

INTRODUCTION TO ACCOUNTING

INTRODUCTION

We live in the *information age*-a time of communication, and a time when information is a vital resource. In this information era, how we live, whom we associate with, and the opportunities we have all depend on our access to and understanding of information. An information system is the collecting, processing, and reporting of information to decision makers. Understanding and processing information is the core of *accounting*.

The kind of information processed in accounting is financial i.e. of a monetary nature. Providing information about what businesses own, what they owe, and how they perform is the aim of accounting. Accounting is, an information and measurement system that identifies, records, and communicates relevant, reliable and comparable information about an organization's (a business's) economic activities.

DEFINITION, IMPORTANCE, AND USER OF ACCOUNTING INFORMATION

1.2.1. Accounting Defined

Accounting is defined as a process of identifying, measuring, recording and communicating economic events of an organization (business or non- business) to interested users of the information.

1. The first part of the process – identifying – involves selecting those events that are considered evidence of economic activity relevant to a particular organization.
2. Once identified and measured in Birr and cents, economic events are recorded to provide a permanent history of the financial activities of the organization.
3. This identifying and recording activity is of little use unless the information is communicated to interested users. The information is communicated through the preparation and distribution of accounting reports, the most common of which are called financial statements.

1.2.2 Importance of Accounting and Users of Accounting Information

Importance of accounting

The main purpose of accounting is to provide financial information to be used for decision-making. For instance, Business executives and managers need the financial information provided by the accounting system to help them plan and control the activities of the business.

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Outsiders such as bankers, potential investors, and labour unions and others also need accounting information.

In short the goal of the accounting system is to provide useful information to decision makers. Thus, accounting is the connecting link between decision makers and business operations.

Users of Accounting Information

Today's accountants focus on the ultimate needs of those who use accounting information, whether the users are inside or outside the business. Accounting is not an end by itself. The information that accounting provides allows users to make "reasonable choices among alternative uses of scarce resources in the conduct of business"

The people who use accounting information basically fall in to two categories:

1. External Users, and
2. Internal Users

1) External Users: External Users of accounting information are parties, which are not directly involved in running the business enterprise. These include lenders, shareholders (stock holders), suppliers, employees and their Unions, government (regulatory bodies) and others. External users rely (depend on) accounting information to help them make better decisions in trying to achieve their goals.

- The area of accounting aimed at serving external users is called ***Financial Accounting***. Its main objective is to provide to external users information through financial statements.

Each external user has its own specified information-need depending up on the decisions to be made. That is to say, all external users do not have the same intentions (objectives) when they use the information.

2) Internal Users: These are persons that are directly involved in managing and operating an organization. They include managers and other important decision makers. The internal role of accounting is to provide information to help improve the efficiency and effectiveness of an organization.

THE ACCOUNTING PROFESSION

If you just joined the accounting profession, you may be wondering what job you will be doing in the future. You probably would apply your expertise in one of three major fields:

- Public Accounting
- Private Accounting or
- Not – for – profit Accounting

i) Public accounting

In Public Accounting you would offer expert service to the general public in much the same way that a doctor serves patients and a lawyer serves clients. A major portion of public accounting practice is involved with Auditing. In this area, a certified Public Accountant (CPA) examines, the financial statements of companies and expresses opinion as to the fairness of presentation. When presentation is fair, users consider the statements to be reliable.

Management consulting is another area of public accounting. In this case, the accountant consults the management generally about the growth and development of the business enterprise.

ii) Private Accounting

Instead of working in public accounting, an accountant may be an employee of a business enterprise. In private accounting, you would be involved in one of the following activities:

1. **Cost Accounting:** Determining the cost of producing specific products.
2. **Budgeting:** Assisting management in quantifying goals concerning revenues, costs of goods sold, and operating expenses.
3. **General Accounting:** recording daily transactions and preparing financial statements and related information.
4. **Accounting information systems:** designing both manual and computerized data processing systems.
5. **Tax Accounting:** preparing tax returns (-forms to be filled by a company and returned to a taxing authority) and engaging in tax planning for the company.
6. **Internal Auditing:** reviewing a company's operations to determine compliance with management policies and evaluating efficiency of operations.

iii) Not for Profit Accounting

Like businesses that exist to make a profit, not - for-profit organizations also need sound financial reporting and control.

ACCOUNTING PRINCIPLES AND CONCEPTS

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GAAP are developed over a long span of years by the accounting profession. That is, their development is not revolutionary rather evolutionary. The main purpose of these basic rules is to guide accountants in measuring and reporting financial events of business enterprises.

In this unit, we will discuss three of the generally accepted accounting principles: Business Entity concept, Cost principle and Monetary Unit Assumption.

i) Business Entity Concept

Accountants frequently refer to a business organization as an accounting or business entity. A business entity is any business organization, such as a “super market”, laundry, barberry, or a hotel, which exist as an economic unit. For accounting purposes, each business enterprise has a separate existence from its owners, creditors, employees, customers and other businesses.

This separate existence of the business enterprise is known as the business entity concept. Thus, the business entity should have a completely separate set of records and its financial records and reports should refer only about the business enterprises.

For example, W/o Muna Mamo has got her own two business enterprises one called Munaye Super Market, and another hotel called Budena Hotel. Each Business would be considered as an independent economic business unit. The activities of each business are kept separately from each other and from the owner’s personal records. Let say W/O Muna bought a house to live in. This house would not be recorded and reported in the records of either the supermarket or the hotel.

ii) The cost principle

The cost principle states “properties and services acquired by business enterprises must be recorded at actual amounts paid or assumed in acquiring the properties.”

For example, **Modern Advertising Company** is considering the purchase of a building. The seller of the building offered a price of Birr 10,000 while the buyer first offered a price of Birr 8000. However, after certain bargaining, the seller agreed to sell the building for Birr 9000 and the buyer paid that amount. According to the “cost principle” the buyer has to record the building in its records at birr 9000- the actual amount paid to get the building.

The buyer may receive an offer of Birr 12,000 for the building a month after if has been acquired. This has no effect on the accounting records because it doesn’t originate from an actual exchange. It is simply a mere offer.

If the buyer sells the building for Birr 20,000 after purchasing it, a gain of Birr. 11,000 would be realized. The new owner would use Birr 20,000 as the cost of the building.

Monetary Unit Assumption

All business activities (events) are recorded in terms of money (-Birr, Dollar, Pound or any other currency). Of course, information of a non -financial nature can be recorded, but it is only through the recording of dollar (Birr) amounts that the activities of a business can be measured. Money is the only factor common to all business activities. Therefore, it is the only practical unit of measurement that can produce financial data that can be compared.

FORMS OF BUSINESS ORGANIZATIONS

There are three basic forms of business organizations: sole proprietorships, partnerships, and corporations.

1. Sole Proprietorships

A sole proprietorship is a business owned by one person and usually managed by the owner. No special legal requirements must be met to start a sole proprietorship and usually only a limited investment is required to begin operations.

A sole proprietorship is a separate entity for accounting purposes (Business entity Concept) but it is not a separate legal entity from the owners. That is, from the legal point of view, the owner and the business are treated as one and the same. The owner will be held personally responsible for the debts and actions of the business.

2. Partnerships

A Partnership is like a sole proprietorship in most ways except that it has more than one owner. A partnership is not a legal entity separate from the owners but an association that brings together the talents and resources of two or more people. The owners of a partnership are known as partners.

3. Corporations

A business organized as a separate legal entity with ownership divided into transferable units of capital is called a corporation. The owners of a corporation are called stockholders or shareholders. The corporation issues capital stock certificates to each stockholder showing the number of shares (orstock) he or she owns. The stockholders are free to sell all or part of

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these shares to other investors at any time. This ease of transfer of ownership adds to the attractiveness of investing in a corporation. Since a corporation is a separate legal entity, the owners (stockholders) are not personally liable for the debts of the corporation.

BUSINESS TRANSACTIONS AND THE ACCOUNTING EQUATION

Business transactions are economic events that should be recorded because they affect the financial position of the business enterprise. These businesses transactions are the raw materials of accounting reports, as cotton is a raw material for a textile factory.

1.7.1 Assets, Liabilities and Owner's Equity

If you have noticed, in any organization you will find properties such as a building, furniture, land, vehicles and the like. Such properties owned by business enterprises are referred to as **Assets**. To buy these assets, businesses get money from two sources: investments made by owners or amounts borrowed from creditors. Therefore, both owners and creditors have a claim over the assets of the business enterprise. The claims or rights of owners are referred to as **Equities**. If the assets owned by a business amount to Birr 50,000 the equities in the assets must also amount to Birr 50,000. The relationship between the two may be stated in the form of an equation, as follows:

$$\begin{array}{l} \text{Economic Resources} = \text{claims over the resources} \\ \text{Assets} \quad \quad = \text{Equities.} \end{array}$$

Equity may be subdivided in to two principal types: the rights of creditors and the rights of owners. The rights of creditors represent debts of the business and are called **Liabilities**. The rights of owners are called **Owners' Equity (capital)**.

$$\text{Assets} = \text{equities}$$

$$\text{Equities} = \text{Liability} + \text{Owner's equity}$$

This equation can be written as:

$$\text{Assets} = \text{liability} + \text{Owner's Equity}$$

It is customary to place "liabilities" before "Owners equity" in the accounting equation because creditors have priority (preferential) rights to the assets. Because of this, the owners

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have a residual claim over the assets. To help you understand this, assume X company has total assets of Br. 5000, liabilities of Br 2000 and owner's equity of Br 3000. If the business is to be closed, the assets of the company will be sold and distributed to the claimants. In accounting, the Owner's are given their share after the creditors are given their entire share. For example, assume the assets are sold for Br 4,500. The creditors will be given their share of Br. 2,000 and what ever remained (Br.2,500)is given to the owners. If the assets were sold for Br. 7,000, the creditors would have been given their share of Br. 2,000 and the remaining balance Br 5,000 would have been given to the owners.



As you can notice, the owners are given whatever is left (it could be greater or less than their share). That is why we said owners have residual claim over the assets of the business whereas creditors are said to have priority clam over the assets as they are paid first

1.7.2 Transactions and the Accounting Equation

All business transactions from the simplest to the complex can be stated in terms of the resulting effect on the three basic elements of the accounting equation. As a means of illustration, suppose Ato Dawit Gemechu establishes a sole proprietorship to be known as Effective Garage, on September1,200x . During September, the business engages in the following transactions:

Transection (1)- Owner's investment

Ato Dawit starts business by depositing Br. 100,000in a bank account opened in the name of Effective Garage. The transfer of cash from the owner to the business is on owner's investment. The effect of the transaction is to increase the assets (Cash) on the left side of the accounting equation by Birr 100,000 and to increase owner's equity by the same amount.

$$\begin{array}{l} \text{Assets} \\ \hline \text{Cash} \end{array} = \text{Liabilities} + \begin{array}{l} \text{Owner's Equity} \\ \hline \text{Dawit Gemechu, Capital} \end{array}$$

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Tran.1 + Br. <u>100,000</u>	+Br. <u>100,000</u>
Balance Br. 100,000	Br. 100,000

At this point, the company has no liabilities; the only party having claim over the assets of the company is the owner.

Transaction (2)- Purchase of land for cash

Effective Garage bought land for Birr 20,000 in cash, to be used as a future site for the business. This transaction changes the composition of the assets but it doesn't change the total amount of assets. It has no effect on the liability and owner's equity of the business.

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
	<u>Cash</u> + <u>Land</u>				<u>Dawit Gemechu, Capital.</u>
Bal. Birr 100,000					Birr 100,000
Tran. 2	<u>-20,000</u> <u>+20,000</u>				<u>-</u>
Bal. Birr 80,000	<u>+ Br.20,000</u>	=			<u>100,000</u>

After the above transaction, the company will have less cash but a new asset (land). The total assets (cash + Land) amount to Birr 100,000, which is equal to the owner's equity.

Transaction (3) -Purchase of Supplies On credit

Ato Dawit bought office supplies for birr 2,500 on credit, to be used by the business. Assets can be purchased on credit (on account) basis, where the buyer promises to pay in the future. This type of transaction is called a purchase on account and it results in a liability to the buyer; the liability created when something is bought on credit is called ***Accounts Payable***.

	<u>Assets</u>		= <u>Liability</u>	+	<u>Owners Equity</u>
	<u>Cash</u> + <u>Supplies</u> + <u>Land</u>		<u>Accounts payable</u>		<u>Dawit Gem, Captal</u>
Bal. Birr 80,000		Br.20,000			Birr 100,000
Tran(3)	<u>-</u> <u>+ 2,500</u>	-	<u>+ 2,500</u>		<u>-</u>
Bal. Br. 80,000	<u>2,500</u>	<u>20,000</u>	<u>2,500</u>		<u>100,000</u>
	Birr 102,500				Birr 102,500

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

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Transaction (4) – Payment of liability

Effective Garage paid Birr. 1,500 to creditors on account. As you might have noticed, the business bought the supplies in transaction “C” by promising to pay in the future, and as per the promise made it is now settling its liability. The effect of this transaction on the accounting equation is as follows:

<u>Assets</u>			=	<u>Liability</u>	+	<u>Owners Equity</u>		
<u>Cash</u>	+	<u>Supplies</u>	+	<u>Land</u>	=	<u>Accounts payable</u>	+	<u>Dawit Gem, Capital</u>
Bal Br 80,000		Br. 2,500		Br.20,000		Birr 2,000		Birr 100,000
Tran.4 <u>-1,500</u>		<u>-</u>		<u>-</u>		<u>-1,500</u>		<u>-</u>
Bal. Br. <u>78,500</u>		<u>Br.2,500</u>		<u>Br.20,000</u>		Birr <u>1,000</u>		<u>Birr 100,000</u>
Birr 101,000						Birr 101,000		

As a result of the transaction, the total cash decreases by birr 1,500 because cash is paid and the liability of the company also decreases by the same amount. After the above transaction is completed, the total amount the company has to pay in the future is only birr 1,000. Please note that the transaction has no effect on the supplies that were bought on credit.

Transaction 5 – Selling of service

The amount charged to customers for goods or services sold to them is called **revenue**. For instance, the amount of money that you pay to a shopkeeper after buying a pair of shoes or something is revenue to the shopkeeper. Different titles may be used for revenue depending up on the source of revenue. For example, a service fee for a garage, interest revenue for interest earned by a bank, rent income for revenues that result from renting rooms, fares earned for revenues from a taxi service and others.

During the first month of operation, Effective Garage earned service Fees of Birr 30,000 receiving the amount in cash for the garage services it rendered.

The effect of this transaction is to increase assets (because cash is collected) and to increase owner’s equity by the same amount as revenue is earned.

<u>Assets</u>			=	<u>Liability</u>	+	<u>Owners Equity</u>		
<u>Cash</u>	+	<u>Supplies</u>	+	<u>Land</u>	=	<u>Accounts payable</u>	+	<u>Dawit Gem, Capital</u>
Bal Br 78,500		Br. 2,500		Br.20,000		Birr 1,000		Birr 100,000

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<u>30,000</u>	-	-	=	<u>30,000</u>
Bol. Br. <u>108,500</u>	Br. <u>2,500</u>	Br. <u>20,000</u>	Birr <u>1,000</u>	Birr <u>130,000</u>
Birr 131,000			Birr 131,000	

Service can be given for cash or on credit. In this example, the service is given for cash (i.e., the company collects the cash on the spot service was given). But instead of requiring customers to pay at the time of sale, a business may let the customers to pay in the future. Such expected collections in the future result in an **Accounts Receivable** to the company. An accounts receivable is as much an asset as cash to the business enterprise. And the revenue from the sale of the service or good on credit is realized and recorded on the date of sale with out waiting for the collection of the cash.

Transaction (6)- Recording Expenses

To generate revenue, Effective Garage has to hire employees and pay salary, it has to consume electric power and water resource and pay the bill, and so forth. The amounts of such cash payments and using up of supplies are **expenses** to the business. That is, an expense is the amount of assets consumed or services used in the process of generating revenue. Just as revenues are recorded when they are earned, expenses are recorded when they are incurred (i.e. when the obligation to pay them arises).

During the month of September, Effective Garage paid Birr 15,000 for different types of expenses (birr 10,000 to salary of employees, birr 3000 Telephone, birr 1,500 for rent, and birr 500 for advertisement).

The effect of these transactions is to decrease assets (because cash is paid) and decrease owner's equity. This can be stated on the accounting equation as follows:

<u>Assets</u>			=	<u>Liability</u>	+	<u>Owners Equity</u>
<u>Cash</u>	+	<u>Supplies</u>	+	<u>Land</u>	=	<u>Accounts payable</u>
Bal Br108, 500		Br. 2,500		Br.20,000		Birr 1,000
<u>-15,000</u>		-		-		<u>-15,000</u>
Bol. Br. <u>93,500</u>		Br. <u>2,500</u>		Br. <u>20,000</u>		Birr <u>1,000</u>
Birr 116,000				Birr 116,000		

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Transaction – 7 Owner’s Withdrawal

Ato Dawit Gemechu, the owner, withdrew Birr 3000 for his personal from the business. Such assets taken out of the business for the owner’s personal use, by the owner are called ***withdrawals***. Owners can withdraw in cash or in kind. For example, an owner of a super market can withdraw soap or something for his personal benefit instead of cash.

The effect of the transaction in our case is to decrease assets as cash is taken out, and decrease owner’s Equity by the same amount. This can be stated on the accounting equation as follows:

Assets			=	Liability	+	Owners Equity
Cash	+ Supplies	+ Land		Accounts payable		Dawit Gem, Capital
Bal Br 93, 500	Br. 2,500	Br.20,000		Birr 1,000		Birr 115,000
-3,000	-	-		-		-3,000
Bol. Br. 90,500	Br.2,500	Br.20,000		Birr 1,000		Birr 112,000
Birr 113,000				Birr 113,000		

Summary

The transactions of Effective Garage can be summarized in a tabular form as shown below. Number identifies the transactions here and the balance of each item is shown after each transaction.

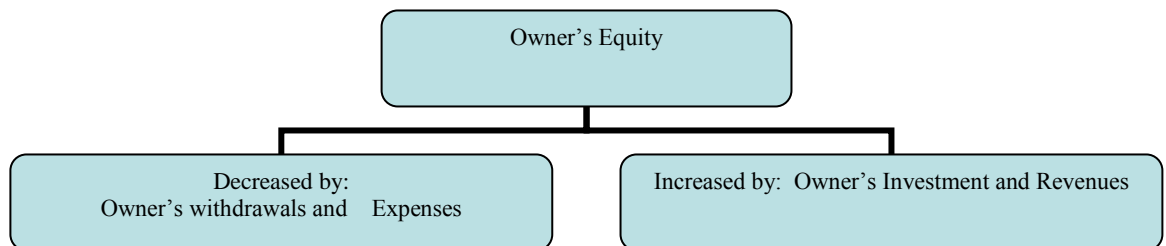
Assets			=	Liability	+	Owners Equity	
Tra. No	Cash +	Supplies +	Land	Accounts Payable	Dawit Gem. Capital	Type of owner’s Transaction	
1	+100,000	-	-	-	+ 100,000	Owners Investment	
Bal	Birr 100,000	-	-	-	Birr 100,000		
2	-20,000	-	+ 20,000	-	-		
Bal	Birr 80,000	-	Birr 20,000	-	Birr 100,000		
3	-	+2500		+2500			
Bal	Birr 80,000	Birr 2,500	Birr 20,000	Birr2500	Birr 100,000		
4	-1,500	-		-1500			
Bal	Birr 78,500	Birr 2,500	Birr 20,000	Birr1,000	Birr 100,000		

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5	+ 30,000	-	-	-	+ 30,000	Service fee
Bal	Birr 108,500	Birr 2,500	Birr 20,000	Birr1,000	Birr 100,000	
6	-15,000	-	-	-	-10,000	Salary Exp.
					-3000	Teleph. Exp
	-	-	-	-	-1500	Rent Exp.
					-500	Adv. Exp.
Bal	Birr 93,500	Birr 2500	Birr 20,000	Birr 1000	Birr 115,000	
7	-3,000	-	-	-	-3000	Owner's withdrawal
Bal	Birr 90,500	Birr 2500	Birr 20,000	Birr 1,000	Birr 112,000	
	Total Assets =Birr 113,000			Total Liabilities and Owner's Equity = Birr 113,000		

The following Observations, which apply to all types of Businesses, should be noted:

1. The effect of every transaction can be stated in terms of increases and /or decreases in one or more of the elements of the accounting equation.
2. The equality of the two sides of the accounting equation is always maintained.
3. The owner's investment and revenues increase the owner's equity. Withdrawals and expenses during the period decrease the owner's equity. The effect of these four types of transactions on owner's equity can be illustrated as follows:



The relationship of the above elements and their effect on the capital balance can be shown as:

$$EC = BC + I - W + R - E$$

Where: EC – End Capital Balance

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BC - Beginning Capital Balance.

I - Owner's Investment

W - Owner's Withdrawals

R - Revenue

E - Expense.

FINANCILA STATEMENTS OF SOLE PROPRIETORSHIPS

After the effect of the individual transactions has been determined, the essential information is communicated to users at certain intervals. The *accounting reports*, which communicate this information, are called *financial statements*. Financial statements are said to be the central features of accounting because they are the primary means of communicating important accounting information to users. Financial statements are the means of transferring the concise picture of the profitability and financial position of the business to interested parties.

The major financial statements used to communicate accounting information about a business are:

- income statement
- balance sheet
- statement of owner's Equity
- statement of cash flows (will be discussed in senior courses)

Since these financial statements are in a sense the end products of the accounting process, a student who acquires a clear understanding of the content and meaning of financial statements will be in an excellent position to appreciate the purpose of the earlier steps of recording and classifying business transactions.

1.8.1 The Income Statement

The income statement is a financial statement that summarizes the amount of revenues earned and expenses incurred by a business over a period of time. It reports the profitability of the business by comparing revenues and expenses for a stated period of time such as a month or a year. If the revenue of a period exceeds the expenses of that same period, net income results. If expenses are greater than the revenues of a period, we say there is a net loss, that is, the business has operated unprofitably.

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N.B. The determination of periodic net income (net loss) is a matching process involving two steps. First revenues earned are recognized during the period. Second, the expenses incurred to generate revenues are matched (compared) against revenues to determine net income or net loss.

All financial statements have three heading that you can find in any kind of a report. The heading of these statements identifies the company, the type of statement, and the time period covered by the statement.

The following is an income statement for Effective Garage for the month ended September 30, 200x.

Effective Garage
Income statement
For the Month Ended September 30,200x

Revenues:

Service Fee	Birr 30,000.00
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Expenses:

Salary Expense	Birr 10,000.00
Telephone Expense	3,000.00
Rent Expense	1,500.00
Advertising Expense	<u>500.00</u>

Total Expenses	<u>15,000.00</u>
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Net Income

<u>Birr 15,000.00</u>

1.8.2 Owner's Equity Statement

This is a statement that summarizes the changes in owner's equity for a specific period of time. Data for the preparation of owner's equity statement are obtained from the owner's equity column of the tabular summary (Illustration 1-) and from the income statement. The heading of this statement identifies the company, the type of statement, and the time period covered by the statement. The time period is the same as that covered by the income statement and therefore is dated " For the Month Ended September 30, 200x." The beginning owner's equity amount is shown on the first line of the statement. Then, the owner's investments, net income and the owner's drawings are identified in the statement.

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The information provided by this statement indicates the reasons why owner's equity has increased or decreased during the period. The Owner's equity statement for effective Garage for the month of September is shown below:

Effective Garage Statement of Owner's Equity For the Month ended September 30,200x

Dawit G. Capital, September 1.....	Birr	-0-
Add: Investments.....	Birr	100,000.00
Net income.....		<u>15,000.00</u>
		<u>115,000.00</u>
Less: Drawings.....		<u>3,000.00</u>
Dawit G. Capital, September 30.....	Birr	<u>112,000.00</u>

1.8.3 Balance Sheet

The balance sheet, sometimes called the statement of financial Position, lists the company's assets, liabilities and owner's equity as of a specific date- usually at the end of a month or year. Shown below is the balance sheet for Effective Garage as of September 30, 200x

Effective Garage Balance Sheet September 30,200x

<u>Assets</u>	<u>Liability</u>
Cash.....Birr 90,500.00	Accounts payable..... Birr 1,000.00
Supplies.....2,500.00	
Land.....20,000.00	<u>Owner's Equity</u>
	Ato Dawit Gem., Capital Br <u>12,000.00.</u>
	Total Liabilities and
Total Assets..... <u>113,000.00</u>	Owner's equity.....Birr <u>113,000.00</u>

ASSIGMENT I

1. Guji company had the following amounts of assets and liabilities at the beginning and end of last year:

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	<u>Assets</u>	<u>Liabilities</u>
Beginning of the year.....	Br.75,000	Br. 30,000
End of the year.....	120,000	46,000

Determine the net income or net loss of Guji for the year under each of the following unrelated assumptions:

- a) Owner made no additional investment and withdrew no amount during the year
 - b) Owner made no additional investment but withdrew Br.17,500 to pay for her personal expenses
 - c) Owner withdrew no amount during the year but made additional investment of Br. 32,500 cash.
 - d) Owner withdrew Br.17,500 and invested Br.25,000 cash during the year.
2. For each of the following give an example of a transaction that creates the described effects:
- a) Decreases a liability and decreases an asset
 - b) Increases an asset and decreases another asset
 - c) Decreases an asset and decreases owners equity
 - d) Increases a liability and decreases owners equity
 - e) Increases an asset and increases a liability
 - f) Decreases an asset and decreases a liability

3. Mimi started a new business called Omo Company and completed the following transactions during November:

Nov.1 Mimi transferred 56,000 out of a personal savings bank account to a checking account she in the name of the business.

1. Rented office space and paid cash for the month's rent of 800
3. Purchased electrical equipment for 14,000 by paying 3,200 and agreeing to pay the remaining balance in six months
5. Purchased office supplies by paying 900 cash.
6. Completed electrical work and received 1,000 cash for doing the work.
3. Purchased 3,800 of office equipment on credit
15. Completed electrical work on credit in the amount of 4,000
20. Paid for the office equipment purchased on Nov.9

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- 24. Billed a customer for electrical work completed 600
- 28. Received 4,000 for the work completed on Nov.15
- 30. Paid salary of employees 1,200
- 30. Paid the monthly utilities bill 440
- 30. Withdrew 700 from the business for personal use

Required:

1. Arrange the following asset, liability and owner's equity titles in a table just like illustrated in this unit: Cash, Accounts Receivable, Office Supplies, Office Equipment, Electrical Equipment, Accounts Payable and Mimi Capital.
2. Use additions and subtractions to show the effect of each transaction on the items in the equation. Show new totals after each transaction. Next to each change in owners equity state whether the change was caused by an investment, revenue, expense or withdrawal.
3. Prepare an income statement, a statement of owner's equity, and a balance sheet

UNIT 2 THE ACCOUNTING CYCLE

INTRODUCTION

In unit 1, you have learned the relationship between the accounting equation and business transactions. Every business transaction affects the elements of the accounting equation. This accounting procedure will be discussed in detail. *The different and interrelated stages of the accounting cycle will be presented.* The chapter is lengthy, but essential for the remaining chapters in this course and other accounting courses. Therefore, you are advised to study the chapter carefully.

NATURE OF AN ACCOUNT

In order to provide the necessary information to users, accountants maintain separate records on each element of the financial statements. For example, to report the balance for cash at the end of a year, a record regarding cash should be kept. The record includes beginning cash balance, cash payments & cash collections during the period. This record is called an **account**. An account is a subdivision under the three elements of the accounting equation used to record the changes over a single element in the financial statements. An account has

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three parts, Title, Debit, and credit. For illustration purposes an account can be represented in the form of capital letter 'T'.

Example

Title	
Debit	Credit
Dr	Cr

CLASSIFICATIONS OF ACCOUNTS

Accounts are classified into five: *assets, liabilities, capital, revenue and, expenses*. The first three are called *balance sheet accounts* and the other two are called *income Statement accounts*. Balance Sheet accounts are those reported on the balance sheet at the end of the reporting period and Income Statement accounts are reported on the Income Statement.

The five groups of account are discussed below

1. Assets: Resources owned by a business or individual are called *assets*. Assets could be tangible or intangible. Tangible assets are assets having physical existence, like cash, land, computer, stationery materials. Intangible assets do not have physical existence. Example: Goodwill, Copyright, patent right.

On the balance sheet assets are classified into two current assets and non – current assets.

Current Assets – are those assets, which can be used, sold, or converted into cash within one accounting year. Example: cash, supplies, prepayments, receivables etc.

Non-current Asset: All assets other than current assets are called non-current assets. Example: land, patent right, office equipment, vehicles.

2. Liabilities: Creditors' claims to the assets of a business; amounts owed to creditors are called *liabilities*. Like assets, liabilities are classified in to two as current liabilities and non – current liabilities

Current liabilities: The liabilities that are payable within the next (one) accounting year are known as current liability. Example: Accounts Payable, Rent Payable, Salary Payable.

Non – Current Liabilities: Debts that are not required to be paid within the next accounting period. Example long term notes payable.

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3. **Capital:** The excess of the assets of a business over its liabilities is referred to as capital. It is the equity of the owner in the business.

4. **Revenue:** Are increases in owner's equity resulting from the main operations of the business.

Examples of revenue accounts are sales, interest income, tuition fee, and sales commission.

5. **Expenses:** are decreases in owner's equity in the process of earning revenue. For example, a hotel has to pay salary to its workers for the services rendered to clients in order to get the income form customers (revenue) the Hotel has pay salary to the employees (expense).

Example of expenses: Salary, insurance, depreciation, supplies, utilities, rent etc.

CHART OF ACCOUNTS

The number and name of accounts used by an organization depends on the nature of its operation. The list of accounts used by an organization and their codes is called the *chart of accounts*. Look at the following chart of accounts of Bati Transport.

Bati Transport	
Chart of Accounts	
<u>Asset</u>	<u>Account number</u>
Cash-----	11
Accounts Receivable-----	12
Supplies-----	13
Prepaid Insurance-----	14
Equipment-----	15
Accumulated Depreciation –Equipment-----	16
Truck-----	17
Accumulated depreciation – Truck-----	18
<u>Liabilities</u>	
Accounts Payable-----	21
Notes Payable-----	22
<u>Owners Equity</u>	
Yimer Adem, Capital-----	31
Yimer Adem Drawing-----	32
Income Summary-----	33

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<u>Revenue</u>	
Service income-----	41
<u>Expense</u>	
Salaries Expense -----	51
Rent Expense -----	52
Utilities Expense-----	53
Supplies Expense-----	54
Insurance Expense-----	55
Maintenance Expense-----	56
Depreciation Expense-----	57
Truck Expense-----	58
Miscellaneous expense-----	59

In the chart of accounts, the asset accounts are listed according to their liquidity. Liquidity is the ease with which an asset can be converted in to cash. Cash is the most liquid asset so it is listed first. Accounts other than cash will be listed in their frequency of use or in alphabetical order.

RULES OF DEBITS AND CREDITS

As shown above every account has three parts. These parts are discussed below:

Title – The name of the account. This is written at the top of the account

Debit – is the left hand side of an account –Debit is abbreviated as ‘Dr.’. When an amount is entered on the left side of an account we say the account is **debited or charged**.

Credit – is the right hand side of an account. Credit is abbreviated as Cr. An account is said to be **credited** when an amount is entered on the right hand side of the account.

An account may increase or decrease on the debit side or on the credit side depending on the nature of the account. In general, accounts appearing on the left hand side of the accounting equation increase on their left side (Dr. side) and decrease on their right side (Cr. Side); whereas accounts on the right side of the equation increase on their right side and decrease on their left side.

The above general rule will be expanded as follows

<u>Debit</u>	<u>Credit</u>
-Increase in assets	-Decrease in assets
-Increase in expenses	-Decrease in expenses

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-Decrease in capital	-Increase in Liabilities
-Decrease in liabilities	-Increase in liabilities
-Decrease in revenue	-Increase in revenue.

The normal balance of an Account

Normal balance refers to the side of an account (Dr. or Cr.), which will have greater entries than the other. The increasing side will be the normal balance for accounts.

Example: The normal balance of all asset accounts is debit

JOURNALIZING BUSINESS TRANSACTIONS

When a business transaction takes place, *source documents* will be obtained and recorded. The *accounting record* in which a transaction is initially recorded is known as a *journal*. The journal is therefore referred to as “The book of original entry”.

The process of recording a business transaction in the accounting record is called *journalizing*.

The Journal commonly used to record all types of transactions is the General Journal. This Journal includes the following parts, entered step by step.

1. The date of the transaction
2. The title of the account debited
3. The title of the account credited
4. The amount of debit and credit
5. Brief explanation of the entry or reference to the source document.

Look at the following General Journal and notice where each of the above information is found.

Journal page _____

Date		Description	P.R	Debit		Credit	
Year							
Month	day	Debited account title		XXX	XX		
		Credited account title				X XX	XX
		Explanation					

There are also other types of Journals like, known as *special journals* that are used to record specific types of transactions. The cash Journal, for instance, is used to record only

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transactions affecting cash. The General Journal is used for illustrations in this chapter. Special journals are discussed in unit 5.

Steps in Journalizing a Transaction

The following steps should be followed in recording a transaction in the journal.

1. Record the date - Insert the year, the month, and the date as shown above.
2. Record the Debit- Insert the account debited in the description column and the amount of debit in the debit column.
3. Record the credit- Insert the account credited below the debited account and indented to the right in the description column and the amount of credit in the credit column.
4. Explanation- Write a brief explanation or reference to source document in the description column, when necessary.

Each one set of debits and credits for a transaction is called a *journal entry*.

In recording a business transaction answer the following questions based on the transaction to be recorded may help you.

- a) Which accounts are affected?
- b) Is each account increased or decreased?
- c) Which account is debited and which is credited?
- d) Prepare the complete journal entry.

Example. On January 10,2003 Tamget P.L.C paid Birr 6,000 to its employees as a salary for the first week of the year.

This business transaction will be analyzed and recorded as follows.

- a) Which accounts are affected? Answer: Cash and Salary Expense.
- b) Is each account increased or decreased? Answer: cash is decreased and salary expense is increased.
- c) Which account is debited and which is credited? Answer: Salary Expense is debited because increase in expenses is recorded on the debit side. And cash is credited because decrease in assets is recorded on the debit side.
- d) Prepare the complete Journal entry.

2003		Description					
Jan.	10	Salary expense		6000	00		
		Cash				6000	00

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		Payment of salary					
--	--	-------------------	--	--	--	--	--

Note: A **journal entry** is the complete presentation of the record in the journal.

Illustration

To illustrate the complete accounting cycle, we will consider the following list of selected transactions. The transactions were completed by Bati Transport in the month of January 2003.

January 1. Ato yimer took Birr 450,000 from his personal savings and deposited it in the name of Bati transport.

January 2. Bati Transport purchased two used trucks for Birr 150,000 each, on cash.

January 4. Bati Transport received a check for Birr 650 for services given to Alem Trading.

January 4. Received an invoice for truck expenses Birr 90.

January 11. Paid Birr 600 for Awash Insurance Company to buy an insurance policy for its trucks.

January 16. Ato Yimer issued a check for Birr 9,400 to the workers as a salary for two weeks.

January 20. Bati trading Billed Muradu Supermarket for goods transported from Djibouti to Gondar Birr 2,650

January 21. Ato Yimer wrote a check for birr 450 to have one of the trucks repainted

January 21. Bati trading purchased stationary materials and other supplies of Birr 740 on account

January 22. Office equipment of Birr 11,600 is bought on account.

January 23. Purchased an additional truck for Birr 250,000 paying birr 100,000 in cash and issuing a note for the difference.

January 23. Recorded services billed to customers on account birr 14,600.

January 25. Received cash from customers on account Birr 15,000.

January 27. The owner withdrew Birr 500 in cash for his personal use.

January 28. Paid Birr 9,400 to workers as a salary for the last two weeks of the month.

January 30. Paid telephone expense of Birr 95 and electric expenses of Birr 125 for the month.

January 30. Paid other miscellaneous expenses Birr 50.

January 31. Paid Birr 4,000 as a rent for a building used for office space.

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These transactions are journalised as follows:

Date	Description	Debit	Credit
2003 Jan.1	Cash Yimer Capital To record investment by owner	450,000	450,000
2	Purchase truck Cash Purchase of trucks	300,000	300,000
4	Cash Service Income Cash received from customers	650	650
4	Truck Expenses Accounts Payable Service received in advance	90	90
11	Prepaid Insurance Cash Purchase of insurance policy	600	600
16	Salary Expense Cash Payment of salary	9,400	9,400
20	Accounts Receivable Service Income Provision of service	2,650	2,650
21	Truck Expense Cash Cash paid to repaint truck	450	450
21	Supplies Accounts Payable Purchase of supplies of account	740	740
22	Office Equipment Accounts Payable Purchase of equipment	11,600	11,600
23	Truck Cash Notes Payable Purchase of truck	250,000	100,000 150,000
23	Accounts Receivable Service Income Provision of service on account	14,600	14,600
25	Cash Accounts Receivable Collection of cash	15,000	15,000
27	Drawings Cash Owner withdrawals	500	500

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28	Salary Expense Cash Payment of salary	9,400	9,400
30	Utilities Expense Cash Payment for telephone, electricity	220	220
30	Miscellaneous Expenses Cash Payment for various expenses	50	50
31	Rent Expense Cash Payment of Rent	4,000	4,000

POSTING FROM THE JOURNAL TO THE LEDGER

After the information about a business transaction has been journalized, that information is transferred to the specific accounts affected by each transaction. This process of transferring the information is called *posting*.

An account could be of two types; the two-column account and the four-column account. We will use the four-column account for our illustration. The two forms of accounts are given below.

The two-column account:

Account _____ Account number _____

Date	Item	P.R	Debit	Date	Item	P.R	Credit

The four-column account:

Account _____ Account number _____

Date	Item	P.R	Debit	Credit	Balance	
					Debit	Credit

The steps in posting are given below:

1. Record the date and amount of Dr. and Cr. Entry to the account
2. Insert the Journal page number in the P.R (Post Reference) column of the account.
3. Insert the account number in the P.R column of the journal.

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Note. The P.R Column is used for reference purposes. The P.R column of the journal shows whether the entry is posted and the account to which it is posted. In the account, the P.R Column shows the Journal page number from which the entry was brought.

The group of accounts used by an organization is called **ledger**.

Illustration. As mentioned above, to illustrate the posting process the four column account is used and the entries to the cash account are posted as follows.

Account Cash

Account Number _____

Date		Item	P.R	Debit		Credit		Balance			
								Debit		Credit	
2003				450,000	00			450,000	00		
Jan	1										
	2					300,000	00	150,000	00		
	4			650	00			150,650	00		
	11					600	00	150050	00		
	16					9,400	00	140650	00		
	21					450	00	140200	00		
	23					100,000	00	40200	00		
	25			15,000	00			55200	00		
	27					500	00	54200	00		
	28					9,400	00	45300	00		
	30					220	00	45,080	00		
	30					50	00	45,030	00		
	31					4,000	00	41,030	00		

Note. The item column is usually left blank. In some cases the word balance is written when the account is carried foreword to a new page.

THE TRIAL BALANCE

After the posting phase is completed, we have to verify the equality of the debit and credit balances. This is done through the use of the 'Trial Balance'. A trial balance is a two column listing of the accounts in the ledger and their balance to make sure that the total of debit balances equals the total of credit balances.

The trial balance for our illustration, Bati Transport is presented bellow. The amounts are taken from the balances of the accounts after all the transactions have been posted. Therefore, after posting the above transactions, you should get the final balances shown on the trial balance in the end.

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Bati Transport Trial Balance January 31, 2003

Cash	41,030	00		
Accounts Receivable	2,250	00		
Supplies	740	00		
Prepaid Insurance	600	00		
Office equipment	11,600	00		
Truck	550,000	00		
Accounts payable			12,430	00
Notes payable			150,000	00
Yimer capital			450,000	00
Yimer drawing	500	00		
Service income			17,900	00
Salary expense	18,800	00		
Rent expense	4,000	00		
Utilities expense	220	00		
Maintenance expense	450	00		
Truuck expense	90	00		
Miscellaneous expense	50	00		
Total	<u>630,330</u>	<u>00</u>	<u>630,330</u>	<u>00</u>

2.8.1 Proof Provided by the Trial Balance

The trial balance debit totals and credit totals are equal implies that the accounting work is more likely to be free from any one or more of the following errors.

1. Error in preparing the trial balance including
 - Addition error
 - The amount of an account balance was in correctly listed on the trial balance
 - A debit balance was recorded as a credit or vice versa
 - A balance was entirely omitted.
2. Error in posting, including
 - An erroneous amount was posted to the account.
 - A debit amount was posted as a credit or vice versa
 - A debit or credit posting was omitted

2.8.2 Limitations of the Trial Balance

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The trial balance amounts are equal doesn't mean that the accounting work is free from error. That is, there are errors that may take place without affecting the trial balance totals. Some examples are mentioned below:

- Failure to record a transaction or to post a transaction
- Recording the same erroneous amount for both the debit and the credit parts of a transaction.
- Recording the same transaction more than once.
- Posting part of a transaction to the correct side but the wrong account.

Note: All these errors have the same affect (increasing or decreasing) on the debit totals and credit totals

ADJUSTMENTS

All the transactions recorded above in the journalizing step are the result of daily transactions. Other transactions result from the passage of time or from the internal operations of the business. For example, insurance premiums are paid for a certain period of time and expire during that time period. Another example is office supplies such as paper, pens & pencils.

At the end of the period the balances in accounts such as supplies and prepaid insurance must be brought up to date. The supplies account balance, for example, must be credited by the consumed part of the supplies, debiting supplies expense.

Example. Stationary materials totaling Birr 1,900.00 were purchased and recorded during the year. At the end of the year, only Birr 150 of the supplies are left in hand.

The adjusting entry prepared at the end of the year to adjust the supplies account will be

1990	Supplies expense			1,750	
Dec31	Supplies				1,750

Note: 1. Adjustments are dated as the last day of the year.

2. The accounting year here – we assume, runs from January 1- December 31.

Additional examples on adjustments will be given below under the topic 'worksheet'

2.9.1 The Accrual Basis and the Cash Basis of Accounting

1. **The cash basis of accounting** – In this basis of accounting revenues are reported in the period in which cash is received and expenses are reported in the period in which cash is paid. Net income will, therefore, be the difference between the cash receipts (Revenues) and cash payments (expenses). This method will be used by organizations that have very few receivables and payables. For most businesses, however, the cash basis is not an acceptable method.
2. **The accrual basis of accounting** – Under this method revenues are reported in the period in which they are earned, and expenses are reported in the period in which they are incurred. For example, revenue will be recognized as services are provided to customers or goods sold and not when cash is collected. Most organizations use this method of accounting and we will apply this method in this course.

2.9.2 The Matching Principle

We have discussed three concepts and principles in accounting in unit one. Now we will see one more principle, the matching principle. This principle states that the expense of a period have to be matched with the revenue of that period regardless of when payment is made. In order to do this, the accrual basis of accounting requires the use of an adjusting process at the end of the period so that revenues and expenses of the period will be determined properly.

WORKSHEET FOR FINANCIAL STATEMENTS

Most of the data required to prepare the accounting reports (financial statements) is now gathered. The data will now be presented in a convenient form. The worksheet is a large columnar sheet prepared to arrange in a convenient form all the accounting data required to prepare financial statements. The worksheet has a heading and a body.

The heading has three parts:

- i) Name of the Organization
- ii) Name of the form (worksheet)
- iii) Period of time covered.

The body contains five main parts each of them with two main columns. These parts are

1. The trial balance
2. The adjustment
3. The adjusted trial balance
4. The income statement

5. The balance sheet.

The worksheet for Bati Transport is given below. The five parts of the body are discussed as follows. You are advised to read and understand the discussions before you look at the respective columns of the worksheet.

Bati Transport
Work Sheet
For th3e month ended jan.31,2003

	Account Title	Trial Balance		Adjustment		Adjusted Trial balance		Income statement		Balance sheet	
1	Cash	41,030				41,030				41,030	
2	Accounts receivable	2,250		©7,400		9,650				9,650	
3	Supplies	740			(a)340	400				400	
4	Prepaid Insurance	600			(b)450	150				150	
5	Office equipment	11,600				11,600				11,600	
6	Truck	550,000				550,000				550,000	
7	Accounts payable		12,430				12,430				12,430
8	Notes payable		150,000				150,000				150,000
9	Yimer Capital		450,000				450,000				450,000
10	Yimer drawing	500				500				500	
11	Service income		17,900		©7,400		25,300		25300		
12	Salary expense	18,800				18,800		18,800			
13	Rent expense	4,000				4,000		4,000			
14	Utilities expense	220				220		220			
15	Maintenance expense	450				450		450			
16	Truck expense	90				90		90			
17	Miscellaneous Expense	50				50		50			
18		630,330	630,330								
19	Supplies expense				(a)340	340		340			
20	Insurance expense				(b)450	450		450			
21					7290	7290	636,830	636,830			
22	Net income										
23								25300	25300	613,330	613,330

1. The trial balance column – this is the same trial balance we have prepared before. The trial balance column of the work sheet can be brought direct from the ledger or from a separate trial balance.

2. The Adjustment column – As mentioned previously, some account balances have to be adjusted at the end of the year.

The accounts in the ledger of our illustration that require adjustment and the adjusting entry for the accounts are presented below.

a) Supplies – The supplies account has a debit balance of Birr 740. The cost of supplies in hand on July 31 is determined to be Birr 400. The following adjusting entry is required to bring the balance of the account up to date:

Supplies expense.....	340
Supplies.....	34

b) Prepaid insurance – Analysis of the policy showed that three – fourth of the policy is expired. That is only Birr 150 of the policy is applicable to future periods. The adjusting entry to transfer the expired part of the insurance to expense will be.

Insurance expense	450
Prepaid insurance.....	450

c) Service Income – At the end of the month unbilled fees for services performed to clients totaled Birr 6,500.

This amount refers to an income earned but to be collected in the future. The journal entry to record it will be

Accounts receivable.....	6,500
Service income.....	6,500

All the above adjusting entries will be inserted in the adjustment column of the worksheet in front of the accounts affected.

Note – The letters a, b & c are used to cross-reference the debits and credits to help future review of the worksheet.

3. The Adjusted Trial Balance Column – The accounts that require adjustment are now adjusted. Transferring the trial balance column amounts combined with the adjustment column amounts will complete the adjusted trial balance column of the worksheet.

4. The income statement and the balance sheet columns – Transfer the income statement account balances (revenue & expenses) to the income statement and balance sheet account balances (Asset, Liability & owners equity) to the balance sheet columns. Note that what we have to transfer is the adjusted trial balance column amounts, to the corresponding columns.

Look at the 22nd row. It shows the net income for the month and it is added to the two columns (Income statement Dr. and balance sheet cr.) as a balancing figure.

FINANCIAL STATEMENT PREPARATION

After the work sheet is completed financial statements could be prepared easily. In chapter one we have discussed four basic financial statements prepared by most organizations. Here, we will prepare three of these statements for Bati Transport form the worksheet.

1. Income statement All the data required to prepare the income statement is brought from the worksheet.

Bati Transport
Income statement
For the month ended. Jan 31, 2003

Service Income	Birr 25,300
Operating expenses	
Salary expense.....	Birr 18,800
Rent “.....	4,000
Maintenance expense	450
Insurance “	450
Supplies “	340
Utilities “	220
Truck “	90
Miscellaneous “	50
Total operating expense.....	<u>24,400</u>
Net Income.....	Birr 900

2. Statement of owner’s equity – This statement shows the beginning balance of capital and the changes that affected it.

The balance of the owners equity account (Yimer capital) in the worksheet may not be the beginning one. Therefore, the ledger has to be reviewed to see if there was an additional investment during the priod or not. In our illustration there is no additional investment.

Bati Transport
Statement of Owner’s equity
For the month ended January 31, 2003

Yimer capital January 1, 2003.....	Birr 450,000
Net income for the month.....	birr 900
<u>Less: Withdrawal.....</u>	<u>500</u> <u>400</u>
Yimer capital, January 31, 2003.....	Birr 450,400

3. Balance sheet – The data to prepare this statement will be taken from the worksheet and the other financial statements. Note that assets and liabilities are classified as current and non – current.

**Bati Transport
Balance sheet
January 31, 2003**

Assets

Current Assets:

Cash.....	Birr 41, 030	
Accounts Receivable.....	9,650	
Supplies.....	400	
Prepaid insurance.....	<u>150</u>	
Total current assets.....		Birr 51,230

Plant Asset (None-Current Assets):

Office equipment.....	Birr 110,600	
Truck.....	<u>550,000</u>	<u>561,600</u>
Total asset.....		Birr <u>612,830</u>

Liabilities

Current liabilities

Accounts payable.....	Birr 12,430	
-----------------------	-------------	--

Non-current liabilities

Notes payable.....	<u>150,000</u>	
Total liabilities.....		Birr 162,430

Owner's equity

Ato Yimer Capital.....	<u>450,400</u>	
Total liability and owners equity.....		Birr <u>612,830</u>

THE CLOSING PROCESS

Some of the accounts in the ledger are temporary accounts used to classify and summarize the transactions affecting capital (owners equity). These accounts will be closed after financial statements are prepared. That is, their balances will be transferred to the Capital account. The temporary accounts that have to be closed are revenue, expense and withdrawal accounts.

Steps in closing:

1. **Closing revenue accounts** - Debit each revenue account by its balance and credit the 'Income Summary' account by the total revenue for the period.

Note: Income summary is an account used to close revenue and expense accounts. This account will immediately be closed to the capital account at the end of the closing process.

2. **Closing expense accounts** – Debit the income summary account by the total of expenses for the period and credit each expense account by its balance.

3. **Closing the income summary account** – Income summary will be closed to the capital account. The balance of his account depends on the nature of operation; credit if result is profit and debit if result is loss.
4. **Closing Withdrawal** – Debit the owners equity account by the total of drawings for the period and credit the drawing account.

The temporary accounts of Bati transport are closed as follows.

2003	Income summary.....	25,300
January	Service income.....	25,300
31	Closing revenue	
31	Salary expense.....	18,800
	rent expense.....	4,000
	Maintenance expense.....	450
	Insurance expense.....	450
	Supplies expense.....	340
	Utilities expense.....	220
	Truck expense	90
	Miscellaneous expense.....	50
	Income expense.....	24,400
	Closing expenses	
2003	Income summary.....	900
January 31	Yemer Capital.....	900
	Closing income summary	
31	Yimer capital.....	500
	Yimer drowing.....	500
	Closing with drowal	

The above closing entries have transferred the balance of the temporary accounts to the permanent capital account.

POST CLOSING TRIAL BALANCE

After the closing entries have been journalized and posted, a trial balance is prepared to prove the equality of the general ledger *before recording the new year's transactions*. It should be noted that this trial balance includes only balance sheet accounts. This is because the temporary income statement accounts are closed during the closing process. This trial balance is called the *post – closing trial balance*. In practice the ledger balance after closing may be checked by a simple calculator print out rather than a formal trial balance. The post closing trial balance for Bait Transport is presented below.

Bati Transport
Post – Closing trial balance
Jan 31, 2003

Cash.....	Birr 41,030	
Accounts Receivable	9,650	
Supplies.....	400	
Prepaid insurance.....	150	
Office equipment.....	11,600	
Truck.....	550,000	
Accounts payable.....		Birr 12,430
Notes payable.....		150,000
Yimer capital.....		<u>450,400</u>
Total.....	Birr <u>612,830</u>	Birr <u>612,830</u>

The accounting cycle is summarized below:

<p>1. When a transaction happens, source are prepared(Transaction))</p>	<p>2. Transactions are recorded in the journal</p> <p>3. Posting to individual accounts</p> <p>4. Preparing a trial balance after determining the balance of each ledger account</p> <p>6. preparing and completing the work sheet with adjustments</p> <p>8. Adjustments are journalized and posted</p> <p>9. Closing entries are journalized and posted</p> <p>10. A post closing trial balance is prepared</p>	<p>7. Preparing financial statements</p>
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EXERCISE

1. Indicate whether each of the following items below is an asset, liability, revenue, expense, gain or loss account and whether it appears in the balance sheet or income statement.

a) Office furniture

- b) Income from services
 - c) Salaries paid to workers
 - d) Supplies on hand
 - e) Salary payable to workers
 - f) Cash
 - g) Income form sale of a used truck
 - h) Goods damaged by fire in the store
2. Given below is a list of selected transactions performed by John Décor during the month of September 2002, the first month of operation.
- a) Record the transactions in General Journal
 - b) Post each entry to the perspective account. Use the four – column account.
 - c) Prepare a trial balance
 - d) Prepare a worksheet. Assume the following adjustment for the accounts and journalize them.
 - e) Prepare a Balance sheet, Income statement and statement of owner’s equity
 - f) close the temporary accounts.

Sept. 10 Mr. John transferred cash form his personal account to be used in the business, Birr 10,000.

“ 10 Paid rent for the month, Birr 500

“ 11 Purchased a truck for Birr 12,000 by paying Birr 3,000 Cash and giving a notes payable for the difference.

“ 12 Purchased equipment on account Birr 1,460.

“ 13 Purchased supplies on account Birr 240.

“ 14 Paid insurance premiums of Birr 170 (Dr. prepaid insurance)

“ 15 Received cash for services completed Birr 360.

“ 16 Purchased Supplies on account Birr 240.

“ 18 Paid salaries of Birr 900.

“ 21 Paid its liabilities for the purchase of equipment

“ 24 Recorded sales on account Birr 2,080

“ 26 Received an invoice for truck expense Birr 115

“ 27 Paid utilities expense Birr 205.

“ 27 Paid miscellaneous expenses Birr 73.

- “ 28 Received cash from customers on account birr 1,420
- “ 30 Paid salaries to employees Birr 950
- “ 30. The owner withdrew Birr 1, 750 for personal use.
3. The trial balance of Betty Beauty Saloon does not balance. The errors in the accounting work are given below. Determine the correct balance of each account and prepare the corrected trial balance

Betty Beauty Saloon

Trial balance

April 30

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

The errors are the following:

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

4. As of Sene 30 1994, the end of the current fiscal year, the accountant for Abay General Trading completed the worksheet before journalizing and posting the adjustments.

Required: (a) Compare the adjusted and unadjusted trial balances and prepare the eight journal entries that were required to adjust the accounts.

(b) Prepare the journal entries that were required to close temporary accounts.

Abay General Trading

Trial Balance

Sene 30, 1994

	Un adjusted		Adjusted	
Cash	12,825.00		12,825.00	
Supplies	8,950.00		3,635.00	
Prepaid rent	19,500.00		1,500.00	
Prepaid insurance	3,750.00		1,250.00	
Equipment	92,150.00		92,150.00	
Accumulated depreciation equipment		53,480.00		66,270.00
Automobile	56,500.00		56,500.00	
Accumulated depreciation automobile		28,250.00		36,900.00
Accounts payable		8,310.00		8,730.00
Salary payable				3,400.00
Tax Payable				1,225.00
Ato Abay capital		41,245.00		41,245.00
Ato Abay drawing	18,600.00		18,600.00	
Service income		261,200.00		261,200.00
Salary Expense	172,300		175,700.00	
Rent Expense			18,000.00	
Supplies Expense			5,315.00	
Depreciation Expense Equipment			12,790.00	
Depreciation Expense Automobile			8,650.00	
Utilities Expense	4,700.00		5,120.00	
Taxes Expense	1,500		2,725.00	
Insurance Expense			2,500.00	
Miscellaneous Expense	1,710.00		1,710.00	
Total	<u>392,485.00</u>	<u>392,487.00</u>	<u>418,970.00</u>	<u>418,970.00</u>

UNIT 3 CONCEPTS AND PRINCIPLES (Optional)

The historical development of accounting practice has been closely related to economic developments. In the earlier periods, a business enterprise was very often managed by its owner, and the accounting records and reports were used mainly by the owner – manager in conducting the business. Bankers and other lenders often relied on their personal relationship with the owner rather than on financial statements as the basis for making loans for business purposes of a large amount was owed to a bank or supplier, the creditor often participated in management decisions.

As business organizations grew in size and complexity, “management” and “outsiders” became more clearly differentiated. From the latter group, which includes owners (Stock holders), creditors, government, labor unions, customer and the general public, came the demand for accurate financial information for use in judging the performance of management. In addition, as the size and complexity of the business unit increased, the accounting problems involved in the issuance of financial statements became more and more complex. With these developments came an awareness of the need for a framework of concepts and generally accepted accounting principles to serve as guidelines for the preparation of the basic financial statements.

Accounting concepts and principles include conventions, axioms, standards, rules, guidelines and procedures that are necessary to have accounting practice at a particular period of time. The word “principles” as used in the context of generally accepted accounting principles does not have the same authoritativeness as universal principles or natural laws relating to the study of astronomy, physical or other physical sciences.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)**1. What are the 12 principle of GAAP?**

There are 4 basic assumptions, 4 principles and 4 constraints in GAAP, each discussed in detail as follows:

Four Basic Assumptions are

Statements of financial Accounting concepts No5 addresses four basic environmental assumptions that significantly affect the recording, measuring, and reporting of accounting information. They are:

1. Business entity Assumption – Accounting deals with specific, identifiable business entities, each considered an accounting unit separate and apart from its owners and from other entities. A corporation and its stockholders are separate entities for accounting purposes. Also partnership and sole proprietorships are treated as separate from their owners, although this separation does not hold true in a legal sense. Under the business entity assumption, all accounting records and reports are developed from the viewpoint of a single entity, whether it is a proprietorship, a partnership, or a corporation. The assumption is that an individual's transactions are distinguishable from those of the business he or she might own.

2. Going – Concern (continuity) Assumption – under this assumption the business entity in question is expected not to liquidate but to continue operations for the foreseeable future. That is, it will stay in business for a period of time sufficient to carry out contemplated operations, contracts and commitments. Continuity supports the measurement and recording of assets and liabilities at historical cost.

3. Unit - of – measure Assumption – It states that the results of a business's economic activities are reported in terms of a standard monetary unit throughout the financial statements. Money amounts are the language of accounting – the common unit of measure (yardstick) enables dissimilar items, such as the cost of a ton of coal and an account payable, to be aggregated into a single total. Example, the unit of measure in the United States is the dollar; in Japan it is the yen, in Ethiopia it is the birr.

4. Time – period Assumption. It requires that changes in a business's financial position be reported over a series of shorter time periods. The time – period assumption recognizes both that decision makers' need timely financial information and that recognition of accruals and deferrals is necessary for reporting accurate information. If a demand for periodic reports didn't exist during the life span of a business, accruals and deferrals would not be necessary.

Basic Principles:

Accounting principles assist in the recognition of revenue, expense, gain, and loss items for financial statement reporting purposes. Income is defined as revenues plus gains minus

expenses and losses. The cost principle, the revenue principle, and the matching concept are employed in practice in the process of determining income.

The four principles are:

1. The cost principle: Normally applied in conjunction with asset acquisitions, the cost principle specifies that the actual acquisition cost be used for initial accounting recognition purposes. The cash – equivalent cost of an asset is used if the asset is acquired via some means other than cash. The cost principle assumes that assets are acquired in business transactions conducted at arm’s length, that is, transactions between a buyer and a seller at the fair value prevailing at the time of the transaction. For non – cash transactions conducted at arm’s length the cost principle assumes that the market value of the resources given up in a transaction provides reliable evidence for the valuation of the item acquired. When an asset is acquired as a gift, in exchange for stock, or in an exchange of assets, determining a realistic cost basis can be difficult. In these situations the cost principle requires that the cost basis be based on the market value of the assets given up or the market value of the asset received, whichever value is more reliably determined at the time of the exchange. When an asset is acquired with debt, such as with a note payable given in settlement for the purchase, the cost basis is equal to the present value of the debt to be paid in the future.

2 The revenue realization principle: This principle requires the recognition and reporting of revenues in accordance with accrual basis accounting principles. Applying the revenue principle requires that all four of the recognition criteria – definition, measurability, reliability and relevance must be met. More generally, revenue is measured as the market value of the resources received or the product or service given, whichever is the more reliably determinable.

The revenue principle pertains to accrual basis accounting, not to cash basis accounting. Therefore, completed transactions for the sale of goods or services on credit usually are recognized as revenue for the period in which the cash is eventually collected. Furthermore, related expenses are matched with these revenues.

3. The matching Principle: Like the revenue principle, the matching principle is predicated on accrual basis accounting, but matching refers to the recognition of expenses. The principle implies that all expenses incurred in earning the revenue recognized for a period should be recognized during the same period. If the revenue is carried over (deferred) for recognition to a future period, the related expenses should also be carried over or deferred since they are

incurred in earning that revenue. Application of the matching principle requires carrying on the books as asset outlays that under cash basis accounting would be expensed at the time cash is disbursed. These expenditure are for fixed assets, materials, purchased services and the like that are used to earn future revenue. Only later, when the revenue is recognized, would the asset accounts be expensed. In this way revenues and related expenses would be matched across accounting period.

4. FULL – Disclosure Principle: This principle stipulates that the financial statements report all relevant information bearing on the economic affairs of a business enterprise. Many items, such as executor contracts, fail to meet the recognition criteria but must still be disclosed for relevance and complete reporting.

The aim of full disclosure is to provide external users with the accounting information they need to make informed investment and credit decisions. Full disclosure requires that the accounting policies followed be explained in the notes to the financial statements. Accounting information may be reported in the body of the financial statements, in disclosure notes to these statements, or in supplementary schedules and other presentation formats for events that fail to meet the recognition criteria.

Four Constraints are

Consistency in the application of accounting principles and uniformity of accounting practice within the profession may not be achievable in all cases. Exceptions to GAAP are allowed in special Situations categorized according to four constraints:

1. Cost –Benefit Constraint: Underlying the cost – benefit constrain is the expectation that the benefits derived by external users of financial statements should outweigh the costs incurred by the preparers of the information. Although it is admittedly difficult to quantify these benefits and costs, the FASB often attempts to obtain information from preparers on the costs of implementing a new reporting requirement. It does not, however, try to estimate indirect costs, such as the cost of any altered allocation of resources in the economy. The cost – benefit determination is essentially a judgment call.

2. Materiality Constraint: Materiality is defined as “ the magnitude of an omission or misstatement of accounting that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement”

The materiality constraint is also called a threshold for recognition. The assumption is that the omission or inclusion of immaterial facts is not likely to change or influence the decision of a rational external user. However, the materiality threshold does not mean that small items and

amounts do not have to be accounted for or reported. For example, Fraud is an important event regardless of the size of the amount. Materiality judgments are situation specific. An amount considered immaterial in one situation might be material in another. The decision depends on the nature of the item, its birr amount, and the relationship of the amount to the total amount of income, expenses, assets, or liabilities, as the case may be. Because materiality matters tend to be case – by – case judgments, the FASB has not specified general materiality guidelines.

3. Industry peculiarities: One of the overriding concerns of accounting is that the information in financial statements be useful. The problem is that certain types of accounting information might be critical for decision making in one industry setting but not in another.

Basically, every industry has its own way of doing things, its own business practices. Under the industry peculiarities constraint, selective exceptions to GAAP are permitted, provided there is a clear precedent in the industry., Precedent is based on the uniqueness of the situation, the usefulness of the information involved, preference of substance over form, and any possible compromise of representational faith-fullness.

4. Conservatism: The conservatism constraint holds that when two alternative accounting methods are acceptable and both equally satisfy the conceptual and implementation principles set out by the FASB, alternatives having the less favorable effect on net income or total assets is preferable. The reasoning is that investors prefer information that does not unnecessary raise expectations. Conservatism assumes that when uncertainty exists, the users of financial statements are better served by under –statement of net income and assets. Prime examples include valuing inventories at the lower of cost or current market and minimizing the estimated service life and residual value of depreciable assets.

Top 10 Differences Between IFRS and GAAP Accounting

International Financial Reporting Standards (IFRS) is the accounting method that's used in many countries across the world. It has some key differences from the Generally Accepted Accounting Principles (GAAP) implemented in the United States.

As an accounting professional or business owner, it's vital to know the variations of these accounting methods, in order to successfully manage your company globally, as well as domestically. Here are the top 10 differences between IFRS and GAAP accounting:

1. Locally vs. Globally

As mentioned, the IFRS is a globally accepted standard for accounting, and is used in more than 110 countries. On the other hand, GAAP is exclusively used within the United States and has a different set of rules for accounting than most of the world. This can make it more complicated when doing business internationally.

2. Rules vs. Principles

A major difference between IFRS and GAAP accounting is the methodology used to assess the accounting process. GAAP focuses on research and is rule-based, whereas IFRS looks at the overall patterns and is based on principle.

With GAAP accounting, there's little room for exceptions or interpretation, as all transactions must abide by a specific set of rules. With a principle-based accounting method, such as the IFRS, there's potential for different interpretations of the same tax-related situations.

3. Inventory Methods

Under GAAP, a company is allowed to use the Last In, First Out (LIFO) method for inventory estimates. However, under IFRS, the LIFO method for inventory is not allowed. The Last In, First Out valuation for inventory does not reflect an accurate flow of inventory in most cases, and thus results in reports of unusually low income levels.

4. Inventory Reversal

In addition to having different methods for tracking inventory, IFRS and GAAP accounting also differ when it comes to inventory write-down reversals. GAAP specifies that if the market value of the asset increases, the amount of the write-down cannot be reversed. Under IFRS, however, in this same situation, the amount of the write-down can be reversed. In other words, GAAP is overly cautious of inventory reversal and does not reflect any positive changes in the marketplace.

5. Development Costs

A company's development costs can be capitalized under IFRS, as long as certain criteria are met. This allows a business to leverage depreciation on fixed assets. With GAAP, development costs must be expensed the year they occur and are not allowed to be capitalized.

6. Intangible Assets

When it comes to intangible assets, such as research and development or advertising costs, IFRS accounting really shines as a principle-based method. It takes into account whether an asset will have a future economic benefit as a way of assessing the value. Intangible assets measured under GAAP are recognized at the fair market value and nothing more.

7. Income Statements

Under IFRS, extraordinary or unusual items are included in the income statement and not segregated. Meanwhile, under GAAP, they are separated and shown below the net income portion of the income statement.

8. Classification of Liabilities

The classification of debts under GAAP is split between current liabilities, where a company expects to settle a debt within 12 months, and noncurrent liabilities, which are debts that will not be repaid within 12 months. With IFRS, there is no differentiation made between the classification of liabilities, as all debts are considered noncurrent on the balance sheet.

9. Fixed Assets

When it comes to fixed assets, such as property, furniture and equipment, companies using GAAP accounting must value these assets using the cost model. The cost model takes into account the historical value of an asset minus any accumulated depreciation. IFRS allows a different model for fixed assets called the revaluation model, which is based on the fair value at the current date minus any accumulated depreciation and impairment losses.

10. Quality Characteristics

Finally, one of the main differentiating factors between IFRS and GAAP is the qualitative characteristics to how the accounting methods function. GAAP works within a hierarchy of characteristics, such as relevance, reliability, comparability and understandability, to make informed decisions based on user-specific circumstances. IFRS also works with the same characteristics, with the exception that decisions cannot be made on the specific circumstances of an individual. It's important to understand these top differences between IFRS and GAAP accounting, so that your company can accurately do business internationally. U.S.-based companies must abide by specific accounting regulations, even if they plan to do business internationally. This leaves some room for mixing owner and nonowner activity within the financial statements.

	GAAP	IFRS
Stands for	Generally Accepted Accounting Principles	International Financial Reporting Standards
Introduction	Standard guidelines and structure for typical financial accounting .	Universal financial reporting method that allows international businesses to understand each other and work together.
Used in	United States	Over 110 countries , including those in the European Union
Performance elements	Revenue or expenses, assets or liabilities, gains, losses, comprehensive income	Revenue or expenses, assets or liabilities
Required documents in financial statements	Balance sheet, income statement, statement of comprehensive income, changes in equity, cash flow	Balance sheet , income statement, changes in equity, cash flow statement, footnotes

	statement, footnotes	
Inventory Estimates	<u>Last-in, first-out; first-in, first-out</u> ; or weighted-average cost	First-in, first-out or weighted-average cost
Inventory Reversal	Prohibited	Permitted under certain criteria
Purpose of the framework	US GAAP (or FASB) framework has no provision that expressly requires management to consider the framework in the absence of a standard or interpretation for an issue.	Under IFRS, company management is expressly required to consider the framework if there is no standard or interpretation for an issue.
Objectives of financial statements	In general, broad focus to provide relevant info to a wide range of stakeholders. GAAP provides separate objectives for business and non-business entities.	In general, broad focus to provide relevant info to a wide range of stakeholders. IFRS provides the same set of objectives for business and non-business entities.
Underlying assumptions	The "going concern" assumption is not well-developed in the US GAAP framework.	IFRS gives prominence to underlying assumptions such as accrual and going concern.
Qualitative characteristics	Relevance, reliability, comparability and understandability. GAAP establishes a hierarchy of these characteristics. Relevance and reliability are primary qualities. Comparability is secondary. Understandability is treated as a user-specific quality.	Relevance, reliability, comparability and understandability. The IASB framework (IFRS) states that its decision cannot be based upon specific circumstances of individual users.
Definition of an asset	The US GAAP framework defines an asset as a future economic benefit.	The IFRS framework defines an asset as a resource from which future economic benefit will flow to the company.

UNIT 4 ACCOUNTING FOR MERCHANDISING BUSINESSES

NATURE OF A MERCHANDISING BUSINESS

INTRODUCTION

There are three different types of businesses that are operated for profit: manufacturing, merchandising, and service businesses. Each type of business has unique characteristics.

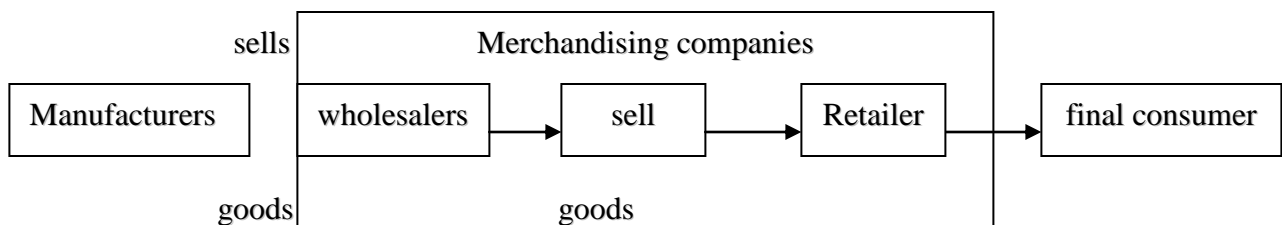
Manufacturing businesses change basic inputs into products that are sold to individual customers.

Merchandising businesses also sell products to customers. However, rather than making the products, they purchase them from other businesses (such as manufacturers). In this sense, merchandisers bring products and customers together. eg coca cola

A merchandising business buys goods in finished form for resale to customers. A merchandising business sells tangible goods to its customers. These goods that a merchandising company sells to its customers are called **merchandise inventory**. One final thing that you should know about a merchandising business is that a merchandising company does not produce the goods that it sells. Instead, it buys these goods from **manufacturers**, which produce the goods using raw materials.

Service businesses provide services rather than products to customers. Transportation, Hospitality lodging, Telecommunications, etc

The following diagram can help you to better visualize the flow of goods from a manufacturer to the final consumer:



A **wholesaler** is a trader, which buys goods from manufacturers and sells them to a retailer or another wholesaler. It is the **retailer** who sells the goods to the final consumer by buying them from wholesalers (or sometimes from a manufacturer).

Comparison of Financial Statements for Merchandising and Service Businesses

Income Statement

A model income statement for a merchandising business and another one for a service business are shown below. Compare them carefully.

ABC service company Income statement For the year ended Dec.31, 200x	XYZ merchandising Income statement For the year ended Dec.31, 200x
Revenue: Service fee.....Birr 23,200	Revenue: Net Sales.....Birr 360,000 Cost of goods sold.....(256,000) Gross Profit104,000
Expenses: Various Operating Expenses (7120) Net Income <u>16080</u>	Various Operating Expenses.....(79,400) Net Income <u>24,600</u>

As you can see from the above Income Statements, merchandising companies have to pay to buy the goods that they sell. Therefore, they have to deduct this cost of goods sold in addition to other operating expenses from their sales revenue to determine their net income.

The difference between sales revenue and cost of goods sold is referred to as gross profit. Why 'gross'? Because other expenses have yet to be deducted to arrive at the net profit or net income of the business.

Balance Sheet

The Balance Sheet of a service business and that of a merchandising business are similar in every aspect except one thing. The current assets section of the Balance Sheet of a merchandising business includes one asset that service companies do not have. That is merchandise inventory. Merchandise inventory refers to goods bought by a merchandising business for resale to customers. So, if a merchandising business has some unsold goods (merchandise) on hand at the end of the year this would be reported as one asset on the Balance Sheet.

THE PERIODIC AND THE PERPETUAL INVENTORY SYSTEMS

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

3. 3.1 The Periodic Inventory System

Under this system, as the name periodic suggests, the inventory account is updated only periodically i.e., only at the end of a period. When goods are bought, a temporary *purchases* account is debited instead of the inventory account itself. Likewise, when goods are sold

revenue is recorded, but the fact that there is a reduction in merchandise inventory is not recognized. This is because the Merchandise Inventory account is not credited every time goods are sold.

3.3.2 Perpetual Inventory Systems

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

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

RECORDING PURCHASES AND SALES TRANSACTIONS

The following discussions in the remainder of this chapter all assume the use of a periodic inventory system. The perpetual system will be discussed in part two of this course.

3.4.1 Recording Sales

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

Net Sales = Gross Sales – Sales Discounts- Sales Returns and Allowances

Recording Gross Sales

The gross sales amount is obtained from sales invoices. An **invoice** is a document, prepared by the seller of merchandise to notify to the buyer the details of the sale. These details can include number of items sold, unit price of items, total price, terms of sale and manner of shipment. When goods are delivered to the customer, the Sales account is credited because revenues are increased by credits.

A company can sell goods either for cash or on account.

Recording Cash Sales

When merchandise is sold on cash, the Cash account is debited and the revenue account Sales is credited.

Example – On January 14, 2001. Ika sold goods for Birr 20,000 on cash. Record the transaction.

January 14,	Cash.....	20,000.00
	Sales.....	20,000.00

Recording Credit Sales

The Accounts Receivable account is debited when goods are sold on account (for credit).

Example -

Ika sold goods worth Birr 35,000 on account on January 15, 2001. Record the transaction.

January 15.	Accounts Receivable.....	35,000.00
	Sales.....	35,000.00

A **trade discount** is a percentage deduction from the specified list price or catalogue price of merchandise. Trade discounts allow us:

- To avoid publishing a new catalogues every time prices change.
- To grant quantity discounts
- Quotation of different prices to different types of customers.

Trade discounts are not recorded in the seller's accounting records; they are only used to calculate the gross selling price.

Example: IKA sold 500 T.V. sets, each with a list price of Birr 80, on January 17, 2001 for cash. It gave the customer a 30% trade discount, as the customer was a very loyal one. Record the sale.

Answer:

List price of goods (80 X 500)	Birr 40,000
Less: Trade discount (30 % of 40,000)	<u>(12,000)</u>
Invoice price	<u>28,000</u>

Journal entry:

Cash.....	28,000
Sale.....	28,000

Recording Deductions from Gross Sales

Go back to illustration 1- and have a look at the model Income Statement of a merchandising company. You will see that the sales reported on the income statement is net sales, i.e., after deduction of sales discounts and sales returns and allowances.

Gross sales (from invoice).....	XXX
Less: Sales discounts.....	(XX)
Sales returns and allowances	(XX)
Net sales.....	<u>XX</u>

Sales Discounts

Sales Discounts are deductions from invoice price to customers who pay early when goods are sold on credit. As a seller, you would usually want to be paid as soon as possible. This is because, as you can imagine, you can use the money for various purposes once you have been paid. If you want your customers to pay you early the customary practice is to offer them a (deduction) discount from the invoice price if they pay early.

How much discount is given usually depends on the **credit terms**. These terms (agreements) are usually stated on the invoice. The most frequently used terms are stated below:

- “n/30” or “Net 30” – means there is no discount even if the customer pays before the payment date.
- 2/10, n/30 –means the due date of the payment is after 30 days of the sale. But if the customer pays with in 10 days she will get a 2% discount.
- 2/EOM, n/60- means the normal due date is with in 60 days of the sale but the customer will get a 2% discount if she pays before the end of month of sale.

Example:

On January 21, 2001 IKA Company sold merchandise for birr 20,000 on account. The credit terms are 2/10, n/30. The customer paid on January 31, (10 days after invoice date).

- A. How much would IKA Company collect from this sale?
- B. Record the necessary journal entries on January 21 and January 31.

Solution:

- A- Since the customer paid with in the discount period, i.e., with in 10 days, she will get a 2% discount. Therefore,

Invoice price.....	20,000
Less: Sales Discount (2% X 20,000).....	<u>(400)</u>
Cash collected	<u>19,600</u>

B- Journal Entries:

January 21 A/R.....20,000

Sales.....	20,000
January 31,	
Cash.....	19600
Sales Discounts	400
A/R.....	20,000

Exercise

IKA Company sold goods worth Birr 120,000 on account to Gizu company terms 1/10, n/60 on January 18, 2001. Gizu Company paid on January 28, 2001.

- A- How much would IKA Company collect from this sale?
 B- Record the necessary journal entries on January 18 and on January 28.

Sales Returns and Allowances

Customers can return merchandise they have bought if they find it to be defective or of the wrong model, or unsatisfactory for a variety of reasons. A sales return is merchandise returned by a buyer. The buyer would be paid back her money if she has already paid. A ***sales allowance*** is a deduction from the original invoice price when the customer keeps the merchandise but is dissatisfied. If, for example, a customer buys an item worth birr 100 and finds it to be of the wrong color after receiving it, she may still want to retain the item even if she is dissatisfied with its color. In that case the seller may let her pay only, say, Birr 95 by giving her an allowance of Birr 5.

Example:

IKA Company sold merchandise worth Birr 15, 000 on February 3, 2001 on account terms 2/10, n/30. On February 5, the buyer returned a portion of the goods worth Birr 5,000 as they were found to be of the wrong model. The buyer then paid on February 13, 2001.

Record the necessary journal entries on February 3,5 and 13.

Solution:

February 3	A/R.....	15,000
	Sales	15,000
February 5	Sales Returns and Allowances	5,000
	A/R.....	5,000
February 13	Cash.....	9800
	Sales Discount	200
	A/R.....	10,000

Here, the buyer paid with in the discount period. Therefore, the amount that would be collected is:

$$15,000 - 5,000 = 10,000$$

Deduct: 2% Cash discount (200)

Cash collected 9800

3.4.2 Recording Purchases

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

Example:

IKA Company bought goods worth Birr 43,000 from Saba Co., which is based in Addis Ababa, on account on January 4, 2001, terms 20/10, n/30. Record the transaction.

Solution:

January 4 – Purchases	43,000
Accounts payable.....	43,000

Deductions from Purchases

Purchase Discounts

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

Example:

IKA Company bought goods worth Birr 50,000 from Gibir Company on account on January 14, 2001, terms 1/10,n/60. Ika Company paid on January 24, 2001. Record the transactions on both dates.

Solution:

Jan. 14.	Purchases.....	50,000
	A/P.....	50,000
Jan. 24.	A/P.....	50,000
	Purchase Discounts	500
	Cash.....	49,500

Purchase Returns and allowances

A purchase return occurs when a buyer returns merchandise to a seller. A purchase allowance is a reduction on the price of goods bought for dissatisfaction on the side of the buyer. Both purchase returns and purchase allowances are recorded in a contra purchase account called Purchase Returns and Allowances.

Example:

IKA Company bought goods worth Birr 50,000 from Gibir Company on account on January 14, 2010. On January 17 Gibir Company acknowledged this and return a birr of 250.

What should IKA Company record on January 17?

Solution:

January 17	A/P.....	250
	Purchase Return and Allowance.....	250

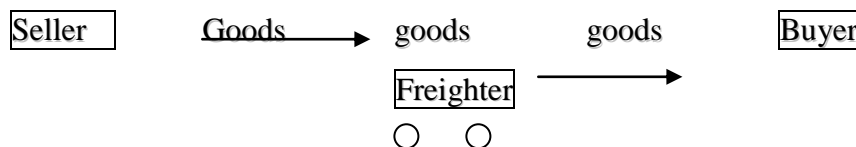
When both purchase discounts and purchase returns and allowances are deducted from purchases what is obtained is called Net purchase. That is,

	Gross Purchase.....	XX
<u>Less:</u>	Purchase discounts.....	(XX)
	Purchase returns and allowances.....	(XX)
	Net Purchases.....	<u>XX</u>

Transportation costs

Once merchandise has been bought it has to be moved from the seller's place to the buyer's place. A third party comes in to the scene here: the **transportation company** who moves the goods between the two places.

That is:



So, the question is, who is going to pay to the freighter (transportation) company. Who covers the transportation costs depends, as you might have guessed, on the agreement between the buyer and seller. The agreements are usually stated in the either of these two terms:

- **FOB Destination** – means “free on board at destination “. That is, since the destination of the goods is the buyer’s place, it is free at destination means transportation cost is paid when the goods are loaded. It simply means the seller pays transportation cost. FOB Destination means goods are shipped to their destination (to the buyer) with out transportation charge to the buyer.
- **FOB shipping Point** –means “ free on board at shipping point”. That is, goods are loaded (on a truck or train) or shipped free of charge. It is, therefore, the buyer, which pays to the transportation company when the goods reach the buyer (their destination) Briefly, when the terms are FOB Shipping Point the buyer pays transportation costs.

Transportation costs paid by a buyer of merchandise increase the cost of merchandise. They are recorded in a separate Transportation-In account that is used to record freight costs incurred in the acquisition of merchandise.

Example

ABC Company bought goods worth Birr 85,000 on account, terms 2/10,n/60 FOB shipping point on March 2, 2001. Transportoin cost of Birr 1,500 was paid on March 2. Ika Company paid on March 31, 2001. Record the necessary journal entries

Solution:

Here, since the terms are FOB Shipping Point, the buyer (Ika) pays transportation.

March 2	-Purchase.....	85,000
	A/P.....	85,000
	-Transportation In.....	1500
	Cash.....	1500
March 31	A/P.....	85,000
	Cash.....	85,000

Example:

IKA Company sold goods worth Birr 135,000 terms 1/15, n/EOM on February 1, 2001. FOB Destination. It also paid transportation costs of Birr 800 on Feb. 1. The customer paid IKA on February 16, 2001. Record the relevant Journal entries.

Answers:

Feb 1	A/R.....	135,000
	Sales.....	135,000
Feb 16	Sales discount	1,350
	Cash.....	133,650
	A/R.....	135,000
	Delivery Expense.....	800
	Cash.....	800

The *Delivery Expense* account shows how much was incurred to deliver goods sold to customers. It is, therefore, shown on the income statement as a selling expense.

Sometimes, the seller prepays the freight as a convenience to the buyer and later collects it on the due date of the invoice even though the terms are FOB shipping Point.

Example

Raey Co. sold goods worth Birr 40,000 on April 1, 2001 to IKA company terms 2/10, n/30 FOB Shipping Point. It also paid Birr 2,500 to Ergib Movers for transporting the goods and added the amount to the invoice. What would each of these companies record assuming IKA paid on April 31, 2001

Raey Co. (seller)	IKa Co (Buyer)
April 1- A/R.....40,000	April 1-Purchases40,000
Sales.....40,000	A/P.....40,000
A/R.....2500	Transport-in2500
Cash.....2500	A/P.....2500
April 31-Cash.....42,500	April 31- A/P.....42,500
A/R.....42500	Cash.....42,500

If the buyer pays the transportation costs for the seller (when the terms are FOB Destination) the buyer simply deducts the freight paid from the amount to be paid to the seller.

Example:

X Company bought merchandise worth Birr 14,000 terms FOB destination from Y Co. on account. It paid Birr 350 transportation costs. What would be recorded on the books of the buyer and seller on the date of the sale?

Buyer (X Co)	Seller Y Co.
-Purchase.....14,000	- A/R.....14,000
-A/P.....14,000	Sales.....14,000
-A/P.....350	-Delivery exp.....350
Cash.....350	A/R.....350

Transfer of Title

Shipping terms determine not only determine who pays for transportation. They also determine at what point ownership title of the goods sold transfers to the buyer. Put briefly, whose property is it when merchandise is in transit?

1. When terms are FOB Destination we have seen that the seller covers transportation costs. By implication the seller takes the responsibility of safely moving and delivering the goods to the buyer. The buyer is not responsible for any damage that can happen to these goods in transit. Therefore, the goods become the buyer’s property only when they are delivered to him /her.

Conclusion: Ownership title of the goods transfers to the buyer at destination when the terms are FOB destination.

2. When the terms are FOB shipping point the buyer pays freight costs. The buyer takes the responsibility of safely moving these goods to his /her own place. The merchandise, therefore, becomes his/her property as soon as they are loaded on a truck or a train.

Conclusion: Ownership title of goods transfers to the buyer at shipping point when terms are FOB shipping point.

The following table summarizes it all.

Shipping terms	Transportation paid by	Title Transfers When goods are Delivered to

FOB Destination	Seller	Buyer
FOB shipping point	Buyer	Freighter (transportation company)

Summary of Important Relationships on the Income Statement

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

REPORTING MERCHANDISING TRANSACTION

COMPLETING THE WORKSHEET FOR A MERCHANDISING COMPANY

The use of a worksheet, as you remember, assists in preparing adjusting and closing entries. In addition it contains all of the information needed for the preparation of the financial statements. Except for the merchandise - related accounts, the work sheet for a merchandising Co. is the same as for a service company.

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

Illustration

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

**Hard Works
Trial Balance
December 31, 2002**

Account title	<u>Dr</u>	<u>CR</u>
Cash	19,663	

Account Receivable	1,880	
Merchandise Inventory	7,000	
Accounts Payable		700
Yibetal, Capital		25,000
Yibetal, Drawings	2,000	
Sales		14,600
Sales Discounts	44	
Sales Returns and Allowances	20	
Purchases	6,000	
Purchase discounts		82
Purchase Returns and allowances		100
Transportation –In	75	
Selling expenses	2,650	
Administrative expenses	<u>1,150</u>	<u> </u>
	40,482	40,482

- ❖ A physical inventory of merchandise carried out on December 31, 2002 showed Birr 10,000 of goods on hand.

Required:

- A- Prepare a worksheet for Hard Works.
- B- Prepare financial statements from the worksheet
- C- Record the necessary adjustment journal entry in relation to merchandise inventory
- D- Record closing entries

Worksheet for the year ended December 31,2002

Account title	Trial Balance		Adjustment		Adjusted Trial balai		Income statement		Balance sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	19,663				19,663				19,663	
Account Receivable	1,880				1,880				1,880	
Merchandise Inventory	7,000		10,000	7,000	10,000				10,000	
Accounts Payable		700				700				700
Yibeltal, Capital		25,000				25,000				2,5000
Yibeltal, Drawings	2,000				2,000				2,000	
Income summery			7,000	10,000	7,000	10,000	7,000	10000		
Sales		14,600				14,600		14600		
Sales Discounts	44				44		44			
Sales Returns & Allowances	20				20		20			
Purchases	6,000				6,000		6,000			
Purchase discounts		82				82		82		
Purchase Return & allowance		100				100		100		
Transportation –In	75				75		75			
Selling expenses	2,650				2,650		2,650			
Administrative expenses	1,150				1,150		1,150			
	40,482	40,482	17,000	17,000	50,482	50,482	16,939	24782	33,543	25,700
							7,843			78,43
							24,782	24782	33,543	33,543

Note:

The merchandise inventory account before adjustment shows the inventory on hand at the beginning of the period. This is because, since purchases and sales of merchandise have not been debited or credited to the merchandise inventory account, this account would still show the beginning inventory amount at the end of the period.

Therefore, an adjustment journal entry is needed to update this account. At the end of the period, a physical inventory would be conducted to determine the amount of inventory on hand.

The adjustment journal entry removes beginning inventory amount from the merchandise inventory account and replaces it with the (ending) actual value of merchandise inventory on hand as determined by the physical inventory.

The adjustment is:

- Income summary (beginning inventory).....XXX
 Merchandise amount inventory.....XXX
- Merchandise Inventory.....XXX
 Income Summary.....XXX

PREPARING MERCHANDISING FINANCIAL STATEMENTS FOR BUSINESSES

We will discuss financial statements as we work on requirement (b) of our illustration.

Once the worksheet has been completed, the financial statements are prepared. Next, any adjusting and closing entries are entered in the journal and posted to the ledger.

Income Statement

There are two widely used formats of the income statement. These are:

The single – Step Income Statement

This format is shown below for Hard Works Co. It shows cost of goods sold and operating expense but has only one subtotal for total expenses.

Hard Works Co.
Income statement
For the year ended December 31, 2002

Net sales.....		Br.14536
<u>Expenses:</u>		
Cost of goods sold.....	2893	
Operating Expenses	<u>3800</u>	(6693)
Net Income.....		<u>7843</u>

The Multiple –Step Income Statement

Hard Works Co.
Income statement
For the year ended December 31, 2002

Revenue:

Gross Sales.....		Br. 14600
Less: Sales Discounts	44	
Sales Returns & All.....	20.....	(64)
Net Sales		14536

Less: Cost of goods sold:

Beg. Inventory (Jan 1).....		7,000
Add: Purchase.....	6,000	

Less: Purchase.....(82)	
Purchase Ret & all.....(100)	
Net Purchases.....5818	
Add: Transportation –In75	
Total cost of purchase.....5893	
Total cost of Goods Available for sale.....12,893	
Less: ending Inventory (Dec.31).....(10,000)	
Cost of Goods sold.....(2893)	
Gross Profit.....11,643	

Operating Expenses:

Selling Expenses.....2,650	
Admin. Exp.....1,150	
Total operating expenses.....	(3800)
Net Income.....	<u>7,843</u>

**Hard Works Co.
Statement of Owner’s Equity
For the year Ended December 31, 2002**

Yibetal Capital Jan1,2002.....Br..25,000
Add: Net Income for the year.....7843
Deduct: Owner’s withdrawal during the year.....2,000
Yibetal Capital December 31, 2002..... <u>30843</u>

**Hard Works Co.
Balance sheet
For the year Ended December 31, 2002**

Assets:	Liabilities & capital
	<u>Liabilities:</u>
Cash.....19663	A/P.....700
A/R.....1880	<u>Owner’s Equity:</u>
Merch. Inventory.....10,000	Yibetal Capital ... 30843
Total Assets..... <u>31,843</u>	Total Liab. & O/E..... <u>31,843</u>

C. Adjustment Journal entry

-Income summary.....7,000

Merchandise Inventory.....	7,000
-Merchandise Inventory.....	10,000
Income Summary.....	10,000

D. Closing entries

-Sales.....	14,600
Income summary.....	14,600
-Income summary.....	66
Sales discount.....	44
Sales Returns and Allowances.....	20
-Income summary.....	6,075
Purchases.....	6,000
Transportation-In.....	75
- Purchase Discounts.....	82
Purchase Ret. & All.....	100
Income Summary.....	182
- Income summary.....	3,800
Selling Expenses.....	2650
Administrative expense.....	1150
- Income summary.....	7,843
Yibeltal Capital.....	7,843
- Yibeltal Captal.....	2,000
Yibeltal Drawings.....	2,000

EXERCISE

Fill in the missing number(s) for each one of the following *independent* cases:

	Case 1	Case 2	Case 3	Case 4
Net Sales	\$80,000	(c)	\$70,000	\$90,000
Beginning Merchandise	10,000	\$ 9,000	(e)	24,000
Net Purchases	30,000	51,000	20,000	(h)
Merchandise Available	(a)	(d)	50,000	(i)
Ending Merchandise	7,000	14,000	(f)	16,000
Cost of Goods Sold	33,000	46,000	33,000	25,000
Gross Profit	(b)	20,000	(g)	(j)

Frisch Corporation had the following items relating to its income statement for 1911

Merchandise Inventory, Jan. 1	40,000	Sales	\$100,000
Merchandise Inventory, Dec. 31	20,000	Sales Returns	2,000
Transportation In	2,000	Sales Discounts	4,000
Purchases Returns	3,000	Purchases Discounts	5,000
Purchases	50,000		

Determine the following:

- (a) Net sales
- (b) Net purchases
- (c) Goods available for sale
- (d) Cost of goods sold
- (e) Gross profit

Assignment (10 point)

1. You are provided with the following data from the records of three merchandising companies: (a), (b) and (c). Determine each of the missing numbers for each company.

	<u>a</u>	<u>b</u>	<u>c</u>
Invoice cost of merchandise purchase	Br.90, 000	Br.40, 000	Br.30, 500
Purchase discounts	4000	?	650
Purchase returns and allowances	3,000	1,500	1,100
Transportation-In	?	3,500	4,000
Merchandise inventory (beginning of period)	7,000	?	9,000
Total cost of merchandise purchases	89,400	39,500	?
Merchandise inventory (end of period)	4,400	7,500	?
Cost of goods sold	?	41,600	34,130

2. Prepare journal entries to record the following merchandising transactions of Shiach Company. The company uses the periodic inventory system.

- July**
- 1 Purchased merchandise from Gizhy Company for \$6,000 under credit terms of 1/15, n/30, FOB shipping point.
 - 2 Sold merchandise to Terra Co. for \$800 under credit terms of 2/10, n/60, FOB shipping point.
 - 3 Paid \$100 for freight (transportation) charges on the purchase of July 1.
 - 8 Sold merchandise for \$1,600 cash.
 - 9 Purchased merchandise from Chilalo Co. for \$2,300 under credit terms of 2/15, n/60, FOB destination.
 - 12 Received a \$200 credit memorandum acknowledging the return of merchandise purchased on July 9.

- 12 Received the balance due from Terra Co. for the credit sale dated July 2, net of the discount.
 - 16 Paid the balance due to Gizhy Company within the discount period.
 - 19 Sold merchandise to Urban Co. for \$1,250 under credit terms of 2/15, n/60, FOB shipping point.
 - 21 Issued a \$150 credit memorandum to Urban Co. for an allowance on goods sold on July 19.
 - 22 Received a debit memorandum from Urban Co. for an error that overstated the total sales invoice by \$50.
 - 24 Paid Chilalo Co. the balance due after deducting the discount.
 - 30 Received the balance due from Urban Co. for the credit sale dated July 19, net of the discount.
 - 31 Sold merchandise to Terra Co. for \$5,000 under credit terms of 2/10, n/60, FOB shipping point.
3. The following unadjusted trial balance was prepared at the end of the fiscal year for Tenkir Company:

TENKIR COMPANY
Unadjusted Trail Balance
July 31, 2000

Cash.....	\$ 4,200	
Merchandise Inventory.....	11,500	
Store supplies.....	4,800	
Prepaid Insurance.....	2,300	
Store equipment.....	41,900	
Accumulated depreciation-Store Equipment...		\$ 15,000
Accounts payable.....		9,000
Gidey Tinker, capital.....		35,200
Gidey Tenkir, withdrawals	3,200	
Sales.....		104,000
Sales discounts.....	1,000	
Sales returns and allowances.....	2,000	
Cost of goods sold.....	37,400	
Depreciation expense – Store equipment.....	-	
Salaries expense.....	31,000	
Insurance expense.....	-	
Rent expense.....	14,000	
Store supplies expense.....	-	
Advertising expense.....	<u>9,900</u>	
Totals.....	<u>\$163,200</u>	<u>\$163,200</u>

Rent and salaries expense are equally divided between the selling and the general and administrative functions. Tenkir Company uses the periodic inventory system.

Required:

1. Prepare adjusting journal entries for the following:
 - a. Store supplies on hand at year-end amount to \$1,650.
 - b. Expired insurance, an administrative expense, for the year is \$1,500.
 - c. Depreciation expense, a selling expense, for the year is \$1,400.
 - d. A physical count of the ending merchandise inventory shows \$11,100 of goods on hand.
2. Prepare a multiple-step income statement.
3. Prepare a single-step income statement.
4. Prepare all the necessary closing entries.

ACCOUNTING CYCLE FOR MANUFACTURING BUSINESS

Financial Statements for manufacturing business

Financial statements of a Manufacturing company are more complex as compared to financial statements of Merchandising and Service companies. Particularly, the Balance sheet, and Income statement of a Manufacturing Enterprise are somewhat different from the Merchandising and Service counterpart.

The Balance Sheet

The balance sheet or statement of financial position, of a manufacturing company is similar to that of a merchandising company. However there are differences in the inventory accounts.

A merchandising company has only one class of inventory- goods purchased from suppliers that are awaiting resale to customers. By contrast, manufacturing companies have three classes of inventories:

- **Raw materials inventory:** shows the cost of raw materials on hand and intended for use in the manufacturing process. Inventory of **Direct Material** represents the costs of materials that are not yet entered into a manufacturing process.
- **Work in process inventory:** shows the cost of goods in the manufacturing process, but not completed at the end of the accounting period. Inventories of **Work-In-Process** represent all goods that are undergoing some manufacturing process but yet not finished to be dispatched for use by customers
- **Finished goods inventory:** shows the cost of the goods completed and ready for sale. The **Finished Good Inventory** embodies the final product that is not yet sold. The cost of finished good inventory includes all manufacturing costs, direct material, direct labour, and manufacturing overhead incurred to produce that product.

A) The Income Statement

Income statement of a manufacturing firm differs from income statement of a merchandising firm by the **Cost of Goods Manufactured** caption. A merchandising firm sells goods after buying it from a manufacturing firm. But a manufacturing firm sells goods that are internally

produced. Hence, the costs of goods sold caption contains cost of goods manufactured instead of purchase. The amount of purchase can easily be found from the ledger, but cost of goods manufactured cannot. Cost of goods manufactured must first be computed before the income statement is prepared.

In order to prepare financial statement for manufacturing company, the following schedules are necessary

Schedule 1: cost of direct material used

Beginning direct material inventory	XX
Purchase in The month	<u>XX</u>
Direct material available for use	XX
Ending direct material inventory	<u>(XX)</u>
Direct material cost used	<u>XX</u>

Schedule 2: cost of goods manufactured

Direct material used cost-----	XX
Direct labor cost -----	XX
Manufacturing over head cost -----	<u>XX</u>
Cost incurred in current period -----	XX
Add: Work in process beginning -----	<u>XX</u>
Total cost incurred to date -----	XX
Less: work in process ending -----	<u>XX</u>
Cost of goods manufactured -----	<u>XX</u>

Schedule 3: cost of goods sold

Finished goods beginning -----	XX
Cost of goods manufactured -----	<u>XX</u>
Cost of goods available for sale -----	XX
Less: Finished goods ending -----	<u>XX</u>
Cost of goods sold -----	<u>XX</u>

Schedule 4: Income statement for manufacturing company

Revenues	XX
Cost of goods sold	<u>XX</u>
Gross profit	XX
Operating expense	<u>(XX)</u>
Operating income	<u>XX</u>

Cost of goods manufactured = Beginning work in process inventory + (Direct material used + Direct labor incurred + Manufacturing overhead) – Ending work in process inventory

CHAPTER FIVE CASH AND RECEIVABLES

5.1 MEANING OF CASH

Cash, the most liquid of assets, is the standard medium of exchange and provide the basis for measuring and accounting for all other item. It is generally classified as a current asset. To be report as “cash” it must be readily available for the payment of current obligations, it must be free from any contractual restriction that limits its use in satisfying debts.

Cash includes money on deposit in banks and other items that a bank will accept for immediate deposit. Money on deposit in banks includes checking and saving accounts. Other items such as ordinary checks received from customers, money orders, coins and currency and petty cash also are included as cash. Banks do not accept postage stamps, travel advances to employees, notes receivable or post-dated checks as cash.

Cash consists of coins, currency, and available funds on deposit at the bank. Negotiable instruments such as money orders, certified checks, cashiers’ check, personal checks, and bank drafts are viewed as cash. Savings accounts are usually classified as cash, although the bank has a legal right to demand notice before withdrawal.

Short investments consist of marketable equity securities (preferred and common stock) and marketable debt securities (government and corporate bonds). **In** order for an investment to be classified as temporary, it must meet both of the following conditions:

1. It must be readily marketable.
2. It must be intended for conversion into cash within 1 year or the operating cycle (whichever is longer).

Readily marketable means that the item can easily be sold. If the stock is not publicly held, there may exist only a limited market for its purchase, thus making it difficult to sell. If this is the case, condition 1 has not been met and the stock is not classified as a temporary investment

5.3 CHARACTERISTICS OF CASH

The following are some of the characteristics of cash:

- a) Cash is used as medium of exchange
- b) Cash is the most liquid asset
- c) Cash is mostly affected by business transactions
- d) Cash is used to measure the value of other assets
- e) Cash is mostly exposed to embezzlements

5.4 MANAGEMENT OF CASH

Cash management refers to planning, controlling and accounting for cash transactions and cash balances. Efficient management of cash is essential to the survival and success of every business organization. Managing cash requires planning wisely so that there will not be excess cash held on hand at any point in time; or there is no shortage of cash at any point in time to meet the business's needs.

5.5 INTERNAL CONTROL OF CASH

The need to safeguard cash is crucial in most businesses because cash is mostly exposed to embezzlement. Firms address this problem through the internal control system. An internal control system is a set of policies and procedures designed to protect assets, provide accurate accounting records and evaluate performances. A sound internal control system for cash increases the likelihood that the reported values for cash are accurate.

Internal control for cash should include the following procedures:

- a) The individuals who receive cash should not also disburse (pay) cash
- b) The individuals who handle cash should not access accounting records
- c) Cash receipts are immediately recorded and deposited and are not used directly to make payments.
- d) Disbursements are made by serially numbered checks, only upon proper authorization by someone other than the person writing the check
- e) Bank accounts are reconciled monthly.

The following are the most common elements of cash control and managements: bank account system, petty cash fund, voucher system, change fund, and cash short and over.

5.5.1 Control of Cash Through Bank Accounts

Bank accounts are one of the most important means of controlling cash that provide several advantages such as:

- Cash is physically protected by the bank,
- A separate record of cash is maintained by the bank,
- And customers may remit payments directly to the bank.

If a company uses a bank account, monthly statements are received from the bank showing beginning and ending balances and transactions occurring during the month including checks paid, deposits received, and service charges. These monthly statements (reports) received from the bank are called **bank statements**. Bank statements generally are accompanied by checks paid and charged to the accounts during the month, debit and credited memos, which inform the company about changes in the cash accounts. For a bank, the depositor's cash balance is a liability, the amount the bank owes to the firm. Therefore, a debit memo describes the amount and nature of decrease in the company's cash accounts. A credit memo indicates an increase in the cash balance of the depositor that it has with the bank.

5.5.1.1 Reconciliation of Bank and Book Cash Balances

Monthly reconciling of the bank balance with the depositor's cash accounts balance is essential cash control procedure. To reconcile a bank statement means to verify that the bank balance and the accounting records of the depositor are consistent. The balance shown in a monthly bank statement seldom equals the balance appearing in the depositor's accounting records. Certain transactions recorded by the depositor may not have been recorded by the bank and vice versa.

The most common examples that cause disparity between the two balances are:

- a) **Outstanding checks:** Checks issued and recorded by the company, but not yet presented to the bank for payment.
- b) **Deposits in transit:** is Cash receipts recorded by the depositor, but not reached the bank to be included in the bank statement for the current month.
- c) **Service charges:**
Banks often charge a fee for handling checking accounts. The amount of this charge is deducted by the bank from bank balance and debit memo is issued for the depositor.
- d) **Charges for depositing NSF- checks:**
NSF stands for "Not Sufficient Funds." When checks are deposited in an account, the bank generally gives the depositor immediate credit. On occasion, one of these checks may prove to be uncollectible because the maker of the check does not have sufficient funds in his or her account. In such a case, the bank will reduce the depositor's account by the amount of this uncollectible item and return the check to the depositor marked "NSF".
- e) **Notes collected by bank:**

If the bank collects a note receivable on behalf of the depositor, it credits the depositor's account and issues a credit memorandum for the depositor.

When the depositor prepares bank reconciliation, the balances shown in the bank statement and in the accounting records both are adjusted for any unrecorded transactions. Additional adjustments may be required to correct any **errors** discovered in the bank statements or in the accounting records.

5.5.1.2 Steps in Preparing Bank Reconciliation

A bank reconciliation is a schedule prepared by the depositor to bring the balance shown in the bank statement and the balance shown in the depositor's accounting into agreement.

The steps to prepare a bank reconciliation are:

- a) The deposits listed on the bank statement are compared with the deposits shown in the accounting records. Any deposits not yet recorded by the bank are deposits in transit and should be added to the balance shown in the bank statements.
- b) The paid and received checks from the bank are compared with the check stubs. Any checks issued but not yet paid by the bank are outstanding checks and should be deducted from the balance reported in the bank statements.
- c) Any credit memorandums issued by the bank that have not been recorded by the depositor, are added to the balance per depositor's record.
- d) Any debit memorandums issued by the bank that have not been recorded by the depositor are deducted from the balance per depositor's record.
- e) Any errors in the bank statement or depositor's accounting records are adjusted.
- f) The equality of adjusted balance of statement and adjusted balance of the depositor's record is compared.
- g) Journal entries are prepared to record any items delayed by the depositor.

5.5.1.3 Illustration of Bank Reconciliation

On January 31, 2000 Cash balance (depositor) balance Shows that Br. 4,262.83. Assume also that on January 31, 2000, bank statement s shows of Br. 5,000.17 and the information

1. A deposit of Br. 410.90 made on Jan. 31 does not appear on the bank statement.
2. Outstanding checks are

Check No. 301	Br. 110.25
Check No. 342	607.50

3. A credit memorandum (collection of a non-interest bearing note receivable from MAN Company Br. 524.74.
4. NSF for the month is 50.25 received from a customer, RON Company.
5. Banks service charge by bank for the month of January amounts to Br. 17
6. Check No. 305 was issued by RAM Company for payment of telephone expense in the amount of Br. 85 but was erroneously recorded in the cash payments journal as Br. 58.

The January 31 bank reconciliation for RAM Company is shown below:

RAM Company

Bank Reconciliation

January 31, 2000

Balance per bank statement, Jan. 31,2000		Br. 5,000.17
Add: Deposit of Jan. 31 not recorded by bank		<u>410.90</u>
Subtotal		Br. 5,411.07
Deduct: outstanding checks:		
No. 301	Br. 110.25	
No. 342	<u>607.50</u>	<u>117.75</u>
Adjusted cash balance		Br. <u>4,693.32</u>
Balance per depositor's record, Jan. 31,2000		Br. 4,262.83
Add: Note Receivable collected by bank		<u>524.74</u>
Subtotal		Br. 4,787.57
Deduct: Bank service charge	Br. 17.00	
NSF check of Ron Co.	50.25	
Error on check stub No. 305	<u>27.00</u>	<u>94.25</u>
Adjusted cash balance		Br. <u>4,693.32</u>

The following are journal entries related to the bank reconciliation.
2000

Jan. 31 cash		524.74	
Notes Receivable			524.74
To record collection of Note Receivable collected by bank			
31. Miscellaneous Expense (bank service charge)		17	
Cash			17
To record bank service charges,			
Accounts Receivable	50.25		
Cash		50.25	
NSF check and error in recording			
Accounting payable	27		
Cash		27	
To record depositor error			

EXERCISE

PROBLEM 1 On November 30, 1991, the Cash T-account (after all postings have been made) for Company AA shows a balance of \$4,200. The bank statement, however, shows a balance of \$5,000. After an examination of the bank statement, the books, and the returned checks, the accountant noted the following:

1. Check no. 482 for \$1,200 and check no. 491 for \$800 are still outstanding.
2. A check for \$200 that was received from Mr. Poor has "bounced." It has been returned with the bank statement and marked "NSF," for "not sufficient funds." This check was in payment for services performed by us on account for Mr. Poor.
3. A deposit we made on November 29 for \$3,000 does not appear on the bank statement.
4. The bank charged us a \$10 service fee to handle the NSF check.
5. The bank also charged us a \$15 monthly checking account fee.
6. Check no. 474 for \$85 was mistakenly charged by the bank for only \$58.
7. The bank collected a \$2,000 note for us and deposited the proceeds into our account.
8. The checking account earned \$30 interest during the month.
9. The bank mistakenly charged us for a check of \$32 as 62 by Company AB.
 - a) prepare bank reconciliation
 - b) prepare necessary journal entry

PROBLEM 1: On May 31, 2002 Lee company showed a balance in its cash account of Birr 1891. On June 2, Lee received its bank statement for the month ended May 31, which showed an ending balance of Birr 3,252.00.

1. A matching of debits to the cash account on the books with deposits on the bank statement showed that the Birr 452.00 receipts of May 31 are included in cash but not included as deposit on the bank statement.
2. An examination of checks issued and checks cleared showed three checks outstanding:

No 9544.....	Birr 322.00
No 9545.....	” 168.00
No 9546.....	” <u>223.00</u>
Total.....	” <u>713.00</u>

3. Include with the bank statement a credit memo for Birr 1225 (principal of Birr 1,200.00 + Birr 25 interest) for collection of a note owed to Lee by Ship Co.
4. Included with the bank statement is a Birr 102.00 debit memo for an NSF check written by Johnson and deposited by Lee
5. Charges made to Lee's account include Birr 12 for safe – deposit box rent and Birr 8 for service charges
6. Check No 9550 for 669 to Taylor Co. on account recorded in cash payments Journal as 666.
 - a) prepare bank reconciliation
 - b) prepare necessary journal entry

5.5.3 Petty Cash Fund

Petty cash fund, which is part of the total cash balance, is used to handle many types of small payments such as employee transportation costs, purchase of office supplies, purchase of postage stamps, and delivery charges. Many businesses find it convenient to make minor expenditures instead of writing checks. The petty cash amount varies from Br. 50 or less to more than Br. 1,000, which will cover small expenditures for a period of two or three weeks.

5.5.3.1 Establishment of Petty Cash

To establish a petty cash fund a check is issued to a bank. This check is cashed and the money is kept on hand in a petty cash box. One employee is designated as custodian of the fund. The issuance of the check for establishment is recorded by debiting petty cash account and crediting cash.

5.5.3.2 Replenishment of Petty Cash

During the period, the custodian makes small payments from the petty cash fund and obtains a receipt or prepares a petty cash voucher. This petty cash voucher explains the nature and amount of every expenditure and is kept with the fund. When the fund runs low or at the end of the company's fiscal period, a check is issued to reimburse the fund for the expenditures made during the period. The issuance of this check is recorded by debiting the appropriate expense accounts and crediting cash or vouchers payable.

The following transactions are typical of petty cash funds:

1. Establishment of the petty cash fund-Cash is drawn out of the checking account and placed into the hands of the custodian. An entry is made at this time debiting Petty Cash and crediting Cash (cash in the bank).

2. Usage of the fund-Employees draw money out of the fund for various expenditures and fill out a petty cash receipt. No entry is made at this time (to require an entry each time cash is disbursed from the fund would be too time-consuming).
3. Replenishment of the fund-The fund is replenished when it reaches a low level, and an entry is made at this time to record the various expenditures, based on the petty cash receipts.
4. Raising the fund level-The fund level is raised above its originally established amount in order to handle a large volume of transactions. Once again, as was done originally, an entry is made debiting Petty Cash and crediting Cash.

These transactions are illustrated in the following example.

For example, if the fund established is Br. 400, the journal entry will be

Petty cash fund	400	
Cash		400

During the first month of the fund's existence, employees draw cash from the fund for the following purposes:

Postage-----	110	
Office Supplies-----	30	
Freight In-----	125	
Office Food-----	<u>120</u>	
Total	\$385	Total cash remaining: \$15

No entries were made for these disbursements; however, petty cash receipts were filled out.

At this point, Petty Coat decides to replenish the fund to its original level of \$400. The entry is:

Postage-----	110	
Office Supplies-----	30	
Freight In-----	125	
Office Food Expense-----	120	
Cash (in bank)-----	385	

Notice that Petty Cash is neither credited at the time of disbursement nor debited at the time of replenishment. The only time we "touch" Petty Cash is when we originally establish the fund, and when we raise the fund level, as we will soon see.

Petty Coat now decides to raise the fund level from \$400 to \$500. The entry is:

Petty Cash-----100

Cash-----100

Exercise Star Company has a Birr 1800.00 petty cash fund. The following transactions occurred in December.

Dec. 2. The petty cash fund was increased to Birr 2,700.00

Dec. 8. Petty cash voucher No. 318 for Birr 48. 42 of delivery expense was prepared and Paid. The fund was not replenished at this time.

Dec. 20. The company decided that the fund was too large and reduced it to Birr 2,250.00

Prepare any necessary journal entries for the above transactions.

CONTROLLING CASH RECEIPTS

Businesses ordinarily receive cash from two main source (1) over the counter from cash customers: and (2) form charge customers making payments on account. The cash that is received immediately over the counter is usually recorded and placed in a cash register. At the end of each day, the cash in each cash register is reconciled with the cash register tape or computer printout for that register. The cash is then taken to the cashier's office and the tapes are forwarded to the accounting department, where they become the basis for entries in the cash receipts journal.

When cash is received later, usually in the form of checks, a record of the checks received should be prepared as soon as they are received. Then the cash is combined with the receipts from cash sales and should be deposited immediately.

In general, though each business varies in its specific procedures for controlling cash receipts, the following basic principles are used:

1. A record of all cash receipts should be prepared as soon as cash is received most thefts of cash occur before a record is made of the receipt.
2. All cash receipts should be deposited in a bank on the day they are received or on the next business day. Undeposited cash is more susceptible to misappropriation.
3. The employee who handles cash receipts should not also be the employee who records the receipts in the accounting records.

If possible, the employee who receives the cash should not also be the employee to disburse the cash. This control measure is possible in all but the smallest companies

Controlling Cash Disbursements

Controls are also needed over cash disbursements. Since most of a company's cash is spent by check, many of the internal controls for cash disbursements deal with checks and authorizations for cash payments.

The following are some basic control procedures for cash disbursements.

1. All payments of cash should be evidenced by a check signed by a designated official if they are not payments from petty cash.
2. All checks should be serially numbered, and access to checks should be limited to employees authorized to write checks.
3. Preferably, two signatures should be required on each check so that one person alone cannot withdraw funds from the bank account
4. The responsibility for issuing purchase orders, inspecting goods received, and verifying contractual and arithmetical details of invoices should be divided among the employees of several departments (That is apply the basic principle of segregation of duties)
5. Approved documents should be required to support all checks issued.

In general it is desirable to coordinate these related activities and to link them with the final issuance of checks to creditors. One of the best systems used for this purpose is the voucher system.

5.5.3.3 Voucher System

One method to control cash disbursements is a voucher system. A **voucher** is a special form, which contains relevant data about a liability and its payment.

In a voucher system, a voucher is prepared for each expenditure and approved by the designated officials. Each approved voucher represents liability and recorded in a voucher register, which is similar to purchases journal. Those registered vouchers are filed according to their payment date in an unpaid vouchers file. The vouchers and supporting documents then are sent to the treasure or other official is the finance department before issuing checks. When the checks are signed, the paid vouchers are recorded in a check register which is similar to cash payments journal. Those paid vouchers are filed in paid vouchers file according to their serial number for future reference.

A voucher system is made up of records, methods and procedures used in proving and recording liabilities and in making and recording cash payments. A voucher system uses (1) vouchers (2) a voucher register (3) a file for unpaid vouchers (4) a check register and (5) a file for paid vouchers.

- **Voucher Register** - After approval by the designated official, each voucher is recorded in a Journal known as voucher register. It is similar to and replaces the purchase journal.
- **Unpaid Voucher File** - After a voucher has been recorded in the voucher register, it is filed in an unpaid voucher file, where it remains until it is paid. The amount due on each voucher represents the credit balance of an account payable and the voucher itself is like an individual account in a subsidiary accounts payable ledger. Accordingly, a separate subsidiary ledger is not needed.
- **Check Register** - The payment of a voucher is recorded in a check register. The check register is a modified form of the cash payments journal and is so called because it is a complete record of all checks.
- **Paid voucher file** – After payment vouchers are usually filed in numerical order in a paid voucher file. They are then readily available for examination by employees or independent auditors needing information About a certain expenditure

5.5.4 Change Fund

A change fund is used to facilitate the collection of cash from customers. The amount of the change fund is deducted from the total cash (including checks, money orders, etc) on hand at the close of business each day to determine the daily cash collections. The cash should be counted and compared with the cash register tape daily. In general, change and petty cash funds are combined with cash on hand and in the bank and are presented as a single amount in the balance sheet. Some businesses that receive cash directly from customers should maintain a fund of currency and coins in order to make change (Amharic=>"zirzir"). Once a change fund is established, there will be no change in its balance unless there is a decision by management to increase or decrease the fund balance.

5.5.5 Cash Short and Over

In handling cash receipts from daily sales, a few errors in making changes will occur. These errors may cause a cash shortage or overage at the end of the day. The account cash short and over is debited if there is shortage and credited if there is overage. At the end of the period if

the account had a debit balance, it appears in the Income statement as miscellaneous expense; if it has a credit balance, it is shown as miscellaneous revenue.

For example, assume that the total cash sales recorded during the day amounts to Br. 12,420. However, the cash receipts in the cash register drawer (actual cash count) total Br. 12,415.

The following entry would be made to adjust the accounting records for the shortage in the cash receipts:

Cash Short and Over	5.00
Cash	5.00
To record a Br. 5.00 (Br. 12,420 – 12,415)	
Shortage in cash receipts for the day	

RECEIVABLES AND ITS CLASSIFICATION

Receivables are all money claims against people or other entities (debtors). Many companies sell on credit/ on accounts in order to sell more services or goods.

For financial statement purposes, companies classify receivables as:

- Current (short-term) receivables
- Noncurrent (long-term) receivables

Receivables are further classified in the balance sheet as either:

- Trade receivable- If a note and account receivables are originate from sales transactions, they are called trade receivable.
- Non trade receivables- Non-trade receivables are those other than trade receivables and include interest receivables, rent receivables, loans by the company to other entities and so on

Based on the above classification, Receivable can be classified as:

- i. **Accounts receivables- are normally informal claims expected to be collected within a relatively short period.** A/R is oral promises of the purchaser to pay for goods and services sold. They represent “open accounts” resulting from short-term extensions of credit. A company normally collects them within 30 to 60 days.
- ii. **Note Receivable- is a written promise to pay a sum of money on demand or at definite period.**

1.3. Accounting for uncollectible accounts

When merchandise or services are sold without the immediate receipt of cash, a part of the claims against customers usually proves to be uncollectible. That is, a debtor fails to pay an account according to a sale contract or dishonors a note on the due date do not necessarily mean that the account will be uncollectible.

Indications are as follows: bankruptcy, closing of the business, disappearance of the debtor, & Failure of repeated attempts to collect receivable.

There are two methods of accounting for uncollectible receivable that is believed to be uncollectible:

1) **Allowance method** which is sometimes called reserve method which provides in advance for uncollectible receivable. *It uses estimates to recognize bad debts before they happen.* The amount of trade receivable estimated to become uncollectible in the future.

They are recognized via an adjusting journal entry on December 31, as follows:

Dec. 31 Bad Debt Expense			
.....xxx			
	Allowance	for	Doubtful
Accounts.....	xxx		

2) **Direct write-off** method. It recognizes the expense only when certain accounts are judged worthless.

The direct write-off method makes an entry for bad debts at the time they take place.

The entry is:

Bad Debt Expense.....	xxx
Accounts Receivable.....	xxx

This method makes sense but is deficient on theoretical grounds. Because, according to the matching principle

, expenses should be recognized in the same accounting period as their related revenue. However, this often will not be the case under this method. For example, if a sale is made late in 1991, bad debts will not arise until January and February of 1992. Thus the revenue has been recognized in 1991 but the expenses are recognized in 1992-an improper matching of the two. Therefore, since this method violates generally accepted accounting principles, it is unacceptable and will not be used in this book

EXAMPLE 1 On December 31, 1991, X Company estimates its bad debts at \$5,000. The adjusting entry is:

Bad Debt Expense	5, 000
Allowance for Doubtful Accounts	5,000

On January 20, 199 2, Mr. X defaults on his \$1,000 balance. Thus, part of the original estimate of \$5,000 has now come to fruition. Should we debit Bad Debt Expense for this \$1,000? The answer is definitely no--we already did so on December 31! The entry for now is:

Allowance for Doubtful Accounts.....	1, 000
Account Receivable (and Mr. X).....	1000

This is called a write-off entry. What is the logic behind this entry? The answer is that until now, as explained earlier, we couldn't credit Accounts Receivable directly because we didn't know who the person is, and we thus could not go to the subsidiary ledger. Now, however, we know it is Mr. X, so we remove his portion from the allowance account, and directly credit both the controlling account and the subsidiary account.

EXAMPLE 2 Refer to Example 1 above. Assume that on February 1, Mr. X feels guilty and decides to pay the \$1,000. We, therefore, must first reverse the write-off entry:

Accounts Receivable.....	1,000
Allowance for Doubtful Accounts	1,000

We then make the regular, routine entry for the collection, which is:

Cash.....	1,000	
Accounts		Receivable
.....	1,000	

EXERCISE

Company A has given you the following information regarding bad debts:

Dec. 31 19X1 Estimate bad debt expense to be 5% of its net sales of \$50,000.

Jan. 15, 19X2 Mr. Poor defaults on his \$1,400 balance.

Feb. 22, 19X3 Mr. Poor repays \$800 of the \$1,400.

Required :- Prepare entries for this information.

SOLUTION

Dec; 31, 19X1 Bad Debt Expense	2, 500
Allowance for Doubtful Accounts.....	2,500
Jan. 15, 19X2 Allowance for Doubtful Accounts	1,400
Accounts Receivable	1,400
Feb. 2, 19X3 Accounts Receivable800
Allowance for Doubtful Accounts.....	800
Cash800
Accounts Receivable.....	800

6.7. NOTES RECEIVABLE

Promissory notes are used in many transactions, including paying for products and services, in the lending and borrowing of money, and to pay for accounts receivable. In this section, we will discuss computations of maturity date and maturity value of a note, how to record receipt of a note, how to account for discounting of a note before it matures. We also discuss cases of dishonored note.

Interest bearing note

The typical notes receivable requires the payment of a specified face amount, also called principal, at a specified maturity date or dates. In addition, interest is paid at a stated percentage of the face amount. Interest is the cost of borrowing money for the borrower or the profit for lending money for the lender. Unless otherwise stated, the rate of interest on a note is the rate charged for the use of the principal for one year.

Interest on notes is calculated as: $I = (P) (R) (T)$

Where, I=Interest, P=Principal, R=Annual Interest Rate, and T=Time (Period)

For example-On January 1, 2017, Chilalo Trading sold fertilizers to cooperatives agreeing to accept, Br 700,000, 12-month, 12% notes. The note is payable on December 31, 2017.

The entry is:

Jan-1, 2007 Notes receivable.....700,000
 Sales revenue.....700,000

(To record the sale of fertilizers)

Dec, 31, 2017. Cash.....784,000
 Notes receivable.....700,000
 Interest income (700,000x12%x1yr) ...84,000

(To record the collection of cash at maturity)

Maturity Date and Period

The maturity date of a note is the day on which the note (principal and interest) must be repaid. The period of a note is the time from the date of the note to its maturity date. Many notes mature in less than a full year, and the period covered by them is often expressed in days. When the time of a note is expressed in days, the maturity date is the specified number of days after the date of the note. As an example, a five-day note dated June 15 matures and is due on June 20. A 90-day note dated July 10 matures on October 8. Thus October 8, due date, is computed as shown below:

Maturity Date Computation:

Terms of Note.....90 days
 July days.....31
 Less days of note.....10 21
 Remaining days69
 Less August days 31
 Remaining days..... 38
 Less September days30
 Maturity Date is October..... 8

The period of a note is sometimes expressed in months or years. When months are used, the note matures and is payable in the month of its maturity on the same day of

the month as its original date. A three-month note, dated July 10, for instance, is payable on October 10. The same analysis applies when years are used.

Receipt of a Note

Notes receivable is usually recorded in a single notes receivable account to simplify record keeping. We need only one account because the original notes are kept on file. This means, that we can understand the maker, rate of interest, due date, and other information by examining the actual note.

To illustrate the recording for the receipt of a note, assume ABC receives a note of the Birr 1,000, 90-day, 12%. This transaction is recorded as:

July 10 Notes receivable	1,000
Sales.....	1,000
(Sold merchandise in exchange for a 90-day, 12% note)	

Discounting notes receivable

Although it is not a common transaction, a company in need of cash may transfer its **notes receivable to a bank**.The discount or (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, namely the time that will pass between the date of the transfer and the due date of the note. The amount of the proceeds paid to the endorser is the excess of the maturity value over the discount.

To illustrate, assume that a 90-day,12% note receivable for \$1,800, dated November 8, is discounted at the payee’s bank on December 3 at the rate of 14%. The data used in determining the effect of the transaction are as follows:

Face value of the note dated Nov.8.....	\$1,800
Interest on note-90 days at 12%.....	<u>54</u>
Maturity value of note due Feb. 6.....	\$1,854
Discount period-Dec 3 to Feb.6.....	65days
Discount on maturity value-65 days at 14%.....	<u>46.87</u>
Proceeds.....	<u>\$1,807.13</u>

The excess of the proceeds received by the endorser from discounting the note, \$1,807.13 over its face value, \$1800, is recorded as interest income. The entry for the transaction, in general journal form, is as follows:

Dec 3.	Cash.....	\$1,807.13
	Note receivable.....	1,800
	Interest income.....	7.13

Honoring and dishonoring a Note

The principal and interest of a note are due on its maturity date. The maker of the note usually honors the note and pays it in full. But sometimes a maker dishonors the note and does not pay it at maturity.

Recording an Honored Note

We use the ABC note transaction above to illustrate the honoring of a note. When ABC collects a note on its due date, It records its receipt as:

Cash.....	615
Notes receivable.....	600
Interest income.....	15

(Collected note with interest of
Birr 600 x 15% x 60/360).

Interest Earned, also called Interest Revenue, is reported on the current period's income statement.

Recording a Dishonored Note

When a maker of a note is unable or refuses to pay at maturity, the note is said to be dishonored. The act of dishonoring a note does not relieve the maker of the obligation to pay. The payee should use every legitimate means to collect.

The balance of the Notes Receivable account normally includes only those notes that have not been matured. When a note is dishonored, we, therefore, remove the amount of this note from the notes receivables account and charge it back to an account receivable from its maker. For instance, Hawani holds a Birr 800, 12%, 60-day note of Bontu.

At maturity, Bontu dishonored the note. Hawani records this dishonoring of its notes receivable as follows:

Accounts receivable-Bontu... 816	
Interest income..... 16	
Notes receivable..... 800	
To charge account of Bontu for a dishonored note and interest of Birr	
800 x 12% x 60/360	