**
		(receipt of Merchandise				

Date		Account Title and	P/R	Debit		Credit
2016 Jan	**6**	**Inventory**		**300**		
		Cost of Goods				**3**
		(to record cost of Merchandise returned)				

Like the record for sale recording sales return and allowance needs two entries the first to record the reduction on sales revenue which is made by increasing (debiting) Sales Return and Allowance and decreasing (crediting) Accounts Receivable. The second entry is to record increase in inventory

account which is made by (debiting) Inventory account and decreasing (crediting) cost of goods sold

Recording Sales Discount:-A cash discount granted by the seller to customers for prompt payment of amounts owed.

January 13 Shewa received cash from customer on account

Here Shewa is required to make a 1% discount on the invoice price, as the amount is collected within the discount period. As per transaction 1, Shewa has a receivable balance of br. 4,500, but as a result of merchandise return on January 6, the receivable is reduced by Br. 500. So the amount expected to be collected is Br. now is Br. 4,000 out of which 1% is deducted and the amount of cash left for collection is Br. 3,960(4,000-(0.01*4,000). the record is made as follows.

A. Periodic Inventory System

Date		Account Title and	P/R	Debit		Credit	
2016 Jan	13	Cash		3,960			
		Sales Discount		40			
		Account				4,000	
		(Collection of cash with					

B. Perpetual inventory system

The same entry to the periodic system

What if the amount is collected on January 15 instead of January 13. No Sales discount is given as a result Shewa debit cash for Br. 4000 and credit Accounts receivable for the same account.

NB: Both Sales Return and Allowance and sales discount are contra accounts to Sales. So they have debit normal balance.

Comparison of Perpetual and Periodic Inventory System

Illustration 4.3 Summarizes records of unique transactions of a merchandising business as follows

Perpetual Inventory System					Periodic Inventory System				
J	2	Inventory	10,0			Purchase	10,0		

		Cash		10,0		Cash		10,
	2	Inventory	800			Transportation In	800	
		Cash		800		cash		800
	4	Account Receivable	4,50			Account	4,50	
		Sales		4,50		Sales		4,5
	4	Cost of Goods sold	3,00			NO ENTRY		
		Inventory		3,00				
	4	Delivery Expense	400			Delivery Expense	400	
		Cash		400		Cash		400
	5	Accounts Payable	2,00			Accounts	2,00	
		Inventory		2,00		Purchase ret. and allow.		2,0 00
	6	Sales return and allowance	500			Sales ret. and allowance	500	
		Accounts Receivable		500		Accounts Receivable		500
	6	Inventory	300			NO ENTRY		
		Cost o Goods		300				
	1	Accounts payable	8,00			Accounts	8,00	
		Purchase		160		Inventory		160
		Cash		7,84		Cash		7,8
	1	Cash	3,96			Cash	3,96	
		Sales Discount	40			Sales Discount	40	
		Accounts Receivable		4,00 0		Accounts Receivable		4,0 00

Transaction Summery of Perpetual and Periodic Inventory System

Perpetual Inventory system

Inventory

Debit	Credit
Jan1 1,500	**-**
Jan2 10,000	**3,000 Jan4**
Jan 2 800	**2,000 Jan 5**
Jan 6 300	**160 Jan12**
Bal. Br.7,440	

Periodic Inventory System

Inventory

Debit **Jan1,** **1,500**	**Credit**
Bal. **Br.1,500**	

Previously on the summery of purchase transaction above the inventory account as per the perpetual record is Br. 10,140 where as it has Br. 7,440 now after posting the sales transaction. This balance represents the cost of inventory left on hand after recording the sales transaction. On the other hand the balance of inventory as per periodic inventory is still br. 1,500 which is the beginning inventory balance.

Synopsis of Lecture

- Sales of merchandise is a principal source of revenue for a merchandising business.
- Sales return and allowance and sales discount are a contra accounts to sales
- Freight out is an expense account
- while using perpetual inventory system, sales of merchandise requires two separate entries to record the sales revenue and the cost of goods sold

Warp-up discussion questions

- Explain contra sales accounts
- explain terms of sales and memos prepared by buyers and sellers
- Explain the terminologies of FOB Shipping and FOB Destination agreements

Next day's assignment

- Read about adjustments for inventory

Session 16 (Hr. 31 and 32)

Topic:-Adjustments Related to Inventory

Session Learning Objectives

- Explain the recording of sales revenues under periodic and perpetual inventory system.

4.6. Adjustment in Relation to Inventory Account

At the end of the accounting period Shewa is required to make physical count of inventories to determine the cost of inventory that are actually found on hand. If the company uses perpetual inventory system the count balance is compared with the inventory account balance of the record. Whenever there is a deference between the two balance, Shewa needs to record adjusting entry that make the record balance similar to the physical

count. The following illustration shows you how to adjust the balance of inventory account in the case of perpetual inventory system

Illustration 4.4. Assume that the physical count of inventory made by Shewa supermarket on January 31 indicates the balance of inventory on hand is Br. 7,400.

As you see the actual inventory balance i.e 7,400 is less than the record balance displayed on the summery above i.e br. 7,440 by Br 40. This is because of two basic reasons. One the record balance includes inventories lost due to damages, breakages and thefts whereas the physical count excludes them. Second there may be errors while recording transactions that affects inventory. Any ways, Shewa has to pass one of the following adjusting entries to make the record agreed with the count.

Date		Account Title and	P/R	Debit		Credit	
2016 Jan	**13**	**Cost of goods sold**		**40**			
		Inventory				**40**	
		(Adjustments of					

As you see from the above tables the inventory account is reduced (credited) by Br. 40, this makes the record inventory balance equal with the actual inventory balance i.e br.7, 400.

If Shewa uses **periodic inventory system**, the counted balance of inventory is the only information that is available to update the inventory balance on the record. As a result Shewa needs to record two adjusting journal entries. The first to remove the beginning inventory balance and the second to insert (substitute) the ending inventory found through physical count.

Illustration 4.5 shows how to adjust the balance of inventory account in the case of periodic inventory system. Consider the information on illustration 4.4 above, i.e the actual balance of inventory on hand is br. 7,400. Shewa needs to record two adjusting entry as follows

Date		Account Title and	P/R	Debit	Credit
2016	31	Income summery		1,500	
		Inventory			1500
		(Adjustment to remove beginning inv.)			

Date		Account Title and	P/R	Debit	Credit
2016 Jan	31	Inventory		7,400	
		Income summery			7,400
		(Adjustments to insert			

After recording and posting the two adjusting entries the balance on the inventory account is updated and reflects the actual balance of inventory on hand at the end of the year.

Perpetual Inventory system

Inventory

Debit	Credit
Jan1 1,500	-
Jan2 10,000	3,000 Jan4
Jan 2 800	2,000 Jan 5
Jan 6 300	160 Jan12
Bal. Br.	40 Jan
7,440	31
Bal. Br. 7,400	

Periodic Inventory System

Inventory

Debit	Credit
Jan1, 1,500	
Bal. Br.1,500	1500 Jan 31

Jan 31		**7,400**	
7400			
Bal. Br.			

NB: look both periodic and perpetual inventory systems reflect the same inventory balance after adjustment.

NB:_ Illustration 4.4 and 4.5 above tries to show you how to record the unique transactions of the merchandizing business. Here be wise to take a time to re-read the concepts and to practice the illustration. Do not proceed to the next discussion until you fill confidence on your ability to record the transactions well.

When the unique transaction are clear for you, the question immediately comes to your mind is that, is the above events are the only business transactions for a merchandizing businesses?A merchandising business also involves lots of transaction other than the above but not included in the illustration. These transactions not included here are the transactions which are totally similar with the transactions you have discussed in chapter 2. It might include purchase of supplies or equipment, payment of salary or rent, owners investment or drawing etc, are also available for a merchandizing businesses. All this transactions are treated in similar way like we did in chapter 2. Now we can proceeds to the next activity i.e completion of the accounting cycle.

4.6. Charts of account for a Merchandising Business

4.7. Financial Position and Statements of income and loss accountsProfitor Loss Statement

100 Assets

110 Cash

400 Revenues

410 Sales

112 Accounts Receivable **411 Sales Returns and Allowances**

115 Merchandise Inventory412 Sales Discounts

116 Supplies 500 Costs and Expenses

117 Prepaid Insurance **510 Cost of Merchandise Sold**

120 Land 520 Salaries Expense

125 Office Equipment 521 Advertising Expense

126 Accumulated Depreciation equipment **523 Delivery Expense**

200 Liabilities 529 Rent Expense

210 Accounts Payable 531 Supplies Expense

211 Salaries Payable 532 Depreciation Expense —Equipment

212 Unearned Rent 533 insurance Expense

215 Notes Payable 534 Miscellaneous Expense

300 Owner's Equity 600 Other Income

310 Owner's, Capital 610 Rent Revenue

311 Owner's, Drawing 700 Other Expense

312 Income Summary 710 Interest Expense

NB: A dear student the above charts of account is the one which is commonly used format. The number of accounts may be varied business to business, but they are not out of the above classification. Those accounts which are displayed bold are accounts unique to merchandising business and are not found on the charts of account of a service giving businesses.

Synopsis of Lecture

- In a perpetual inventory system adjustment is required to reconcile the recorded inventory balance of the ledger with the actual inventory at hand.
- In a periodic inventory system adjustment is necessary to determine the cost of inventory at and cost of goods sold.
- Sales return and allowance and sales discount accounts are a contra account to sales.
- Unlike transportation-in, transportation- out account is an expense account.

Warp-up discussion questions

- Identify those accounts which belongs to a merchandising business
- explain the two methods of inventory adjustment used in perpetual inventory system

Next day's assignment

Read about the accounting cycle of a merchandising business

Session 17 - 19 (Hr. 33, to 36)

Topic:-Accounting Cycle of a Merchandising Business

Session Learning Objectives

After completing this section you should able to:

- Explain the steps in the accounting cycle for a merchandising company.
- Prepare a work sheet for a merchandising business(optional step)
- Distinguish between a multiple-step and a single-step income statement.
- Explain the computation and importance of gross profit.
- Prepare adjusting and entries for a merchandising business

- Prepare post closing trial balance
- Prepare reversing entry(optional step)

4.7. Completion of the Accounting Cycle of a Merchandising Business

Completion of the cycle is a yearend operation, which is done for the preparation of financial statement. The completion process is started afterall transactions are recorded, posted and presented on the trial balance. Like a service giving company merchandising business involves the following completion activities.

i. Preparation of work sheet
ii. Preparation of financial statements
   - Income Statement
   - Statements of Owners Equity
   - Statements of financial position
iii. Record and post adjusting entries
iv. Record and post closing entries
v. preparation of post closing trial balance
vi. record reversing entry

The following illustration shows how to complete the accounting cycle for a particular a merchandizing business

Illustration 4.7. The following unadjusted trial balance belongs to Shewa Super Market for year ended December 31.

Shewa Supermarket

Trial Balance

December 31,2016

Account Title	Debit	Credit
Cash	11,800	
Accounts receivable	17,400	
Inventory	22,500	
Supplies	1,200	
Prepaid Insurance	2,800	
Equipment	49,300	
Accumulated Dep.		5,800
Accounts payable		5,200
Notes Payable		7,000
Owner's Capital		61,500
Drawing	4,900	
Sales		115,000
Sales Discount	6,000	
Sales return and allowance	13,500	
Cost of Goods Sold	47,700	
Salary Expense	8,800	
Rent Expense	5,600	
Advertising expense	2,000	
Utilities Expense	1,000	
Total	**194,500**	**194,500**

Information for Adjustment

a. Insurance expired during the year
   Br. 1,800
b. supplies on hand Br. 500
c. Deprecation on office equipment Br. 1,200
d. salary accrued Br. 1,500
e. Interest accrued Br. 300

Instructions:-Using the above information of Shewa Supermarket prepare the following:

a. Work Sheet
b. Prepare financial statement
    a. Income statement
    b. Statements of owners equity
    c. Statements of financial position
c. Record and post adjusting entries
d. Recording and posting closing entries
e. Prepare post closing trial balance
f. Reversing entry

ii. Work sheet

Shewa Super market

Work Sheet

December 31,2016

Account Title	Unadjusted Trial Balance		Adjustments		Adjusted trail balance		Statements of Profit or Loss and other		Statements of Financial Position	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	11,800				11,800				11,800	
Accounts	17,400				17,400				17,400	
Inventory	22,500				22,500				22,500	
Supplies	1,200			(b)	500				500	
Prepaid	2,800			(a)1,8	1000				1000	
Equipment	49,300				49,300				49,300	
Accumulat		5,800		(c)3,2		9,000				9,000
Notes		7,000				7,000				
Accounts		5,200				5,200				12,200
Salary				(d)1,5		1,500				1,500
Interest				(e)		300				300
Owner's		61,500				61,500				61,500
Drawing	4,900				4,900				4,900	
Sales		115,0				115,0		115,00		
Sales	6,000				6,000		6,000			
Sales ret	13,500				13,500		13,500			
Cost of	47,700				47,700		47,700			
Salary	8,800		(d)		10,300		10,300			
Rent	5,600				5,600		5,600			
Advertisin	2,000				2,000		2,000			
Utilities	1,000				1,000		1,000			
Supplies			(b)		700		700			
Insurance			(a)		1,800		1,800			
Depreciati			(c)3,2		3,200		3,200			
Interest Expense			(e) 300		300		300			
Total	194,500	194500	7,500	7,500	199,500	199500	92,100	115,000	107,400	84,500
Net Income							22,900			22,900

							115,000	**115000**	**107400**	**107,400**

iii. Financial Statement

a. Statements of Profit or Loss and other Comprehensive Income for a merchandising business might have the following two formats.

Multiple Step Profit or Loss Statement

The multiple-step statementis so named because it shows several steps in determining net income. A multiple-step statement also distinguishes between **operating**and **non operating activities**. Finally, the statement also highlights intermediatecomponents of income and shows sub groupings of expenses.

A multiple statement starts with presenting sales revenues. This section determines the amount of **Net Sales** by deducting Sales from Sales Discount and Sales Return and Allowance. The next section of the statement determines **Gross Profit** by deducting Costs of Goods Sold from Net Sales. Then **Operating Income** is determined by deducting total Operating Expenses from Gross Profit. Finally non operating income is added and non operating expenses are deducted from Operating income to determine **Net Income** or net loss for the period. Illustration 4.8 presents a multiple step income statement as follows:

Shewa Supermarket

Statements of profit or Loss and other Comprehensive Income

For the Year ended December 31,2016

Sales Revenues				
Sales			**Br. 115,000**	
Less	**Sales return and Allowance**	**Br.13,500**		
	Sales Discount	**6,000**		**19,500**
Net Sales			**95,500**	
Costs of Goods Sold				**47,700**
Gross Profit				**47,800**
Operating Expenses				
Salary Expense		**10,300**		
	Rent expense	**5,600**		
	Advertising expense	**2,000**		
	Utilities Expense	**1,000**		
	Supplies Expense	**700**		
	Insurance expense	**1,800**		
	Depreciation Expense	**3,200**		
	Total operating Expense			**24,600**
Income from Operations			**23,200**	
Other		**0**		

revenue and gains		
Other expense and losses		
interest expense	**-300**	
Net Income	**22,900**	

Non Operating Activities

Nonoperating activitiesconsist of various revenues and expenses and gains and losses that are unrelated to the company's main line of operations.

The following items are categorized under other income and gains:

- **Interest revenue** from notes receivable and marketable securities.
- **Dividend revenue** from investments in common stock.
- **Rent revenue** from subleasing a portion of the store.
- **Gain** from the sale of property, plant, and equipment.

The following items are categorized under other expense and losses:

- **Interest expense** on notes and loans payable.
- **Casualty losses** from recurring causes, such as vandalism and accidents.
- **Loss** from the sale or abandonment of property, plant, and equipment.
- **Loss** from strikes by employees and suppliers.

Single Step Statement

The other format for income statement is the single-step income statement. The statement is so named because only one step i.e. subtracting total expenses from totalrevenues and is required in determining net income.In a single-step statement, all data are classified

into two categories: one is revenues,which include both operating revenues and other revenues and gains; and the second is expenses,which include cost of goods sold, operating expenses, and other expensesand losses. Illustration 4.9 below presents single step income statement.

Shewa Supermarket

Statements of profit or Loss and other Comprehensive Income

For the Year ended December 31,2016

Revenues		
Net Sales		**Br. 95,500**
Other revenue		**0**
Total Revenue		**95,500**
Expenses		
Costs of Goods Sold	**47,700**	
Operating Expense	**24,600**	
interest expense	**300**	
Total Expense		**72,600**
Net Income		**22,900**

b. Statement of Owners Equity

The definition and the way of preparing owners equity is totally similar with the owners equity statement of a service giving business, one you have learned in chapter 1 and chapter 2. So please turn back and revise it again. Illustration 4.9 presents statements of owner's equity as follows.

Shewa Supermarket

Statements of Owner's Equity

For the year ended December 31,2016

Owners Capital January 1,		**61,500**
Add	**Net income**	**22,900**
	sub total	**84,600**
Less	**Drawing**	**4,900**
	Owner's capital December 31,	**79,500**

c. Statements of Financial Position

The definition and the way of preparing statements of financial position is totally similar with the service giving business, one you have learned in chapter 1 and chapter 2. So please turn back and revise it again. Illustration 4.9 presents statements of owner's equity as follows. Illustration 4.10 presents the statements of financial position as follows.

Shewa Supermarket

Statements of Financial Position

For the Month ended August 30,2016

Asset		
Non current		
Property Plant and Equipment		
Equipment	**49,300**	
Accumulated deprecation on equipment	**9,000**	
Total PPE's		**40,300**
Current Assets		
Prepaid Insurance		**1,000**
Supplies		**500**
Inventory		**22,500**
Accounts Receivable		**17,400**

Cash		**11,800**
Total Current Asset		**53,200**
Total Asset	**Br.93,500**	
Liability and Equity		
Owners Equity		
Enkopa's Capital 79,500		
Liabiliti		
Notes Payable	**Br. 7,000**	
Accounts Payable	**5,200**	
Salary Payable	**1,500**	
Interest Payable	**300**	
Total Liabilities		**14,000**
Total Equity and liabilities		**Br.93,500**

iv. Recording Adjusting Entries

Adjusting Entries

Date		Account Title and Descriptions	P/R	Debit		Credit	
201	3	Insurance Expense		1,800			
		Prepaid				1,800	
		(Adjustment of					
	3	Supplies Expense		700			
		Supplies				700	
		(Adjustment of supplies)					
	3	Depreciation Expense		3,200			
		Accumulated				3,200	
		(Recording deprecation)					
	3	Salary Expense		1,500			
		Salary Payable				1,500	
		(Recording Accrued					
	3	Interest Expense		300			

		Interest Payable				300	
		(Recording Accrued					

v. Recording Closing entry

Closing Entries

Date		Account Title and Descriptions	P/R	Debit		Credit	
201	3	Sales		115,0			
		Income Summery				115,0	
		(Closing revenue					
	3	Income Summery		92,10			
		Sales return and				13,50	
		Sales Discount				6,000	
		Cost of Goods Sold				47,70	
		Salary Expense				10,30	
		Rent Expense				5,600	
		Advertizing				2,000	
		Utilities Expense				1,000	
		Supplies Expense				700	
		Insurance Expense				1,800	
		Depreciation				3,200	
		Interest Expense				300	
		(Closing Expense					
	3	Income Summery		22,90			
		Owner's Capital				22,90	
		(Closing income					
	3	Owner’s Capital		4,900			
		Owner’s Drawing				4,900	
		(Closing Drawing					

v. pr v. Preparation Post Closing Trial Balance

Shewa Supermarket

Post closing Trial Balance

December 31,2016

Account Title	Debit	Credit	
Cash	**11,800**		
Accounts receivable	**17,400**		
Inventory	**22,500**		
Supplies	**500**		
Prepaid Insurance	**1,000**		
Equipment	**49,300**		
Accumulated Dep.		**9,000**	
Notes Payable		**7,000**	
Accounts payable		**5,200**	
Salary payable		**1,500**	
Interest payable		**300**	
Owner's Capital		**79,500**	
Total	**102,500**	**102,500**	

Reversing Entry

Accrued salary and accrued interest results a liability on the financial Position Statement of Shewa Super Market. The company might have two options to treat those liabilities resulted from yearend adjustment. That is either to keep these liabilities until the actual payment date or avoid the liabilities from the recording of the subsequent period. If the company prefers the second option a reversing entry is required to be recorded on the first day of the new accounting period. Reversing entries are the exact reverse of adjusting entries made. Reversing entries are made at the first date of the new accounting period. as a result reversing accounts is an optional step in completion of accounting cycle.

Reversing entries for Shewa Super Market

NB. Reversing entry is not a mandatory step of completing an accounting cycle.

2017	**1**	**Salary payable**		**1,500**			
		Salary Expense				**1,500**	
		(Recording Accrued Salary)					
	1	**Interest Payable**		**300**			
		Interest Expense				**300**	
		(Recording Accrued Interest)					

SELF- EXAMINATION QUESTIONS

1. If the supplies account, before adjustment on May 31, indicated a balance of Br. 2,250 and an inventory of supplies on hand at May 31, totaled Br.950, the adjusting entry would be:
    e. Debit Supplies Br.950, credit Supplies Expense Br. 950
    f. Debit Supplies Br. 1,300, credit Supplies Expense Br. 1,300
    g. Debit Supplies Expense Br. 950, credit supplies Br. 950
    h. Debit supplies expense, Br. 1,300, credit Supplies Br, 1,300
3. If the estimated amount of deprecation on equipment for a period is Br. 2,000, the adjusting entry to record deprecation would be:
    a. Debit Depreciation Expense, Br. 2,000, credit Equipment Br. 2,000
    b. Debit Equipment, Br. 2,000, credit Depreciation Expense, Br. 2,000
    c. Debit Deprecation Expense, Br. 2,000, credit Accumulated Depreciation, Br. 2,000

d. Debit Accumulated Depreciation, Br. 2,000, credit Deprecation Expense Br. 2,000

4. If the equipment account has a balance of Br. 22,500 and its accumulated deprecation account has a balance of Br. 14,000, the book value of equipment is:
   a. Br. 36,500
   b. Br. 22,500
   c. Br. 14, 000
   d. Br. 8,500
5. Which of the following account would be closed to the income summery account at the end of a period?
   a. Sales
   b. Salary Expense
   c. Both sales and salary expense
   d. Neither sales nor salary Expense
6. The post closing trial balance would include which of the following account
   a. Cash
   b. Sales
   c. salary Expense
   d. All of the above
7. If merchandise purchased on account is returned, the buyer may inform the selle of the details by issuing
   a. debit memorandum
   b. a credit memorandum
   c. an invoice
   d. a bill
8. If merchandise is sold on account to a customer for Br. 1,000, terms FOB shipping Point, 1/10, n/30, and the seller prepays Br. 50 in transaction costs, the amount of the discount for early payments would be:
   a. Br. 0
   b. Br. 5
   c. Br. 10
   d. 10.50
9. For a business using a periodic inventory system, which of the following is added to merchandising inventory at the beginning of the period in computing the cost of mechanizing available for sale?

a. Purchase discount
c. Ending Merchandising inventor
b. Purchase returns and allowance
d. Fright out

ILLUSTRATIVE PROBLEM

Discount supermarket entered in to the following selected transactions during August of the current year.

August 1 purchased merchandise on account, terms 2/10, n/30, FOB shipping point, Br. 28,500.

1, paid rent for August, Br. 4,500

2, Paid transportation charges on purchase of August 1,Br. 1,180.

5, Purchases office supplies for cash Br. 600

7, Sold merchandise on account, terms 1/10, n/30, FOB destination, Br. 12,400

8, Paid transportation charges on August 7, Br. 550

11, Paid for merchandise purchased on August 1, less discount

12, Received merchandise returned from sales of August 7, Br. 3,200.

14, Purchased merchandise n account, terms 4/14, n/30, FOB shipping point Br.18,300 with prepaid transportation costs of Br.750 added to the invoice.

16, returned merchandise purchased on augest14, Br. 5,200.

17, Received cash on account from sale of August 7, less returns and discount.

18, Sold merchandise on account, terms, 1/10, n/20 FOB shipping point Br.8,800. prepaid transportation costs as an accommodation for the customer Br. 250.

26, Sold merchandise on bank credit card, Br. 3,700

29, Paid for merchandise purchased on august 14, less returns and discount.

31, Received cash on account from sale of August 18, Br. 9,050.

Instructions

1. Record the above transactions using general journal
2. The merchandise inventory on hand at September 1, 2016, the beginning of the current fiscal year, was Br. 250, 000, the physical count taken on august 1, 2016 , determined that merchandise on hand was Br, 274,600. Prepare the adjusting entries for merchandise inventory for the current fiscal year ended August 31, 2017.

CHAPTER FIVE

ACCOUNTING SYSTEMS

Learning Objectives:

After completing this chapter you will be able

- Identify the basic concepts of an accounting system.
- Describe the nature and purpose of a subsidiary ledger.
- Explain how companies use special journals in journalizing.
- Indicate how companies post a multi-column journal.

Session 19 and 20 (Hr. 37 to 40)

Topic:- Basics of Accounting System Design

Session Learning Objective

- Identify the basic concepts of an accounting system.
- Describe the nature and purpose of a subsidiary ledger.

Reading Assignment Discussion

- Goals of designing an accounting system

5.1. Introduction

The accounting system collects and processes transaction data and communicates financial information to decision makers. The system will vary from business to business, because of the differences in the nature and size of business, the number of transactions to be processed, etc. Regardless of these variations an accounting systemis normally supported by either manual or computerized operations. This chapter deals about the basic principles of an accounting system and the tools used to implement the system.

5.1 Basics of Accounting System Design

As a business exhibits expansion and growth, its accounting system is required to be redesigned in a way that accommodates the information requirement of the business. There are three-step in designing an accounting system. process these are:

Step 1. Analyzeuser information needs.

Step 2. Designthe system to meet the user needs.

Step 3. Implementthe system.

Analysis the information need enables to determine the information requirement of a particular company and to identify the gap of the existing system. On the base of this requirement and the gap identified the accounting system is designed. The design is made using a basic manual system that included a chart of accounts, a two-column journal, and a general ledger. Finally, the designed system is implemented to record transactions and prepares financial statements. Once a system has been implemented, feedback,or input, from users is used to analyze and improve the system.

Efficient and effective accounting systems is designed and implemented in a way that fulfills the basic principles of cost-effectiveness, usefulness, and flexibility of information produced.

Cost-Effectiveness:- The accounting system must be cost effective.Benefits of information mustoutweigh the cost of providing it.

Usefulness: - To be useful, information must be understandable, relevant, reliable, timely, and accurate. Designers of accounting systems must consider the needs and knowledge of various users.

Flexibility: - The accounting system should accommodate a variety of users and changing information needs. The system should be sufficiently flexible to meet the resulting changes in the demands made upon it.

5.2. Internal Control and an Accounting System

Internal controls and information processing methods are essential in an accounting system. The designed accounting system has to work smoothly

with the internal control elements of a particular company. The system is required to strengthen the internal control and catalyze the smooth implementation of the control activity.

Internal control is a process designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance. In more detail, it consists of all the related methods and measures adopted within an organization to safeguard assets, enhance the reliability of accounting records, increase efficiency of operations, and ensure compliance with laws and regulations. Internal control systems have five primary components as listed below.

- **A control environment.** It is the responsibility of top management to make it clear that the organization values integrity and that unethical activity will not be tolerated. This component is often referred to as the "tone at the top."
- **Risk assessment.** Companies must identify and analyze the various factors that create risk for the business and must determine how to manage these risks.
- **Control activities.** To reduce the occurrence of fraud, management must design policies and procedures to address the specific risks faced by the company. The six principal of **control activities are,**
    - Establishment of responsibility:- Assign a task to specific employees and give the employee the appropriate authority and responsibility. So that employee is liable for his actions.
    - Segregation of duties:- Different individuals should be responsible for related activities, and separating record keeping from physical custody. If an employee who orders goods also handles the invoice and receipt of the goods, as well as payment authorization, he or she might authorize payment for a fictitious invoice.

- Documentation procedure:- Companies should establish procedures for documents. Companies should use pre-numbered documents, and all documents should be accounted for and promptly forward source documents for accounting department.
- Physical controls:- relate to the safeguarding of assets and enhance the accuracy of the accounting records, using safe volts, passwords, locks etc.
- Independent internal verification:- verify records periodically, reconcile it with the existing assets by an independent employee. Eg, compare the cash balance of the record with the actual cash available.
- Human resource controls:- involves making a good background check of employees, rotating the employee from one task to another and obtaining insurance protection to employees against theft,

- **Information and communication.** The internal control system must capture and communicate all pertinent information both down and up the organization, as well as communicate information to appropriate external parties.
- **Monitoring.** Internal control systems must be monitored periodically for their adequacy. Significant deficiencies need to be reported to top management and/or the board of directors.

5.3. Manual and computerized accounting system and enterprise resource planning

5.3.1. Manual Accounting System

Accounting systems are manual or computerized. Understanding a manual accounting system is useful in identifying relationships between accounting

data and reports. Also,most computerized systems use principles from manual systems.

In prior chapters, the transactions for Enkopa Company were manually recorded in an all-purpose (two-column) general journal. The journal entries were then posted individually tothe accounts in the ledger. Such a system is simple to use and easy to understand when there are a small number of transactions. However, when a business has a large number of similartransactions, using an all-purpose journal is inefficient and impractical.For example, in a given day, a company might earn service fees on account from 100 customers.Recording each fee earned by debiting Accounts Receivable and crediting Service feewould be inefficient. Also, a record of the amount each customer owes must be kept. Insuch cases, subsidiary ledgers and special journals are useful.

5.3.2. Computerized Accounting Systems

Computerized accounting systems are widely used by even the smallest of companies.Computerized accounting systems have the following three main advantages overmanual systems:

1. Computerized systems simplify the record-keeping process in that transactions are recorded in electronic forms and, at the same time, posted electronically to general and subsidiary ledger accounts.
2. Computerized systems are generally more accurate than manual systems.
3. Computerized systems provide management with current account balance informationto support decision making, since account balances are posted as the transactionsoccur.

The popular QuickBooks, Peachtree accounting software etc. are used by small- to medium-sized businesses.

NB: Dear Students you will discuss and practice the detail application of computerized recording on your advanced accounting course named "**Computerized Accounting**".

5.4. Subsidiary Ledgers and Controlling Accounts

An accounting system should be designed to provide information on the amounts duefrom various customers (accounts receivable) and amounts owed to various creditors(accounts payable). A separate account for each customer and creditor could be addedto the ledger. However, as the number of customers and creditors increases, the ledgerwould become awkward.

A large number of individual accounts with a common characteristic can be grouped together in a separate ledger called a **subsidiary ledger**. The primary ledger, which contains all of the balance sheet and income statement accounts, is then called the **generalledger**. Each subsidiary ledger is represented in the general ledger by a summarizing account, called a **controlling account**. The sum of the balances of the accounts in a subsidiary ledger must equal the balance of the related controlling account. Thus, a subsidiary ledger is a secondary ledger that supports a controlling account in the general ledger. Two of the most common subsidiary ledgers are as follows:

1**. Accounts receivable subsidiary ledger**:- collects transaction data for individual customer

2. **Accounts payable subsidiary ledger**;-collects transaction data for individual creditors

The **accounts receivable subsidiary ledger**, or customer's ledger, lists the individual customer accounts in alphabetical order. The controlling account in the general ledger that summarizes the debits and credits to the individual customer accounts is Accounts Receivable. The **accounts payable subsidiary ledger**, orcreditor's ledger, lists individual creditor

accounts in alphabetical order. The related controlling account in the general ledger isAccounts Payable.

To illustrate assume that the account receivable general ledger of a ZZ Company shows a balance of Br.20, 000 as of September 30, 2016. The company has four credit customers namely Mr. A Mr. B and Mr. C each owed Br. 2,000, Br. 9,500, and Br. 8,500 respectively. The following are to illustrate how the customer ledger captures the credit history of individual customers and how it is controlled by the general ledger.

Illustration 5.1 General and subsidiary ledgers for Accounts Receivable

Accounts Receivable General Ledger

Date		Item	p/r	Debit		Credit		Balance	
2016s	4			15,0				15,000	
	12					7,000		8,000	
	20			18,0				26,000	
	30					6,000		20,000	

Accounts Receivable subsidiary ledgers

Mr. A

Date		Ite	p/r	Debit		Credit		Balance		
2016s	1			5,00				5,000		
						3,000		2, 000		

Mr. B

Date		Item	p/r	Debit		Credit		Balance	
2016s	4			10,0				10,000	
	12					4,000		6,000	
	20			5,50				11,500	
	30					2,000		9,500	

Mr. C

Date		Item	p/r	Debit		Credit		Balance	
2016s	2			12,5				12,500	
	3					4,000		8,500	

As you see there are three customer ledgers (subsidiary ledger) opened by the name of each customers and one general ledger (controlling ledger) opened by the name of an account called “Accounts Receivable”. The sum of the ending balance of the three subsidiary ledger (Br. 2,000 + 9,500 + 8,500) exactly equal with the balance in general ledger of account receivable (Br. 20,000).

NB; the number of subsidiary ledgers is increased by an increase in number of credit customer.

Synopsis of Lecture

- System analysis, system design and implementation are the tree steps in changing an accounting system.
- Cost-effectiveness, usefulness, and flexibility is the basic principle for the accounting system design.
- Ledgers opened by the name of individual customers or credits is a subsidy ledgers
- A ledger that controls the subsidiary ledgers is referred to as a general ledger.

Wrap –Up Discussion Question

- Discuses the deference between manual and computerized accounting.
- Explain the meaning of the principles of accounting system design.
- Discuss the interrelationship between an accounting system and internal control.
- Discusses the difference between general and subsidy ledger.

Next day’s reading assignment

Read about special journals and there necessity

Session 22 and 23 (Hr 43 to 46)

Topic :-Special Journals and Vouchers

Session learning objective

- Explain how companies use special journals in journalizing.
- Indicate how companies post a multi-column journal.

Reading Assignment Discussion

Discussion issues

Special journal and their role in recording

5.4. Special Journal and Vouchers

5.4.1. Special Journals

One method of processing data more efficiently in a manual accounting system is toexpand the all-purpose two-column journal to a multicolumn journal. Each column in a multicolumn journal is used only for recording transactions that affect a certain account.For example, a special column could be used only for recording debits to the cashaccount. Likewise, another special column could be used only for recording credits to thecash account. The addition of the two special columns would eliminate the writing of *Cash*in the journal for every receipt and every payment of cash. Also, there would be no needto post each individual debit and credit to the cash account. Instead, the *Cash Dr.* and *CashCr.* columns could be totaled periodically and only the totals posted. In a similar way, specialcolumns could be added for recording credits to Service Fees, debits and credits toAccounts Receivable and Accounts Payable, and for other entries thatare repeated.

An all-purpose multicolumn journal may be adequate for asmall business that has many transactions of a similar nature.However, a journal that has many columns for recording many differenttypes of transactions is impractical for larger businesses.The next logical extension of the accounting system is to replace the single multicolumnjournal with several **special journals**. Each special journal is designed to beused for recording a single kind of transaction that occurs frequently. Most transactions of merchandise for example, fall in to four groups i.e sales on account, purchase on account, cash receipt and cash disbursements etc. To record each transaction types the following four special journals are used.

Sales Journal

Sales journal is used only for recording sales of merchandise on account; sales of merchandise for cash are recorded in the cash receipt journal. Sales of non merchandise assets are recorded in the cash receipt journal or the general journal depending on whether the sales is made on account or for cash. Illustration 5.2, below sows the general format for sales journal.

Sales Journal

Da te	Accounts Debited	Post. Ref	Acc. Rec. Debit sales

As you see from the above format, there is one amount column to record a debit to accounts receivable and credit sales. This mean an amount inters on the column represents both increase in an asset and revenue account resulted from sale. If the company uses general journal it requires two amount columns to record accounts receivable and sales separately. In addition recording each sale requires at least three rows to write (1)

Account Receivable, (2) Sales (3) brief description of the transaction in a general journal but only one raw in special journal.

Using sales journal saves the time and space of posting, because only the total amount of sales is posted to the sales ledger in the case of sales journal. But in general journal sales is posted individuals to the sales ledger.

NB: the 2nd column named “Accounts debited” used to insert the name of credit customer.

Purchase Journal

All purchases made on accountare recorded in purchase journal using a special column named purchase debit.Cash purchases would be recorded in the cash payments journal.Purchase of Supplies, equipment and other plant assets also recorded in purchase journal general columns other than the special column. Illustration 5.3, shows the general format for Purchase Journal.

Purchase Journal

Date	Accounts Credited	Post Ref.	Purchase Debit	Accounts PayableCredit	Other Account Debited

As the above illustration shows you a typical purchase journal having two special columns and one general column. The special columns represent Purchase debit and Accounts Payable credit serves to record the most frequent transaction of purchase of merchandise. The general column “other account debited” used to record purchase of supplies or equipments on account. All the accounts in special journal are posted in total, where as all accounts in general column is posted individually to their respective ledgers.

NB: Accounts credited column used to list the names of those businesses and individuals who offered credit to the company.

Cash Receipt Journal

All transactions that increase the amount of cash are recorded in cash receipt journal. In a typical merchandising business, the most frequent source of cash receipt is likely to be cash sales and collection from customers on account. Illustration 5.4 below shows the general format for cash receipt journal.

Cash Receipt Journal

Date	Accounts Credited	Post Ref.	Other account credit	Accounts Receivable	Cash Debit

As of the above illustration cash receipt journal has two special columns used to record Accounts receivables and Cash. Only one column entitled other account credit used to record receipts other than collection from credit customers. Accounts in the special column are posted tin total where as accounts in general column is posted individually.

Cash Payments Journal

All transactions that involve the payment of cash are recorded in a **cash payments journal**. The kinds oftransactions in which cash is paid and how often they occur determine the titles of the other columns Thus; the cash payments journal has two special columns named Accounts Payable debit and Cash credit. Illustration 5.5 shows you the general format for cash payments journal.

Cash payments Journal

Date	Accounts Debited	Post Ref.	Other Accounts	Accounts Payable Debit	Cash Credit

The above special journal has two special columns to record a reduction in both Accounts Payable and Cash. So the special column used to record payment of cash for purchase of merchandise on account. The general

column other account debit is used to record cash payments for expenses or purchase of assets like inventories, equipment etc.

5.4.2. The Voucher System

A voucher system is any system that gives documentary proof and written authorization for business transaction. It consists of procedures for systematically gathering, recording, and paying a company's expenditure. Goal of voucher system is to exercise tightest possible control over expenditure. For maintaining effective control the system separate the responsibility of Authorization for expenditure form receipts of goods, Validating liability and payment of liability.

Under the voucher system, every liability must be recorded as soon as it is incurred. A written authorization, called a voucher, is prepared for each future expenditure, and checks are written only for approved vouchers. In large companies, the duties of authorizing expenditure, verifying receipts, recording liability and issuing check are divided among different people. A voucher is a written authorization for each expenditure. A separate voucher is attached to each bill as it comes in and it is given an identification number.

Steps of Operation in a Voucher System

There are five steps to implement a voucher system. These are

Step 1, preparation of the voucher

Step 2, Recording the Voucher

Step 3, Paying the voucher

Step 4, Posting the voucher and check registers

Step 5 Summarizing unpaid voucher

Preparation of the voucher: - a voucher is prepared for each expenditure. All documents i.e. Purchase invoices, invoices, and receiving reports should be attached to the voucher when it is submitted for approval.

Recording the Voucher: - All approved vouchers should be recorded in the voucher register. Vouchers that do not have appropriate approval or supporting documents should be investigated immediately. If the net method were used, the purchase would be recorded at the net purchase price after deducting the anticipated discount.

Paying the Voucher:- After a voucher has been recorded, it is placed in an unpaid voucher file. Many companies file the vouchers by due date and by vendor (Supplier) within due date, so that checks can be drown each day to cover all vouchers due on that day. In this way, all discounts forprompt payments can be taken. After payments vouchers are filled by voucher number.

On the date voucher is due, a check accompanied by the voucher and supporting documents, is presented to the individual authorized to sign checks. Based on this information a schedule for unpaid voucher is prepared.

Posting the Voucher and Check Registers:- Posting the voucher and check registers is very similar to posting the purchase journal and cash payment journal. The only difference is that the Voucher payable account is substituted for accounts payable.

Summarizing unpaid vouchers:- At any time, the sum of the vouchers in the unpaid vouchers file should equal the credit balance of the vouchers payable account. At the end of each accounting period, the unpaid vouchers file should be totaled to prove the balance of the vouchers payable account.

The Voucher System and Management

The voucher system not only provides effective accounting controls but also aids management in discharging other responsibilities, for example the voucher system gives grater assurance at all payments is in settlement of valid liabilities. In addition current information is always available for use in determining future cash requirement. This in turn enables management to make the best use of the resources. Invoices on which cash discount are allowed can be paid within a discount period and other vouchers can be paid on the final date of the credit period, thus reduce costs and maintaining a favorable credit standing.

Synopsis of Lecture

- Special journal is used for recording a single kind of transaction that occurs frequently. Special journal includes, Sales journal, purchase Journal, Cash receipt and cash payment Journals.
- A voucher system is any system that gives documentary proof and written authorization for business transaction.
- The five steps to implement a voucher system are, preparation of the voucher, recording the voucher, paying the voucher, posting the voucher and check registers, Summarizing unpaid voucher.

Wrap –Up Discussion Question

- Discuses the deference between manual and computerized accounting.
- Explain the meaning of the principles of accounting system design.
- Discuss the interrelationship between an accounting system and internal control.
- Discusses the difference between general and subsidy ledger.

SELF – EXAMINATION QUESTION

1. The detailed procedure used by management to direct operations to the enterprise goals can be archived are termed:
   a. Internal controls
   b. System analysis
   c. System design
   d. System implementation
2. a payments of cash for the purchase of merchandise would be recorded in the:
   a. Purchase journal
   b. Cash payments journal
   c. Sales journal
   d. Cash receipt journal
3. A voucher system is requires all vouchers for purchase to be recorded in a net amount, and a purchases is made for Br. 500 on account terms 1/10, n/30
   a. purchases would be debited for Br, 495 to record the purchases
   b. Discount lose would be debited for Br. 5 if the voucher is not paid within discount period
   c. If the voucher is not paid until the discount the discount period is expired, the discount lost would be reported as an expense on income statement
   d. All of the above
4. when there is a large number of individual accounts with a common characteristics, it is common to place them in a separates ledger called a:
   a. Subsidiary ledger
   b. Creditors Ledger
   c. accounts payable ledger
   d. Accounts receivable ledger
5. the controlling account in the general ledger that summarizes the debit and the credits to individual customers account in the subsidiary ledger is entitles:
   a. Accounts Payable
   b. Accounts receivable
   c. Sales
   d. Purchases
6. the voucher system is strengthen internal control requiring that a voucher be prepared to authorize payment on liability at the time that the liability is
   a. Paid
   c. Planned

b. incurred d. Audited

ILLUSTRATIVE PROBLEM

Selected transactions of Marry Co., for the month of May is as follows

a. may 1, issued a check no. 1001 for payment of rent for may
b. May 2, purchased merchandise on account from McMillan Co. terms 2/10, n/30. fob shipping point Br, 3,600.
c. may 7, issued check number 1003 in payment of transaction charges on merchandising purchased on may 2, Br.320
d. may 8, sold merchandise on account to waller Inc. Invoice no 51, terms 1/10, n/eom, fob shipping point Br. 4500.
e. may 9 Issued check no 1005 for office supplies purchased Br, 450.
f. May 10, received cash from office supplies sold to employee at cost Br. 120
g. May 11, purchased office Equipment on account from Fender Office Product Br, 15,000
h. May, 12, Issued credit memorandum No. 801 for Br.400 to waller inc. for merchandise returned
i. may 12, issued check no 1010 in payment of merchandise purchased from McMillan Co. on may 2, less discount Br, 3,528.
j. May 16, sold merchandise on account to ripe co, invoice no.58. terms 1/10, n/30, fob shipping point Br. 8,000
k. may 18, received Br.4,059 from waller Inc. in payment of may 8 purchase, less return on may 12 and discount.
l. May 20, issued additional capital stock for Br. 100,000
m. may25, sold merchandise for cash br. 15,900
n. may 31, recorded adjusting entry for the work sheet prepared for the fiscal year ended may 31.

Merry Co. maintains a purchase journal, a cash payments journal, a sales journal a cash receipt journal and a general journal. in addition the account receivable and account payable ledgers are used.

Instruction

1. Indicate the journal entry in which each of the preceding transaction (a) through (n) would be recorded.
2. Indicate whether an account is the account receivable or the account payable subsidy ledger would be affected for each of the preceding ding transactions
3. Record transaction b,c,d,h,I, and k in the appropriate journal.

CHAPTER SIX

ACCOUNTING FOR CASH

6.0. Chapter Overview

In small businesses the owner may be able to control the entire operations through personal supervision and direct participation in its activity. However as a business grows higher and higher it becomes difficult to actively participate in routine operations and maintain adequate control. At this point it becomes necessary to delegate authorized persons and design a reliable internal control system over the business resources. The nature and extent of control might vary resources to recourse. For instance liquid assets like cash and receivables need strict internal control system compared with assets which are less liquid. This is due to the highest venerability of these assets for misuses and theft. In this chapter unitwe will discusses internal control over cash.

Learning Objectives:

After completing this chapter the students should be able to:

- Define cash and its characteristics
- Identify the principles of internal control over cash
- Indicate the control features of a bank account
- Prepare bank reconciliation.
- Preparation of bank reconciliation

- Identify other mechanisms of control over cash receipt

Session 24 (Hr. 47 and 48)

Topic :- Control over Cash

Session learning objective

- Define cash and its characteristics
- Identify the principles of internal control over cash
- Indicate the control features of a bank account
- Prepare bank reconciliation.

Reading Assignment discussions

Discussion issues

Exercise and problems of chapter five

Reading Text

6.2. Meaning and Characteristics of Cash

Cash is the most liquid asset that can easily convertible to any other type of asset. **Cash** consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository institutions.

Cash is a medium of exchange and is used to measure the value of other assets. Majority of the business transactions involves cash; this makes cash the most repeatedly used account in the recording system. These in tail increase the probability of making recording error compare with other accounts used in the recording system. In addition Money is light in weight and heavy in value. Anybody can easily pick and use it unless there is a strong control preventive mechanism.

6.3. Control over Cash

Because of the ease with which money can be transferred, cash is the asset most likely to be diverted and used improperly by employees. In addition, many transactions either directly or indirectly affect the receipt or paymentof cash. It is therefore necessary that cash can be effectively safeguarded by special controls.

In general speaking cash is an asset account which is highly exposed to embezzlements and misuse. As a result it is crustal to establish and exercise a strong internal procedure control over cash.

Internal control for cash should include the following procedures:

- The individual who receive cash should not disburse (pay) cash.
- The individual who handle cash should not make the accounting records.
- Cash receipts are immediately recorded and deposited and are not used directly to make payments.
- All mail receipts should be opened by more than one mail clerk and endorsed with “only for Deposit” stamp
- Cash disbursements should be made by serially numbered check, only up on proper authorization by somebody other than the person writing the check.
- Bank accounts should be reconciled monthly with a employee who has no other responsibility pertaining to cash
- Using a petty cash fund for small payments.

6.3.1 Control of Cash through Bank Account

Using bank account is one of the most important mechanisms to control cash. To get an effective control over cash all receipts must be deposited in the bank account and all cash payments should be made through check. Banks provide physical protection for cash and maintain separate records of transactions which belong to cash.

Once a company starts using bank accounts, the bank sends a monthly bank statement to the depositor. Bank statement is a bank report or a copy of banks record sent to a customer. if you or your family members have current account you can see the following information on it.

i. an opening or beginning cash balance, the balance of cash brought from the previous month
ii. checks paid and other debits (such as debit card transactions or direct withdrawals for bill payments) that reduce the balance in the depositor's account,
iii. Deposits and other credits that increase the balance in the depositor's account, and
iv. The account balance after each day's transactions.

A bank statement is accompanied by checks paid, debit and credit memorandum. Debit memos describe the amount and nature of decreases in the company's cash with the bank. It includes bank service charge, fund transfers etc. Credit memorandums inform the increase in the cash balance of the depositor. It includes collection of notes receivables, fund transfers etc

This bank statement is used to check whether the cash balance on the bank account agrees with the balance on the accounting record. If there is difference the company accountant finds out the reason and reconciles the two balances.

NB: a bank credits customer's account for every deposit. As a result deposits are considered as a liability for the bank. Banks debits customers account for every payments, because payment reduces the banks liability.

6.4. Reconciliation of Bank and Book Cash balance

Balance of cash as per the bank record seldom agrees with the balance of cash as per the depositor because of two reasons i.e time lags and errors made by either party. Time lags prevent one of the parties from recording the transaction in the same day as the other party and result different cash balance. For example deposit in transit and outstanding check. In addition to the difference, both balances are different from the "correct" or "true" balance. Therefore, it is necessary to make the balance per books and the balance per bank agree with the correct or true amount i.e. a process called **reconciling the bank account**.

Synopsis of lecture

- Cash is an asset item highly exposed to embezzlements and misuse
- Control over cash means having an effective control over cash receipts and payments
- The bank account is used as a tool to control cash
- Bank reconciliation is a statement that brings the bank balance and the book balance in to agreement

Wrap-up discussion questions

- Explain the reason why special control is required to cash
- Identify the elements of internal control over cash
- Explain how the control system is supported by a bank account

Next day's assignment

Read about control over cash receipts

Session 25, (Hr. 49 and 50)

Topic:- Procedures and steps in a bank reconciliation

SessionLearning Objective

- Preparation of bank reconciliation
- Identify other mechanisms of control over cash receipt

Reading Assignment Discussion

Discussion issue;

Internal control over cash receipt

Reading Text

Bank reconciliation should be a routine monthly activity that has to goes in line with the company's internal control procedures. The activity should be undertaken by a designated employee who is free from other responsibilities related to cash.

The starting point in preparing the reconciliation is to enter the balance per bank statement and the balance per books on the reconciliation schedule. The company then makes various adjustments as per the following step.

1. **Step 1. Deposit in transit:-** Deposits recorded by the depositor that have not been recorded by the bank are the **deposits in transit**. Add these deposits to the balance per bank. This is made by comparing the deposit lists of the depositor with the deposit list shown in the bank statement.
2. **Step 2. Outstanding Check:-**Issued checks recorded by the company but that have not yet been paid by the bank are **outstanding checks**. Deduct outstanding checks from the balance per bank. This is made by comparing the list of checks paid

by the bank with the same list in cash payment journal of the company.

3. **Step 3. Bank Errors:-** any error made by the bank and discovered in the foregoing steps are included in the schedule. An error which overstates the cash balance is deducted where as an error which understates the cash balance is added to the balance as per the bank. For example if a bank paid a check for Br. 547 and incorrectly record it as Br.574. Here the bank understates cash balance by Br. 27 (547-574) and this amount is added to the cash balance as per the bank. What if it is incorrectly recorded as Br. 457 instead of Br. 574? Now the error overeats the cash balance for br. 90 (547-457) the amount is deducted from the bank balance.
4. **Step 4.Bank credit memorandum:-** collection of notes receivables and other fund transfers made by the bank on behalf of the depositor. List all credit memos and add them to the cash balance as per the book.
5. **Step 5. Bank Debit memorandum**: -Banks charge a monthly fee for their services called service charge. The bank also sends with the statement a debit memorandum explaining the charge noted on the statement. Other debit memoranda may also be issued for other bank services such as the cost of printing checks, issuing traveler's checks, and wiring funds to other locations. List all the debit memos and deduct them from the cash balance as per the Book.
6. **Step 6**.**Charges for depositing NSF- Checks:-** When checks are deposited in an account, the banks generally gives the deposit immediate credit. On occasions, one of these checks may prove to be uncollectable because the maker of the check does not have sufficient funds in his or her account. in such cases the bank will reduce the depositor's balance by the amount of the uncollectable item and return that check to the depositor marked NSF. Deduct the amount of the NSF check from the cash balance as per the book.

7. **Step 7**. **Depositor Error:-** Any error made by the depositor is added or deducted from the cash balance as per the book, in the same we made for bank error of step 3.
8. **Step 8.Prove the equality** of the adjusted cash balances as per the bank and as per the book.
9. **Step 9.Prepare adjusting entries** to record those items which are not yet recorded by the depositor.

Illustration of Bank Reconciliation

Enkopa Company is a customer of Dashin Bank Sc. The company received bank statements for the month November 31, 2016. The statement shows cash balance of Br. 23,932.50 at the end of the month. The balance of cash as per the company record is Br. 27, 220.50. The comparison of the statement with the cash account reviled the following reconciling items.

1. A debit memorandum for Br. 30 for bank service charge accompanied the statement.
2. The following checks issued in November are not yet paid by the bank.

   Ck No. CD 232425 Br . 762

   Ck No CD 231429 Br., 930
3. Cash payment made for Br. 250 is incorrectly recorded as Br. 205 on the cash payment journal. The payment is for purchase of supplies made on account.
4. A deposit of Br. 5,800 made after banking hour is not appearing on the bank statement.
5. A credit memorandum for br. 2,200 is accompanied the statement for the collection of notes receivable
6. On November 30, the bank statement showed an “NSF” chares of Br. 1,100 for a check issued by a customer on account.

Enkopa Company

Statements of Bank Reconciliation

For the month November 30,2016

Cash Balance as per the bank statement			**23,932.50**
Add	**Deposit In transit**		**5,800**
	Sub total		**29,732.50**
Deduct	**Outstanding checks**		
	No.232425	**762**	
	No.232429	**930**	**1,692**
Adjusted Bank Balance			**28,040.50**
Cash Balance as per the book Balance			**27,220.50**
Add	**Note receivable collected by the bank**		**2,000**
	sub total		**29,220.50**
Deduct	**Bank service charge**	**Br. 35**	
	NSF check	**1100**	
	Error of recording payment of Br.250 as 205	**45**	**1,080**
Adjusted Book balance			**28,040.50**

Adjusting Entries for a Bank Reconciliation

Adjusting entry is necessary to update cash balance as per the book. As you see from the above schedule the company did not record collection of notes receivable, payments for service fee. More over the company did not record the check returned for NSF and the error made by the company accountant.

As a result the company records the following four adjusting entries to update cash balance.

Date		Account Title and Descriptions	P/R	Debit		Credit	
2016	3	Cash		2,000			
		Notes Receivable				2,000	
		Recording Bank					
	3	Administrative		35			
		Cash				35	
		Recording bank service charge					
	3	Accounts Receivable		1,100			
		Cash				1,100	
		Recording NSF					
	3	Account Payable		45			
		Cash				45	

.Internal Control over Cash Receipts

Retile businesses normally receive cash from two main sources (1) Over the counter from the customers (2) By mall from charge customers making payments on account. At the end of the business day, each sales clerk counts the cash in the assigned cash drawer and records on a memorandum form. An employee from the cashers department removes the cash register tape on which total receipts were recorded for each cash drawer, count the cash and compare the total with the memorandum and the tape and forwarded to the accounting department, where they become the basis for entries in the cash receipt Journal.

The employees who open incoming mail compare the amount of cash received with the amount shown on the accompanying remittance advice to be certain that the two amounts agree. If there is no separate remittance advice, an employee prepares one of the form designed for such use. All

cash received usually in the form of check and money order sent to the cashers department, where it is combined with receipts from cash sales and a deposit ticket is prepared. The remittance advice is delivered to the accounting department, where they become the basis for entries for cash receipt journal and for posting to the customer account subsidiary ledger.Duplicate deposit ticket, or other bank receipt forms obtained by the casher are sent to the controller or other financial officer, who compare the total amount with that reported by the accounting department as a total debit to cash in bank for the period.

Cash Short and Over

The amount of cash actually received during a day often does not agree with the record of cash receipt. Whenever there is the difference between the recorded and the actual cash and no error can be forum on the record, it must be assumed that the mistake occur in making change. The cash sort or over account is recorded in accounting title. a common method for handling such mistake to record it as a debit to cash sort and over account whenever there is shortage and credit cash short and over account whenever there is cash excess.

If there is a debit balance in the cash short and over account at the end of the fiscal year, it is expense and may be presented in the other expense and loss section of the income statement. If there is a credit balance, it is revenue and may be listed in the other income and gain account section of the income statement.

Cash Change funds

Retail stores and other business is that receive cash directly from customers must maintain a fund if currency and coins in order to make change. The fund may be stabilized by drawing a check for the required amount –

Debiting Cash on hand and Crediting cash in bank. No additional change or credit to cash on hand at the end of each business day, the total amount of cash received during the day is deposited and the original amount of the cash change fund is maintained. Exchanging bills or coins maintain the desired composition of the fund for those of other denomination at the bank.

Synopsis of lecture

- Adjusting entry is necessary to recognize unrecorded cash receipt or payment belonging to bank reconciliation
- Cash sort and over is an account used to handle mistakes in making cash change
- All cash received in the form of check should be endorsed to the company account
- The employees who open the incoming mail compare the amount of cash received to the remittance advice.

Wrap-up discussion questions

- What does the term deposit in transit means?
- What is the need to have cash change fund?
- Which section of the reconciliation statement used to make adjusting entry?

Next day's assignment

Read about Internal control over cash payments

Section 26 (Hr. 51 and 52)

Topic:- Internal Control over Cash Payments

Session learning Objective

- Illustrate internal control over cash

- Describe the voucher system
- Describe the operation of a petty cash fund.

6.5 Internal Control over Cash Payments

Control over cash payments involves two mechanisms, i.e the voucher system and petty cash handling system. The voucher system is one of the best systems that control disbursements. A voucher system is made up of records, methods and procedures used in proving and recording liabilities and in making and recording cash payment. A voucher system uses (1) Voucher, (2) A voucher register, (3) a file for unpaid voucher, (4) a check register and a file for unpaid voucher. dear students the full discussion for voucher system is included in the previous chapter (Chapter 5) and refer that for your understanding.

6.5. Petty Cash Fund

As you recalled from the above discussion, controlling cash through bank account is effective when “all payments” are made through check. However, using checks to pay small amounts is both impractical and a costly to a company. For example, writing a check to pay a Br. 5 taxi fare, or a br. 10 daily labor fee. A better way to handle such small payments is establishing a petty cash fund.

A petty cash fund is a special cash fund proposed to cover many small payments for a period of two or three weeks. The operation of a petty cash fund, often called an **imprest system**, involves (1) establishing the fund, (2) making payments from the fund, and (3) replenishing the fund.

i. Establishing the petty cash fund

Establishment of the fund has three steps (1) assigning a custodian who handle the fund. (2) Determining the maximum amount of fund required to cover anticipated payments for two or three weeks. (3) Determine the

minimum amount left in the custody to replenish the fund (4) Issue a check for the maximum amount and record the appropriate journal entry.

Illustration assume that on august 10, 2016, Loin Company decides to establish a petty cash fund and writes a check of Br. 500. The following is the journal entry to record the establishment of a petty cash fund.

Date		Account Title and Descriptions	P/R	Debit		Credit	
2016 Augu	**10**	**Petty Cash**		**500**			
		Cash				**500**	
		recording establishment of					

The custodian cashed the check, put in on safe custody or a petty cash box and then makes payment from the fund for authorized purpose only.

NB: The Company will make no additional entries to the Petty Cash account unless management changes the maximum amount of the established fund. For example if Loin decides to increase the fund to Br. 650, then the company debit Petty Cash fund Br. 150 and credit cash for Br. 150.

ii. Making payment from the Petty Cash Fund

The custodian has authority to make payments from the fund. For each payment the custodian prepares and keeps supporting evidence. The evidence must show the date and amount of payment, the name and signature of the payee and the reason for payment. No journal entry is required to record the payments until replenishment or the end of the fiscal year. When the fund gets smaller and smaller and reaches a minimum level, the custodian prepares a summary of payment and requests the treasurer' to replenish the fund.

iii. Replenishing the petty cash fund

To replenish a petty cash fund the treasurer examines the summery and the supporting documents of paymentto verify that proper payments were made. Then the treasurer approves the request and replenishes the fund.

To illustrate, assume that on August 25, Loin's custodian made payments for the following items and requests replenishment for Br. 437. The payments are for Delivery expense Br. 160 Postage stamp Br. 72, purchase of supplies Br. 205. The following is the journal entry to record the issuance of the check for replenishment.

Date		Account Title and	P/R	Debit		Credit	
2016	25	Delivery Expense		160			
		Postage Expense		72			
		Supplies		205			
		Cash				437	
		Recording					

Look the above entry do not change the balance of the petty cash fund rather it simply substitutes the amount of cash withdrawn from the petty cash box.

Treatment for cash Short and over

In handling cash receipts from daily sales or in making payments from petty cash fund, a few errors will occur. These errors might cause a cash short or cash over at the end of the day. The account cash sort and over is debited if there is shortage and credited if there is overage.

To illustrate consider the information of the above illustration and assume that amount of cash left on the petty cash box is Br. 55 instead of Br. 63(Br. 500-437). The balance shows Br.8 shortage and recorded as follows while replenishing.

Date		Account Title and	P/R	Debit		Credit	
2016	25	Delivery Expense		160			
		Postage Expense		72			
		Supplies		205			
		Cash Short and over		8			
		Cash				445	
		Recording cash short					

Illustration 2 Assume that the cash register tape shows total cash sales for the day amounts to Br. 23,980. However, the actual cash count shows total of Br. 23,992. Here there is cash over of Br. 12 and recorded as follows

Date		Account Title and	P/R	Debit		Credit	
2016	3	Cash		12			
		Cash Short and				12	
		Recording cash over					

Electronic Funds Transfer (EFT) System

It is not surprising that companies and banks have developed approaches to transfer funds among parties without the use of paper (deposit tickets, checks, etc.). Such procedures, called **electronic funds transfers (EFT)**, are disbursement systems that use wire, telephone, or computers to transfer cash balances from one location to another. Use of EFT is quite common. For example, many employees receive no formal payroll checks from their employers. Instead, employers send electronic payroll data to the appropriate banks. Also, individuals now frequently make regular payments such as those for house, car, and utilities by EFT.

EFT transfers normally result in better internal control since no cash or checks are handled by company employees. This does not mean that opportunities for fraud are eliminated. In fact, the same basic principles related to internal control apply to EFT transactions. For example, without proper segregation of duties and authorizations, an employee might be able to redirect electronic payments into a personal bank account and conceal the theft with fraudulent accounting entries.

6.6. Reporting Cash

Companies report cash in two different statements: the statement of financial position and the statement of cash flows. When presented in a statement of financial position, cash on hand, cash in banks, and petty cash are often combined and reported simply as **Cash**. Cash is listed last in the current assets section of the statement of financial position.

The statement of cash flows shows the sources and uses of cash during a period of time. In this section, we discuss some important points regarding the presentation of cash in the statement of financial position.

Cash Equivalents

Many companies use the designation “Cash and cash equivalents” in reporting cash. **Cash equivalents** are short-term, highly liquid investments that are both readily convertible to known amounts of cash, and insensitive to changes in interest rate. Examples of cash equivalents are Treasury bills, commercial paper (short-term corporate notes), and money market funds. All typically are purchased with cash that is in excess of immediate needs.

While cash equivalents are now frequently reported with cash, it appears likely that the IASB will end this practice in the future. Instead, those items that are now referred to as cash equivalents will be reported as short-term investments.

Restricted Cash

A company may have **restricted cash**, cash that is not available for general use but rather is restricted for a special purpose. Cash restricted in use should be reported separately on the statement of financial position as restricted cash. If the company expects to use the restricted cash within the next year, it reports the amount as a current asset. When this is not the case, it reports the restricted funds as a non-current asset.

Synopsis of lecture

- Voucher system is designed to control payments of liability and expenses.
- Small payments are controlled by establishing petty cash fund.
- A means of transferring funds using telephone, or computer is referred to as electronic fund transacted.

Wrap-up discussion questions

- Explain the term unpaid voucher
- discuss how cash is presented on financial statement
- Explain the elements of establishment and replenishment of petty cash fund

SELF EXAMINATION QUESTION

1. In preparing a bank reconciliation the amount of the check outstanding would be:
   a. Added to the cash balance according to the bank statement
   b. Deducted from the cash balance according to the bank statement
   c. Added to the cash balance according to the depositor's record
   d. Deducted from cash balance according to the depositor's record
2. Journal entries based on the bank reconciliation is required for:
   a. Additions to the cash balance according to the depositor's record
   b. Deducted from the cash balance according to the depositor's record
   c. Both a and b d. Neither a nor b
3. The journal used to record liability when a voucher system is used is called
   a. A Voucher c. A check register
   b. An unpaid voucher d. A voucher register

4. The voucher system records all purchases at net amount, which is the correct record for a Purchase is made for Br. 5000 , terms 1/10, n/30
   a. Purchase should be debited for Br, 4,950
   b. Discount lose would be debited for Br. 50 , if the voucher is not paid with in the discount period.
   c. If the voucher is not paid after the discount period has expired, the discount lost would be reported as expense on income statement
   d. All of the above
5. A petty cash fund is:
   a. used to pay relatively small amounts
   b. Established by estimating the amount of cash for disbursement to relatively small amounts
   c. Reimbursed when the amount of money in the fund is reduced to a predetermined minimum amount.
   d. All of the above

ILLUSTRATIVE PROBLEM

1. The bank statement of Dunlap company for April 30, indicated a balance of Br.10,443.11, the company employees a voucher system in controlling expenditure. All cash receipts are deposited each evening in the night depository, after the banking hour. The accounting records indicate the following summary data for cash receipts and disbursements.
   - Cash in bank as of April 1 , Br. 5,143.50
   - Cash receipt journal's total cash receipt Br. 28,971.60
   - Total amount of check issued in April Br. 26,060.85

Comparison of the bank statement and the accompanying canceled check and memorandum with the records revealed the following items

a. The bank had collected for Dunlop Co. Br. 912 on a note left for collection. the face value of the note is Br. 900

b. A deposit of Br. 1,852.21 representing a receipt of April 30 had been made too late to appear on the bank statement
c. Check outstanding totaled Br. 3,265.27
d. A check drown for Br, 79 had been erroneously charged by the bank as Br.97
e. a check of Br. 10 returned with the statement had been recorded in the check register as br.100. the check was for the payment of an obligation to Davis co. for purchase of office supplies.
f. Bank service charge for April amounted to Br. 8.20

Instructions

i. prepare statements of bank reconciliation fro April
ii. Journalize the necessary entries

CHAPTER SIX

ACCOUNTING FOR RECEIVABLES

Chapter Learning Objective

After completing this part of the study you should be able to:

- Identify the different types of receivables.
- Explain how companies recognize accounts receivable.
- Distinguish between the methods and bases companies use to value accounts receivable.
- Describe the entries to record the disposition of accounts receivable.
- Compute the maturity date of and interest on notes receivable.
- Describe how companies value notes receivable.
- Describe the entries to record the disposition of notes receivable.

Section 27 (Hr. 53 and 54)

Topic:- Definition and Classification of Accounts Receivables

Session learning Objective

- Identify the different types of receivables.
- Explain how companies recognize accounts receivable.
- Explain how to control Accounts Receivables

6.1 Definition and Classification of Receivable

Receivable is a legally enforceable claim for payment held by a business for goods supplied and/or services rendered that customers have ordered but not paid for.

Classification of Receivables

i. **Accounts Receivable:-** used for selling merchandise or services on credit, and normally expected to be collected in a relatively short period. Such receivables are supported only by sales invoice, no formal written promise for payment. It is also known as open account.

ii. **Notes Receivable:-** used to grant credit on the basis of a formal instrument of credit, called a promissory note. Compared with account receivable note receivables is more formal and legally binding. Notes are normally used for periods longer than 6o days and for the transaction of relatively large in amount. Note may be used in settlement of open account and in borrowing and lendingmoney.

iii. **Other Receivables**:- include interest receivable, taxes receivable, and receivables from officers and employees advance. This receivables are known as Non- trade receivable.

6.2. Internal Control over Receivables

Like cash strong internal control procedure is necessary for receivables also. The following are among the control mechanisms:

- Background and paying capacity of customers should be examined before allowing credit sales.
- Credit sales should be approved by as designated employee only.
- Don't allow that, related functions like selling, approving and recording is performed by one individual.
- Sales return and allowance and sales discount should be authorized, and there adjustments are reviewed by aconcerned party.
- Effective collection effort should be made to minimize uncollectable.

6.3. Issues Associated with Receivables

There are three primary accounting issues are associated with receivable: These are

- Recognizing receivables
- Valuing receivables
- Disposing of receivable

6.3.1. Recognition of Receivables

When goods or services are sold on account, a business can recognize receivables at that point of sale at invoice price by debiting accounts receivable and crediting sales or service revenue. To illustrate, assume on

July 3 Alemu Garage gives a repair service on account Br. 2,000. Here the appropriate record is as follows.

Date		Account Title and	P/R	Debit		Credit	
2016	3	**Accounts Receivable**		**2,000**			
		Service fee				**2,000**	
		Record sales on					

6.3.2. Valuation of Accounts Receivables

To ensure that receivables are not overstated on the balance sheet, they are stated at their cash realizable value.Cash (net) realizable value is the net amount expected to be received in cash and excludes amounts that the company estimates it will not be able to collect.There is no general rule for when an account becomes uncollectible. The common indictorsthat an account becomes uncollectable are:

- The receivable is past due.
- The customer does not respond to the company's attempts to collect.
- The customer files for bankruptcy.
- The customer closes its business.
- The company cannot locate the customer.

6.3.2.1. Accounting for Uncollectable

Each customer must satisfy the credit requirements of the seller before the credit sale is approved. Inevitably, though, some accounts receivable become uncollectible. For example, a customer may not be able to pay because of a decline in its sales revenue due to a downturn in the economy. Similarly, individuals may be laid off from their jobs or faced with unexpected hospital bills. Companies record credit losses as debits to **Bad Debt Expense** (or Uncollectible Accounts Expense). Such losses are a

normal and necessary risk of doing business on a credit basis. Recently, when home prices in many parts of the world fell, home foreclosures rose and lenders experienced huge increases in their bad debt expense.

Two methods are used in accounting for uncollectible accounts: these are:

i. The direct write-off method
ii. The allowance method

i. Direct Write-off Method

Under the **direct write-off method**, when a company determines a particular account to be uncollectible, it charges the loss to Bad Debt Expense. Under the direct write-off method, Bad Debt Expense is not recorded until the customer's account is determined to be worthless. once the accounts is worthless,that customer's account receivable is written off by debiting bad debt expense and crediting Account receivable. To illustrate assume that, on October 20, 2016 a Br. 2,000 account receivable from Wt. Elsa has been determined to be uncollectable. The entry to write of this account is as follows

Date		Account Title and	P/R	Debit		Credit	
2016	20	**Bad debt Expense**		**2,000**			
		Account Receivable-				**2,000**	
		To record write-off					

NB: Under this method, Bad Debt Expense will show only actual losses from uncollectable. No attempt is made to match bad debts to sales revenues or to show cash realizable value of accounts receivable on the Statements of financial position. This reduces the usefulness of the financial statements. Consequently, unless bad debt losses are insignificant, this method is not acceptable for financial reporting purposes.

Synopsis of Lecture

- The major categories of receivables are Accounts receivable and notes receivable. But there are also other receivables which hold receivables like tax, interest etc.
- The three issues related to accounts receivable are, recognition, valuation and disposal of accounts receivables.
- Inthe financial statement Accounts Receivables are valued at their cash realizable value.
- Two methods are: direct write-off and allowance are the two methods used in accounting for uncollectible accounts.
- Direct write-off method, records Bad Debt Expense when it is known that a particular customer's account is worthless.

Wrap-up discussion questions

- Explain the three classifications of receivables.
- Discuss how and why receivables are valued.
- Explain the meaning of cash realizable value.

Next day's assignment

- Read about Allowance method of uncollectable

Section 29 (Hr. 57 and 58)

Topic:- Allowance method of accounting for uncollectable

Session Learning Objective

- Explain how companies apply Allowance method.
- Understand the two methods of estimating uncollectable
- Understand how to reinstate account receivables

Reading Text

ii. Allowance Methods of Uncollectable

The allowance method estimates the amount of uncollectible for accounts receivable at the end of theaccounting period and recognize Bad Debt Expense using adjusting entry. Compared to Direct write of method, Allowance method has two advantages i. e (1) Bad debit expanse is charged to the period in which the related sales is made and (2) Accounts receivable is reported at the amount the company actual expects to received (i.e. Net realizable Value).

IFRS requires business to use the allowance method for financial reporting purposes. This method has three essential features:

a. Estimating doubtful accounts

To illustrate assume that, after making the appropriate review, the company estimated its uncollectable accounts will be amounted Br. 5000. The following is the adjusting entry to record the estimate.

Date		Account Title and	P/R	Debit		Credit	
2016	31	**Bad debt Expense**		**5,000**			
		Allowance for doubtful accounts				**5,000**	
		To record estimated					

NB: Allowance for doubtful account is a contra account to accounts receivable like accumulated depreciation is a contra account to equipment. As a result it has a credit normal balance and presented on the statements of financial position.

b. Write-off Uncollectable

In allowance method when a particular customers is known to be uncollected after performing all necessary collection steps, the allowance account is reduced and the customer is written off.

Account receivable of br. 1,500 hold by Mr. Aaron(one of the credit customer) is now known to be uncollected the appropriate record is as follows

Date		Account Title and	P/R	Debit		Credit	
2017	10	**Allowance for doubtful accounts**		**1,500**			
		Account Receivable -				**1,500**	
		To record actual					

NB: As you see from the above table actual uncollectible are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable at the time the specific account is written off.

c. Recovery of actual Uncollectable

When there is recovery of an account that had been written off: two entries are require, the first to reinstate the account written off and the second to record the collection (recovery). To illustrate assume that on February 16, the company received the br. 1,500 from Ato Aron, which had been written off on January, 10. The following entries are required to be recorded.

Reinstatement of the Account Written off

Reinstating means simply reversing the journal we record to written off the actual uncollectable.

Date		Account Title and	P/R	Debit		Credit	
2017	16	**Account Receivable – Aron**		**1,500**			
		Allowance for doubtful accounts				**1,500**	
		To record reinstatement					

NB: as you see from the above table the entry is the exact reverse of the record made on January 10 to write off the account. Now account receivable has a debit of Br. 1,500 this canceled the previous written of and make the receivable outstanding.

Record cash Collection of the Recovery

Date		Account Title and	P/R	Debit		Credit	
2017	16	Cash		1,500			
		Account Receivable -				1,500	
		To record the recovery					

NB: The three essential feathers for allowance method are summarized as follows;

- Companies **estimate** uncollectible accounts receivable and debit estimated uncollectible to Bad Debt Expense and credit them to Allowance for Doubtful Accounts through an adjusting entry at the end of each period.
- When companies write off a specific account, they debit the actualuncollectible to Allowance for Doubtful Accounts and credit to Accounts Receivable of specific customer.
- Whenever there is a recovery of balance written off, the company reverses the entry recorded during written off and record the collects as a debit to cash and a credit to accounts receivable of a specific customer.

6.3.2.2. **Estimating and Recording Uncollectible**

Allowance for Doubtful Accounts shows the estimated amount of claims on customers that the company expects will become uncollectible in the future. There are two common methods used to estimate uncollectable. The first method is the estimate made on the base of the relationship between bad debt expenses and sales called an income statement approach. The second is estimate made based on relationship between the age of account receivable and the allowance for doubtful accounts called financial Position approach. After the estimate is made Companies use a contra account instead of a direct credit to Accounts Receivable because they do not know

the specific customer will fail to pay its balance. As a result allowance account will is credited in place of accounts receivable.

i. Estimating Based on Percentage of Sales

Since accounts receivable are created by credit sales, uncollectible accounts can be estimated as a percent of credit sales. If the portion of credit sales to sales is relatively constant, the percent may be applied to total sales or net sales. This method is better to match expenses with revenue of a particular period and follows an income statement approach.

To illustrate assume BM Bajai has a credit sales of Br. 850,000 in the year ended December 31,2016. Based on past experience 1% of the credit sales are uncollectable. As per this estimate the adjusting entry for uncollectable is as follows.

Bad Debt Expense= sales * Bad debit as a percentage of sales

Bad Debt Expense = 850,000 * 0.01= 8,500

Date		Account Title and	P/R	Debit		Credit	
2016	31	**Bad debt Expense**		**8,500**			
		Allowance for doubtful accounts				**8,500**	
		To record write-off					

Allowance for doubtful account

Debit	Credit
Jan 1, 2016	Jan 1, Br. 6,000
	Dec 31, 8,500

.

	Bal. Br 14, 500

NB: As you see from the above illustration Allowance for doubtful account has a credit balance of br. 8,500. This is so if the account has zero balance before adjustment. What it the account has a credit balance of br. 6,000 before adjustment. The adjusted balance of Allowance account is Br. 14,500 now.

Allowance for doubtful account

	Credit
	Jan 1, 2016. -0-
Debit Jan 1, 2016.	**Dec 31, Br. 8500**
	Bal. Br 8500

i. Estimate based on Percentage of Account Receivables

ii. Estimating Based on Ages or Receivables

The analysis of receivables method is based on the assumption that the longer an account receivable is outstanding, the less likely that it will be collected. Company's prepares an **aging schedule**, in which it classifies customer balances by the length of time they have been unpaid. Then multiply each aged classes by an estimated percentage of uncollectable as shown in the table below. The analysis of receivables method places more

emphasis on the net realizable value of the receivables and, thus, emphasizes the financial position. The following table illustrates it.

Account	**Total Amount of Account Receivables**						
Total Balance	**Not past due**	**Days past Due**					
		1-30 days	**31-60**	**61-90**	**91-180**	**181-365**	**above 365**
Br. 225,000	**70,000**	**25,000**	**18,0**	**22,0**	**8,00**	**4,**	**5,000**
Percentage uncollectable	**2%**	**5%**	**10%**	**20%**	**30%**	**50%**	**80%**
Estimate of Uncollectable(18	**1,400**	**1,250**	**2,800**	**4,400**	**2,400**	**2,000**	**4,000**

As per the above analysis of account receivable the amount of estimated uncollectable receivable on December 31, 2016 is Br. 18,250. To record the adjusting entry this method takes the balance of allowance on unadjusted trialbalance in to consideration. Here the amount of the adjusting entry is the difference between the estimated balance and the existing balance in the allowance account.

To illustrate assume that the allowance for doubtful account has a balance of br. 12,150 before adjustment. The appropriate adjusting entry will use Br. 8,150 i.e(18,250 - 12,150)

Date		Account Title and	P/R	Debit		Credit	
2016	31	**Bad debt Expense**		**6,100**			
		Allowance for doubtful accounts				**6,100**	
		To record allowance					

What it the allowance for doubtful account has no balance before adjustment. Now we take the estimate directly as follows.

Date		Account Title and	P/R	Debit		Credit	
2016	31	**Bad debt Expense**		**18,250**			
		Allowance for doubtful accounts				**18,250**	
		To record allowance					

NB: as the above table shows you the amount for adjustment is exactly equal to the estimate.thi is because the difference between the estimate and the unadjusted balance is the same with the estimate. i.e (Br. 18,250- 0)

Comparison between Direct Write off Method and Allowance Method

Dear students previously we have discussed about the meaning and the application of the two methods in recognizing uncollectable. Now to

enhance your understanding about the difference between the two methods it is better to add one more illustration as a comparison.

Illustration

The following selected transactions, taken from the records of Home Depo Plc. for the year ending December 31, 2016, are used:

May 10. Wrote off account of Wt. Luna, Br. 4,500,

June . 18,. Received Br. 3,100 2,250 as partial payment on the Br. 6,000 account of Ato Markos and Wrote off the remaining balance as uncollectible.

August 25. Received the Br. 4,500 from Wt, Luna, which had been written off on May 10. Reinstated the account and recorded the cash receipt.

October 1. Wrote off, the various customer accounts as uncollectible Br. 8.250.

Dec. 31. Home Depo uses the percent of credit sales method of estimating uncollectible expenses. Based on past history and industry averages, 2% of credit sales are expected to be uncollectible. Home Depo recorded Br. 2,000,000 of credit sales during 2016

Direct write-off Method					Allowance Method			
	10	Bad Debt	4,50			Allow. for	4,50	
		A/R Luna		4,50		A/R – Luna		4,50
To Record Write off Luna account								
	1	Cash	3,10			Cash	3,10	
		Bad Debt Expense	2,90			Allow. for	2,90	
		A/R – Markos		6,00		A/R – Markos		6,00
To Record partial collection and Write off Markos account								
	2	A/R Luna	4,50			A/R – Luna	4,50	
		Bad Debt Expense		4,50 0		All. for doubtful Acc		4,50 0

To reinstate the account Written off									
	2	**Cash**	**4,50**			**Cash**	**4,50**		
		A/R – Luna		**4,50**		**A/R – Luna**		**4,50**	
To record recovery of cash									
	1	**Bad debits**	**8,25**			**Allw. for doubtful**	**8,25**		
		A/R- various		**8,25**		**A/R- various**		**8,25**	
To record write-off for various accounts									
	3					**Bad debt Expense**	**40,0**		
		No Entry				**All.for**		**40,0**	
To record estimated uncollectable									

NB: As you see from the above table no allowance account is used for direct write off method.

6.3.3. Disposing of Accounts Receivable

Companies frequently dispose of accounts receivable in one of two ways:

1. Sell to a factor such as a other company or a bank and
2. Make credit card sale

Sales of Receivables

Companies might sale there receivables when immediate borrowing is expensive and impossible to finance their urgent cash need or, when the billing and collection procedures are costly and time taking for them. The process of selling receivable is called factoring. A factor buys receivables from businesses for a fee and collects the payments directly from customers.

To Illustrate assume that on Februarys 26, 2017 Loyal Supermarket factors its receivable amounted Br. 100,000 Dashin Bank Sc. The bank charges 3% on the amount of receivable sold. Thejournal entry to record the transaction is as follows.

Date		Account Title and	P/R	Debit		Credit	
2016	**26**	**Cash**		**97,000**			
		Service Charge Expense		**3,000**			
		Accounts				**100,0**	
		To record sales of account receivable					

NB: service Charge Expense= 100,000 * 3%= 3,000

If the company often sells its receivables, it records the service charge expense as a selling expense. If the company infrequently sells receivables, it may report this amount in the “Other income and expense” section of the income statement.

Credit Card Sales

Credit cards are frequently used by retailers who wish to avoid the paperwork of issuing credit. Retailers can receive cash more quickly from the credit card issuer. A credit card sale occurs when a company accepts national credit cards, such as Visa, MasterCard, Discover, and American Express.

The three parties involved when credit cards are used in making retail sales are the company issued the credit card, the retailer, and the customer.A retailer’s acceptance of a national credit card is another form of selling (factoring) the receivable.The retailer pays the credit card issuer a fee of 2-6% of the invoice price for its services. From an accounting standpoint, sales from Visa, MasterCard, and Discover are treated differently than sales from American Express**.** Because selling using American Express is considered as credit sales.

To illustrate assume that Shraton Addis gives catering service for br. 12,000 and received MASTERCARD from the customer. The service fee that MASTERCARD charge is 4%. The journal entry to record the transaction is

Date		Account Title and	P/R	Debit		Credit	
2016	26	Cash		11,520			
		Service Charge Expense		480			
		Sales				12,00	
		To record sales on					

What is the sale was made using American Express cared instead of MASTER, or VISA cards. If so Account receivable is debited instead of cash as follows.

Date		Account Title and	P/R	Debit		Credit	
2016	26	Accounts receivable		11,520			
		Service Charge Expense		480			
		Sales				12,00	
		To record sales on					

Synopsis of lecture

- Estimates for doubtful accounts can be made using an income statement or financial position approach.
- Allowance for doubtful account is a contra account to Accounts receivable and is reversed when a particular costumer account is known to be uncollectable.
- Receivable in one of the two ways to dispose account receivables are factoring and making credit sales.

- The process of selling receivable to financial institutions is called factoring.
- A credit card sale occurs when a company accepts national credit cards, such as Visa, MasterCard, Discover, and American Express.

Wrap-up discussion questions

- Explain the difference between income statement and financial position approach for estimating uncollectable.
- Explain the meaning of Allowance for doubtful account.
- Explain the ways of disposing accounts receivables

Next day's assignment

- Read about meaning and characteristics of notes receivable

Section 60 (Hr. 59 and 60)

Topic:- Notes Receivables and its Characteristics

Session learning Objective

- Compute the maturity date of and interest on notes receivable.
- Describe how companies' value notes receivable.
- Describe the entries to record the disposition of notes receivable.

Reading Text

6.4. Notes Receivable

A promissory note is a written promise to pay a specified amount of money on demand or at a definite time. A note has some advantages over an account receivable. By signing a note, the debtor recognizes the debt and agrees to pay it according to its terms. Thus, a note is a stronger legal claim.

6.4.1. Characteristics of Notes receivables

A promissory note is a written promise to pay the face amount, usually with interest,on demand or at a date in the future. Characteristics of a promissory note are as follows:

1. The maker is the party making the promise to pay.

2. The payee is the party to whom the note is payable.

3. The face amount is the amount the note is written for on its face.

4. The issuance date is the date a note is issued.

5. The due date or maturity date is the date the note is to be paid.

6. The term of a note is the amount of time between the issuance and due dates.

7. The interest rate is that rate of interest that must be paid on the face amount for the term of the note.

6.5. Issues Related to Notes Receivables

Companies frequently accept notes receivable from customers who need to extend the payment of an outstanding account receivable. They often require such notes from high-risk customers.

The basic issues in accounting for notes receivable are the same as those for accounts receivable:

1. Recognizing Notes Receivable.
2. Valuing Notes Receivable.
3. Disposing of Notes Receivable.

6.5.1. Recognition of Note Receivables

To illustrate, assume that a company accepts a 60-day, 12% note dated August21, 2016, in settlement of the account of Bunna Co., which is past

due and has abalance of 7,500. The company records the receipt of the note as follows:

Date		Account Title and	P/R	Debit		Credit	
2016	21	Notes receivable		7,500			
		Accounts				7,500	
		To record acceptance of					

NB: notes receivable is recorded at face value and no interest revenue is recognized on the date of acceptance

6.5.1.1. Determining Maturity Date of a Note Receivable

The life of a note can be expressed in terms of months or days. When the life of the note is expressed in terms of months, the due date is found by counting the months from the date of issue Example: The maturity date of a 3-month note dated May 31 is August 31.

When the life of the note is expressed in terms of days, you need to count the days.In counting, the date of issue is omitted but the due date is included. To illustrate Assume MC. company issued a 45 days note on March 25. The maturity date of this note is computed as follows.

Term of the Note		45 days
March 31 -25	6	
April	30	36
Maturity Date, May		9

Computing Interest for Note Receivable

The basic formula for computing interest on an interest-bearing note is:

Interest= Face value * interest rate * time in terms of one year

The interest rate specified on the note is an annual rate of interest.

To illustrates Merry Co. issued a br. 6,000, 10% , 90days note to Jattu Company. Compute the value of interest.

Interest = 6,000 * 10% * 90days/360= 150

6.5.2. Valuing Notes Receivable

Valuing short-term notes receivable is the same as valuing accounts receivable. Like accounts receivable, companies report short-term notes receivable at their **cash (net) realizable value**. The notes receivable allowance account is Allowance for Doubtful Accounts. The estimations involved in determining cash realizable value and in recording bad debt expense and the related allowance are done similarly to accounts receivable.

6.5.3. Disposing of Notes Receivable

Honor of Notes Receivable

A note is honored when it is paid in full at its maturity date. For an interest-bearing note, the amount due at maturity is the face value of the note plus interest for the length of time specified on the note.

Illustration Assume that Miky Co. lends Simert Inc. Br. 25,000 on May 1, accepting a 6-month, 10% interest-bearing note.Miky collects the maturity value of the note from Simert on November

Date		Account Title and Descriptions	P/R	Debit		Credit	
Nov 2016	1	Cash		26,250			
		Notes Receivable				25,00	
		Interest Revenue				1,250	
		collection of a note					

End period Interest Adjustment

Consider the above illustration for Miky Co, and assume that the company prepares financial statements as of June 30. Here two months interest is accrued but not yet received until maturity. The maturity date falls on the

next accounting period. As a result interest revenue is recognized by the amount of interest accrued as follows.

Date		Account Title and	P/R	Debit		Credit	
June 2016	30	Interest Receivable		417			
		Interest Revenue				417	
		Recognition of interest					

Br. 417 = 25,000 * .1 * 2/12 months

At the note's maturity on November 1, Miky receives Br. 26,250. This amount represents repayment of the Br.25, 000 note as well as six months of interest, i.e Br. 1,250 as shown below.

Date		Account Title and	P/R	Debit		Credit	
Nov 2016	30	Cash		26,250			
		Note receivable				25,00	
		Interest receivable				417	
		Interest Revenue				833	
		Collection of note					

The Br. 1,250 is comprised of the Br. 417 Interest Receivable accrued on June 30 plus Br. 833 four months interest earned (July to October).

6.6. Discounting Note Receivable

A company in need of cash may transfer its notes receivable to a bank by endorsement. This process is referred to as discounting note. Through discounting notes receivable can be converted to cash before they mature. The discount interest charged by the bank is computed on the maturity value of the note for the period of time the bank must hold the note. The amount of the proceed paid to the endorser is the excess of the maturity value over the discount.

The proceeds from discounting the note receivable may be less or greater than the face value. If it is less than the face value, the excess of face value

over the proceed will be recorded as a debit interest expense. Otherwise interest revenue is recognized.

To illustrate, assume that a 90-day, 12%, Br.40, 000 Note Receivable from Amrot Co. dated June 10, 2016 is discounted at Awash Bank on July 10, 2016 at a discount rate of 14%. The amount of proceeds is computed using the following steps:

Step1 – determine the maturity date and maturity value

- Maturity date September 8
- i.e 20days in June + 31 days in July + 31 days of August + 8days of September = 90days
- Maturity Value = Face value + interest
- Maturity Value = 40,000 + (40,000 * 12% * 90/360) = 41,200

Step 2 – Determine the bank discount

Bank discount = Maturity value * Discount rate * Discount period

- 41,200 * 14% * 60 days = 961

NB: Bank discount is an interest that is charged by the bank and is computed based on the maturity value of the note for discount periods. On the other hand discount period in the number of days that the bank holds the note.

Step3 – determine bank proceed

- Bank proceed = Maturity Value – Bank Discount
- Bank Proceed = 41,200 – 961 = 40,239

Step 4 – Record the necessary entry at the date of discount

Date		**Account Title and**	**P/R**	**Debit**		**Credit**	
July 2016	**10**	**Cash**		**40,239**			
		Notes Receivable				**40,00**	
		Interest Revenue				**239**	
		Record of Discounting					

The length of the discount period and the difference between the interest rate and discount rate determine whether interest expense or interest revenue will result from the discounting.

To illustrate assume in the above case that the discount rate of Awash bank is 18 % instead of 14%, what will happen to the proceed of the note.

- Now the bank discount = 41,200 * 18*60/360 = 1,236
- Bank proceed = 41,200 – 1,236 = 39,964

the journal entry will be as follows

Date		Account Title and	P/R	Debit		Credit	
July 2016	10	Cash		39,964			
		Interest expense		34			
		Notes Receivable				40,00	
		Record of Discounting					

As you see from the above table the face value of the note Br.40,000 is greater than the bank proceed Br. 39,964, as a result a Br. 36 expanse is incurred by the company.

Dishonor of Notes Receivable

If the maker of the note fails to pay the debt on the due date, the note is said tobe dishonored.A dishonored notes receivable is no longer negotiable and for this reason the holder usually transfers the claims, including an interest due, to account receivable account.

It should be observed that the proceeds from discounting a note receivable might be less than the face value. When this situation occurs, the excess of the face value over the proceeds is recorded as interest expense. Notes receivable are discounted with recourse 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. If a note is discounted **with recourse** and

the original maker of the note fails to pay the bank when it matures, the original payee of the note must pay for it. This means a company discounting a note with recourse has a contingent liability until the bank is paid. A company should disclose contingent liabilities in notes to its financial statements.

To illustrate Assume that Dashin Co., holds a Br. 30,000, 12%, 30-day note of Ato Mesert . At maturity, Meseret dishonored the note. Dashin Co. records this dishonoring of its N/R, on March 20, as follows:

Date		Account Title and	P/R	Debit		Credit	
March	**20**	**Accounts Receivable**		**30,300**			
		Notes Receivable				**30,00**	
		Interest revenue				**300**	
		Record of Dishonored					

If instead on November 1 there is no hope of collection, the note holder would write off the face value of the note by debiting Allowance for Doubtful Accounts. No interest revenue would be recorded because collection will not occur.

6.7. Presentation of Accounts Receivable

Companies should identify in the statement of financial position or in the notes to the financial statements each of the major types of receivables. Short-term receivables appear in the current assets section of the statement of financial position. Short-term investments appear after short-term receivables because these investments are more liquid (nearer to cash). Companies report both the gross amount of receivables and the allowance for doubtful accounts.

In an income statement, companies report bad debt expense and service charge expense as selling expenses in the operating expenses section. Interest revenue appears under “Other income and expense” in the non-operating activities section of the income statement.

Synopsis of Lecture

- Notes receivable is a written promise to pay a certain sum of money on specific future date to a specific person or entry.
- A note is honored when it is paid in full at its maturity date.
- Discounting is mechanism used to convert notes receivable to cash before they mature.
- If the maker of the note fails to pay the debt on the due date, the note is said to be dishonored.

SELF EXAMINATION QUESTIONS

6. How much is the maturity value of a 90Day’s, 12%, not for Br. 10,000:
   a. Br. 8,800 c. Br. 10,300
   b. 10,000 d. Br. 11,200
7. On June 16, the enterprise discounts a 60 day’s 10% notes receivable for Br. 15,000, dated June 1 at the bank of 12%. The proceed is
   a. Br. 15,000.00 c. 15,250
   b. Br. 15,021.25 d. 15,478.75
8. At the end of the fiscal year, before the accounts are adjusted, the accounts receivable ledger has a balance of Br. 200,000 and the allowance for doubtful account has a credit balance of Br. 2,500. if the estimate of uncollectable amount as a credit balance of Br. 2,500, the current provision to be made for uncollectable accounts expanse would Br,
   a. Br. 2,500 c. Br. 8,500
   b. Br. 6,500 d. Br. 200,000

ILLUSTRATIVE PROBLEM

2. Selected transactions completed by Topaz co. are as follows. the company uses allowance method of accounting for uncollectable accounts receivable

Jan 28. Sold merchandise on account Br. 10,000 to LacKland Co.

Mar 1, accepted a 60 –day, 12% notes from lackland co. on account

April 11. Wrote off a Br. 4,500 account from Exdel inc. as uncollectable

April 16, loaned Br. 7,500 cash to Tomas receiving a 90day's , 14% note

April 30, received the interest due from Lakeland inc. and a new 90 day's, 14% note as a renewal of the loan(record both the debit and credit to the notes receivable)

May 1 Discounted the note from Tomas at first national bank at 10%

June 13, Reinstated the account of Exdel Inc. written on April 11 and received Br. 4,500 in full payment

July 15, received a note from first national bank that Tomas dishonored this note. paid the bank the maturity value of the note plus Br.20 protest fee.

July 29, received from Lakeland inc. , the amount due on its note on April 30.

Dec 31. it is estimated that 2% of the credit sales of br. 958,600 for the year ended December 31, will be uncollectable.

Instructions:

Record the transaction in general journal

3. The account receivable ledger of Morning Co.shows a balance of Br. 65,200 at the end of current year. The analysis of the accounts in the customers' ledger indicates uncollectible accounts of Br.6,010. (the company uses the percentage of receivable method) Record the adjusting entry under the following assumptions.

A. The allowance for doubtful account before adjustment has zero balance.

B. The allowance for doubtful account before adjustment has a debit balance of Br. 400

C. The allowance for doubtful account before adjustment has a credit balance of Br. 2,100

4. Assume on February 20 Beki Plc. determines it can't collect Br. 1,020 owed to it by its customer Lusi. Co. Record the adjusting entry using the direct write-off method.