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Basic Accounting

Bookkeeping:

Bookkeeping is a process of detailed recording of all the financial transaction of a business. This means keeping detailed and up to date records on business transactions, the date each one occurred, items received or supplied to and their total prices. Bookkeeping records are entered into the books called books of prime entry and ledger accounts. Together they will provide a complete record of every transaction of business has made.

Accounting:

Accounting involves the preparation of financial summaries and statements from bookkeeping records. The purpose of accounting is to measure the profit or loss and value of a business. The owner of a business needs to know whether the business is making a profit or loss for this purpose an income statement is prepared. The owner of the business also needs to know the financial position at regular intervals so statement of financial position is prepared which summaries financial information about the value of the business.

The bookkeeping and accounting process:

Recording transactions -> Classifying and grouping transactions -> Summarizing financial information -> Reporting and using financial information

Titals/Pillars of accounts:

A -> Assets
L -> Liabilities
C -> Capital
E -> Expenses
R -> Revenue

Assets:

Asset is a resource which are controlled by an entity from which future benefit is derived. There are two types of assets

A) Non-current asset are those assets which have a life of more than one year and it remains productive for several years and can be used over and over again in day to day operation for example machinery, premises, equipment and vehicles.

B) current assets they are those assets which are to be used within one year for example inventory, accounts receivable (debtors), cash at bank, cash at hand.

Inventory: Anything which is purchased for the intention to resale.

accounts receivable (debtors): It represents the amount owed to the business by its credit customer.

Liabilities:

They are the financial obligations to repay money owed to other people and organisations. These include non current liabilities such as bank loans which are amount payable in more than one year and current liabilities which will required repayment quickly, often with in a few months in the accounting for example bank overdraft and accounts payable (creditors).

accounts payable (creditors): It Represent the amount the business owes to the credit suppliers of goods.

Capital:

Owner's capital or equity is the money invested in business assets by the business owners from their own funds. It is the total resources provided by the owner and represents what the business owes the owner.

Expense:

Expired cost of an asset from which no further benefit can be gained are called expenses for example salary expense, rent expense, transportation expense.

Revenue:

It is the gross inflow of resources arises during the course of business example sales, rent income, commission received

TRIAL BALANCE:

It is a list of balance b/d extracted from the T accounts. The trial balance is prepared to check the arithmetical accuracy of the double entry bookkeeping records. It has two side debit and credit side and these two sides are always equal to each other, if these two sides are not equal it means there is an error while recording or posting the transactions in the T accounts. From the trial balance, financial statements are made.

RUNNING BALANCE ACCOUNT :

It is an alternative format of T account. The advantage of such format is that balance can be determined after every transaction and is always available.

Q. What are the *advantages* of recording transactions using double entry system?

- Less risk of errors
- Less risk of fraud
- Easier to refer to previous transactions
- Financial position can be ascertained
- Easier to prepare financial statements
- Easier to make business decisions
- Easier to calculate accounting ratios

Accounting Equation

The total money invested in the total Assets of a business will always be equal to the amount of capital owed by the business to its owners and the total of its liabilities to other people and Organizations. That is

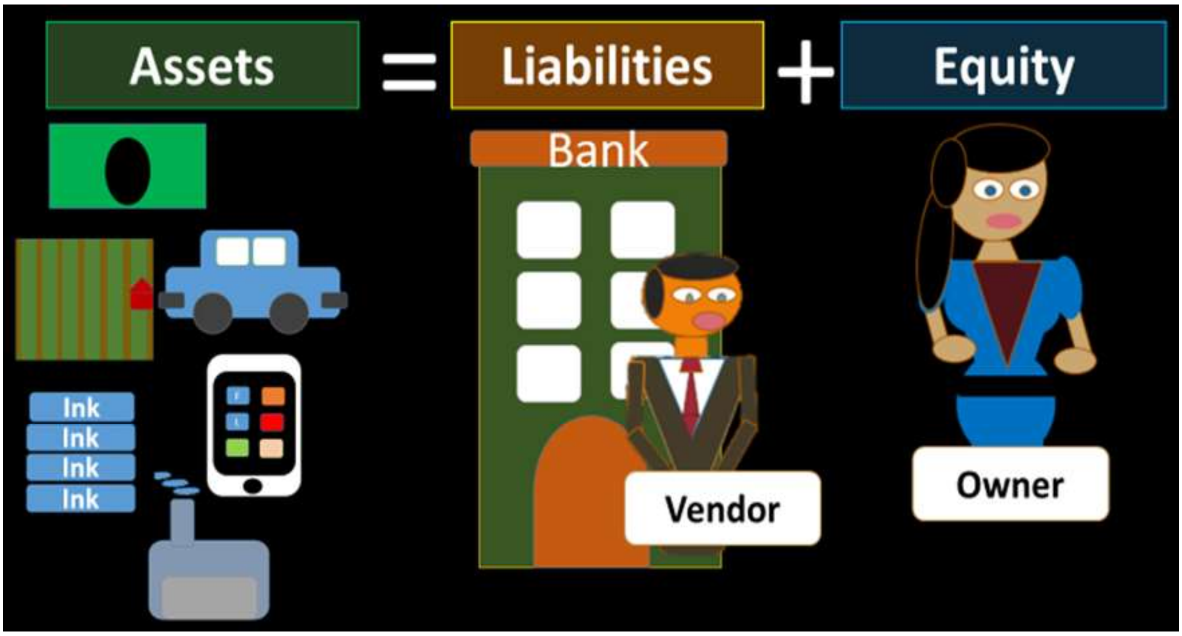
assets = Capital + liabilities

or by simply rearranging

Capital = assets - liabilities

or

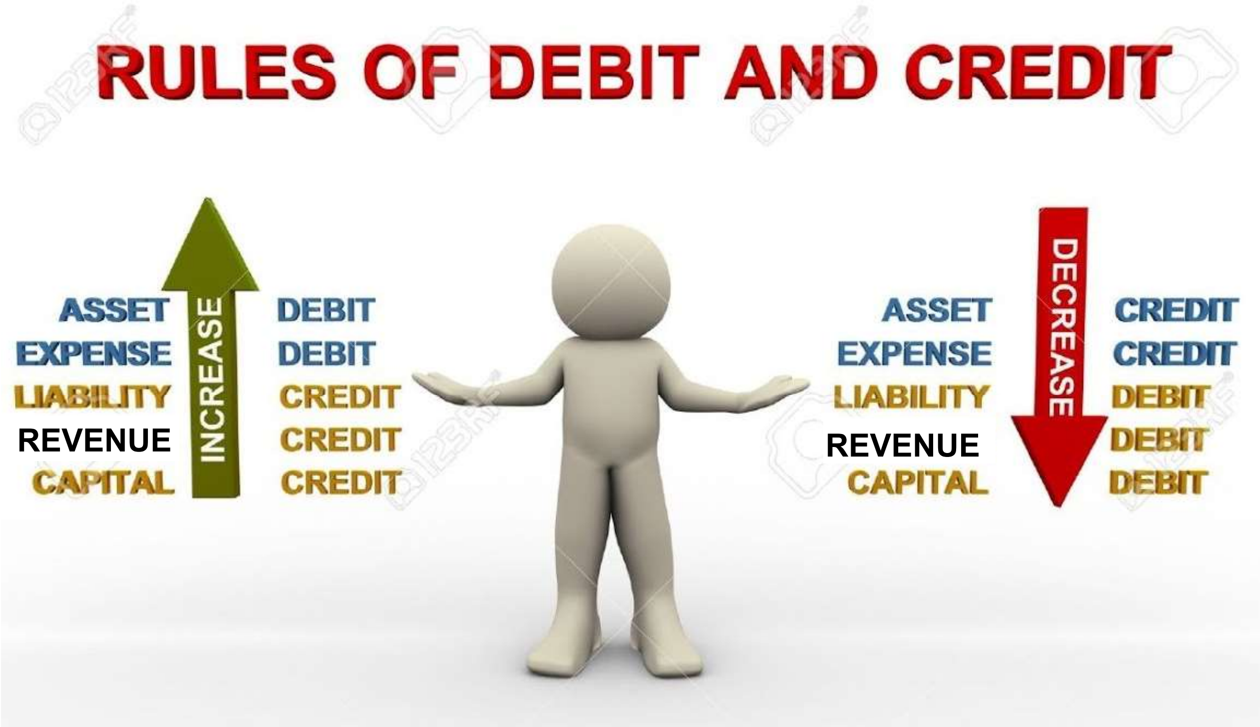
liabilities = assets - capital



Debit and credit

Double entry:

The day to day transactions are recorded in the books of a business using the double entry system of bookkeeping. The term double entry is used because the two effects of a transaction are both recorded in the ledger. A business maintained as separate ledger account for each type of asset, Expense, liability and income and also for each individual debtor and creditor. Every transaction is recorded in the ledger account relating to that particular person or item. Ledger accounts are divided into two sections. The left hand side is known as the debit side and the right hand side is known as the credit side. That the term debit is abbreviated to 'dr' and the term credit is usually abbreviated to 'CR'.



Books of Prime Entry and Source Documents

Books of prime entry:

A book of prime entry is one in which transactions are recorded before being entered in the ledger.
There are 6 books of prime entry

1) Sales journal
2) Purchase journal
3) Sales return journal
4) purchase return journal
5) Cash book
6) General journal

1) Sales journal:

The sales journal shows a list of the names of businesses to which credit sales have been made, the value of the goods sold and the date on which the sales were made.

2) Purchase journal:

The Purchase journal shows a list of the names of the businesses from which credit purchases have been made, the value of the goods purchased and the date on which the purchases were made.

3) Sales return journal:

The sales return journal shows a list of the names of businesses which have returned goods previously sold on credit , the value of the goods return and the date on which the returns were made.

4) Purchase return journal:

The Purchase returns channel shows a list of the names of the businesses to which goods previously purchased on credit, have been returned , the value of the goods returned and the date on which the returns were made .

5) Cash book:

Businesses hold cash to make payments for the goods and services they buy and some cash business keep on their premises which are called cash in hand. However most businesses keep up much larger Reserve of cash in a bank account which is called cash in bank. Every transaction of a business involving the exchange of cash should be recorded in its cash book

6) General Journal:

All other transactions that do not fit in any other book of prime entry are recorded in general journal.

Ledger:

Ledger is where a transaction is finally debited and credited
There are three types of ledger
1) Sales ledger
All debtors' accounts are kept in the sales ledger
2) Purchase ledger
All creditors' accounts are kept in the Purchase ledger
3) General ledger
Rest of the accounts is in general ledger including control accounts for both sales and purchase ledger.

Source documents:

Business transactions are recorded from source documents. Whenever a business transaction takes place, involving sales or purchases , receiving or payment money it is usual for the transaction to be recorded on a document. These documents are the source of all the information recorded by a business. Documents used to record the business transactions in the books of account of the business include the following

1) Invoice:

When a business sells goods or services on credit to a customer it sends out an invoice. Invoice details the amount and type of goods supplied on credit.
- Sales invoice; for the supplier the invoice is sales invoice since he is selling
- purchase invoice; for customer it is a purchase invoice since he is purchasing

2) Debit note:

Document sent by a customer to a supplier in respect of goods returned or an over payment made

3) Credit note:

A document sent by a supplier to a customer in respect of goods returned or over payments made by the customer.

4) Receipt:

A written confirmation that money has been paid. This is normally in respect of cash sales

5) Statement of account:

A document sent out by a supplier to a customer listing all invoices, credit notes and payments received from the customer

6) Cheque counterfoil:

It is a part of a cheque that has been retained as a record of the transaction.

Discount:

Reduction in payment is called discount
There are two types of discount
<u>a) Trade discount</u>
<u>b) Cash discount</u>

a) Trade discount:

Discount which business allowed on bulk purchases, on customer loyalty, bargaining or on reference. This discount are never recorded in the books of accounts

B) Cash discount:

Discount which business allowed on prompt payment. There are two types of cash discount
I) discount allowed; it is an expense for business
II) Discount received; it is an income for business

Bank Reconciliation Statement

Bank Reconciliation Statement:
It is a document prepared by a business to explain why the updated bank balance in the cash book does not agree with the balance on the bank statement.

Items Presented in Cash Book not in Bank Statement:

I) Unpresented cheque:

These are the cheque that have been paid by the business entered on the credit side of the cash book, but which do not appear on the bank statement. This may be because the suppliers have not paid the cheque into his bank or the cheque is still in the banking system and has not yet been deducted from the business account.

II) Uncleared Cheque:

An **uncleared cheque** is a **cheque** that has been written and recorded by the business on the debit side of the cash book, but the **cheque** has not yet been paid by the bank on which it is drawn.

Items Presented in Bank Statement not in Cash Book:

I) Credit Transfer:

They are money received from customers directly through the **banking** system. It will be debited in cash book.

II) Standing Order:

Standing Order is an instruction to the **bank** to transfer funds of a specific amount to another account on a specific date on a recurring basis. Therefore, the balance as per **bank** statement may be lower than the balance as per cash book due to payments made through **standing orders** not yet accounted for by the entity.

III) Direct debit:

There are payments which have to be made, such as gas bills electricity bills, telephone bills, Instead of asking the bank to pay the money, as with standing orders, you give permission to creditor to obtain the money directly from your bank account.

IV) Dishonoured Cheque:

They are **cheques** deposited and debited in cash book but subsequently returned by the **bank** due to nonsufficient amount or any other reason.

V) Dividend:

A **dividend** is a payment made by a corporation to its shareholders, usually as a distribution of profits. It will directly credited by company in customer's bank account.

VI) Bank Charges:

The bank may deduct an amount from the customer's account to cover the cost of running the account.

VII) Interest Credited:

The bank credits interest in customer's saving account. On receiving bank statement business make entry debit side of the cash book.

VIII) Interest Debited:

The bank charge interest from its customers on overdrafts and loans. On receiving bank statement business make entry credit of the cash book.

Quad-E-Azam
Bank recompilation statement
As at 31 July 2018

	$	$
Balance as per up to date cash book		xx
Add, Unpresented cheque		
F Nelson	xx	
W Grean	xx	xx
Less, Uncleared cheque		
W Hack	xx	
G Grill	xx	(xx)
Balance as per bank statement		xx
Or		
Balance as per bank statement		xx
Add, Uncleared cheque		
W Hack	xx	
G Grill	xx	(xx)
Less, Unpresented cheque		
F Nelson	xx	
W Grean	xx	xx
Balance as per up to date cash book		xx

Control Account

Purpose:
If the trial balance fails to balance and the error cannot be readily located, it is necessary to check all the accounting records. This can take a considerable amount of time. The Checking process can be speeded up if a control account for the sales ledger and control account for the purchase ledger have been prepared. These accounts act as a check on the individual accounts with in these ledgers.

Sales ledger control account:
It is used to check the accuracy of the total for all the entries for the transaction posted to trade receivable account in the same ledger.

Purchase ledger control account:
The Purchase ledger control account is used to check the accuracy of the total for all the entries for transaction to trade payable accounts in the purchase ledger.

Advantages of control account:
1) It calculate total receivables and total payable to be recorded in financial statements
2) It checks the arithmetical accuracy of books of prime entry and subsidiary ledgers
3) it prevents from theft, errors and frauds.

Sources of information of sales ledger control account:

1. Sales journal
2. Sales return journal
3. Cash book
4. The journal

Sources of information of purchase ledger control account
1. Purchase journal
2. Purchase return journal
3. Cash book
4. The journal

Limitations of control account:

1. It only provides a summary of each transaction but do not provide the details of each transaction
2. These accounts cannot detect all types of errors for example error of commission and omission
3. As it is not a part of a double entry system it is difficult to locate each error.

Dr. **Sales Ledger Control Account** Cr.

Details	$	Details	$
Balance b/d (Debit balance)	xxxx	Balance b/d (Credit balance)	xxx
Credit Sales	xxxx	Cash/Bank	xxxx
Bank (Dishonored cheque)	xx	Discount Allowed	xx
Bank/Cash (Refunds to trade receivables)	xx	Sales Returns	xx
Interest charged on overdue accounts.	xx	Bad debts	xx
		Set-off (transfer to purchases ledger)	xx
Balance c/d (Credit balance)	xxx	Balance c/d (Debit balance)	xxxx
	xxxx		**xxxx**
Balance b/d (Debit balance)	xxxx	Balance b/d (Credit balance)	xxx

Dr. **Purchases Ledger Control Account** Cr.

Details	$	Details	$
Balance b/d (Debit balance)	xxxx	Balance b/d (Credit balance)	xxx
Cash/Bank	xxxx	Credit Purchases	xxxx
Discount received	xx	Bank/Cash (Refunds from trade payables)	xx
Purchase returns	xx	Interest charged on overdue account	xx
Set-off (transfer to sales ledger)	xx		
Balance c/d (Credit balance)	xxx	Balance c/d (Debit balance)	xxxx
	xxxx		**xxxx**
Balance b/d (Debit balance)	xxxx	Balance b/d (Credit balance)	xxx

Correction of Errors

Errors which do not affect trial balance:

Name of error	Description of error	Example
Error of commission	This occurs when a transaction is entered using the correct amount and on the correct side, but in the wrong account of the same class.	Cash received from Malini credited to Mallika's account.
Error of complete reversal	This occurs when the correct amount is entered in the correct accounts, but the entry has been made on the wrong side of each account.	Cash drawings debited to the cash account and credited to the drawings account.
Error of omission	This occurs when a transaction has been completely omitted from the accounting records. Neither a debit entry nor a credit entry has been made.	Payment of wages not entered in the books.
Error of original entry	This occurs when an incorrect figure is used when a transaction is first entered in the accounting records. The double entry will therefore use the incorrect figure.	Goods, $100, bought on credit but recorded as $1000.
Error of principle	This occurs when a transaction is entered using the correct amount and on the correct side, but in the wrong class of account.	Motor expenses debited to the motor vehicles account.
Compensating errors	These occur when two or more errors cancel each other out.	Purchases account under-added by $100 and sales returns account over-added by $100.

Errors which affect trial balance:
Some errors may occur that result in the totals of the trial balance not balancing. If the errors are not found immediately, the trial balance is balanced by insulting the difference between two sides in a **suspense accounts**. It is regarded as a temporary account in which the difference on the trial balance is held until the errors are discovered.

ERRORS AFFECTING TRIAL BALANCE

- Incomplete double entry
- Incorrect addition
- Unequal amounts of debit and credit side

Incomplete double entry :

A transaction was not completed in the books of account , only a debit or credit entry was made in one account by omitting either credit or debit side entry.

Incorrect addition :

A ledger account total was wrongly calculated therefore balances were not equal.

Unequal amounts of debit and credit side :

A transaction was recorded and double entry was complete but one of the amounts on debit or credit side was under/over stated . For example, sales account was credited by $500 and debtors account was debited by $400 (under casted by $100).

Suspense account :

A suspense account is an account used to temporarily store transactions for which there is uncertainty about where they should be recorded. Once the accounting staff investigates and clarifies the purpose of this type of transaction, it shifts the transaction out of the suspense account and into the correct account(s). An entry into a suspense account may be a debit or a credit.

Accounting concepts

Matching concept:

Profit is determined by matching revenue for the period against the expenses incurred in earning that revenue. Revenue received and expenses paid that do not relate to the period are excluded from financial statements.

Prudence concept:

Expenses should be recognized even if they are likely to be occurred and income when right of a receivable becomes established.
For example provision for doubtful debts, no income would be recorded on the basis of price bond or Lottery ticket.

Business entity concept:

Business is an entity separate from its owner; personal transactions of the owner are not recorded in the books of accounts.

Consistency concept:

Once an accounting method has been chosen, that method should be used unless there is a sound reason to do so.

Going concern concept:

The business will be able to continue its operations in the foreseeable future. Assets will be recorded in the balance sheet at their cost value instead of market value.

Money Measurement:

The accounting process records only activities that can be expressed in monetary terms.

Historical cost:

It is the measures of value used in the accounting in which the price of an asset in the statement of financial position is based on its original cost.

Materiality:
Information is material if its omission or miss statement good influence the economic decisions of users taken on the basis of the financial statements.

Dual aspect:

For every debit, there is a Credit entry of an equal amount
Accounting Period Convention
Final accounts are prepared at the end of the accounting period i.e. one year.

Realization concept:
Revenue is recognized when goods are sold, either for cash or credit i.e. the debtor accepts the goods or services and the responsibility to pay for them
Substance over form
Real substance take over legal form i.e. we consider the accounting point of you rather than legal point of view in recording transaction.

Capital & Revenue Expenditure

As important as many different aspects of accounting are, what is just as important is the ability to differentiate between expenses and revenues. But does it end there? No. In accounting, one has to learn to differentiate between the different types of expenses and revenue as well.

Capital Expenditure: Meaning and Examples

Capital Expenditure is an expenditure that occurs solely for creating future benefits. Any expense that leads to the purchase of a non-current asset, improvement in the life or quality of an existing asset belongs to this category. It may also be an expense that increases the capacity of an asset or makes it more productive. All such types of expenses are Capital Expenditure. It also includes all expenses such as legal costs, transport costs and installation costs that incur to bring a newly bought asset to its present location and condition for the first time.

Examples:
1): Buying a new car is a capital expenditure.
2): Painting a new house for the first time is capital expenditure.
3): Building an extension to a new house is capital expenditure.

Revenue Expenditure: Meaning and Examples

Revenue Expenditure is an expenditure that incurs solely for the day-to-day running of the business. Examples include Stationary, Salaries, Rent and Lightning etc. all belong to the same category. Buying a new asset might be Capital Expenditure but repairing an old asset is Revenue Expenditure, as it is not increasing the original value of the asset, only restoring it. This type of expense only gives short-term benefits, rather than long-term in case of Capital Expenditure.

Examples:
1): Heating and Lightning.
2): Rent and Rates.
3): Sundry Expenses.

DIFFERENCE	
CAPITAL EXPENDITURE	**REVENUE EXPENDITURE**
• Results in an addition in an asset account.	• Results in an addition in an expense account.
• Payments for new assets or extensions to previous ones that increase their life.	• Payments for repairs and replacement parts of old vehicles which restore their life.
• Benefits two or more accounting periods.	• Benefits only the accounting period in which it occurs.
• It appears under the Non-Current Asset section in the Statement of Financial Position.	• It appears under the expense section in Income Statement.

Capital Receipts/Income: Meaning and Examples

Just like there are differences in expenditures, there are also differences in income. Capital Receipts are receipts that arise from the sale/disposal of capital non-current assets like machinery, vehicles or equipment, which seldom occur. Following are examples of Capital Receipts:

1): Bonds and Cash.
2): Sale of shares in the business.
3): Sale of Non-Current Assets.
4): Insurance claim for a damaged fixed asset.

Revenue Receipts/Income: Meaning and Examples

Revenue Receipts are receipts earned from daily activities like sale of goods, are repetitive in nature and are shown in the credit side of the Income Statement. These result from daily activities and are used to pay business expenses. Examples of Revenue Receipts are:

1): Interest Received.
2): Rent Received.
3): Dividend Received.
4): Commission Received.

DIFFERENCE	
CAPITAL RECEIPTS	**REVENUE RECEIPTS**
• Decreases the value of an asset or increases the value of a liability.	• Does not affect the value of an asset or liability.
• Shown in the Statement of Financial Position.	• Shown in the Income Statement.
• Produces Revenue Receipts in the future. (Capital invested gives revenue receipts)	• Does not produce neither Capital nor Revenue receipts.
• It has long-term effect, with the benefit lasting for many years.	• It has a short-term effect and does not last for more than one accounting period.

Depreciation

It is a systematic allocation of depreciable amount over the useful life of an asset.

OR

Fall in the value of fixed asset during one year

Why fixed assets depreciate **OR** causes of depreciation

1) Wear and tear
2) Obsolescence
3) Environmental conditions

Why Depreciation has to be provided in financial statements

1) to record as an expense in income statement
2) to record net book value of the Asset in statement of financial position.

Methods of depreciation:

1) Straight line method:

In this method equal amount of depreciation is charged each year. Depreciation is calculated by dividing the cost of fixed asset by number of years estimated. It can be calculated as follows

Formula:

$$\frac{\text{Cost} - \text{Scrap/Residual Value}}{\text{Useful Life (In years)}}$$

or

$$(\text{Cost} - \text{Scrap Value}) \times \%$$

2) Reducing balance method:

This method is applied on those assets which perform efficiently in initial years and less efficiently in later heirs. Depreciation can be calculated as follows

$$[\text{Cost} - \text{Accumulated Depreciation}] \ \mathbf{x} \ \text{Rate} \ (\%)$$

3) Revaluation method:

This method is applied on low cost items like loose tools. It is difficult to ascertain the value of each item so collectively they are valued it and amount used is depreciation. It can be calculated as follows

	$
Value at Start	XXX
Add: Purchases	X
Available for use	XXX
Less: Value at end	(XX)
Depreciation	XX

Double entry for depreciation

	Debit	Credit
Income Statement	XX	
Provision for Depreciation		XX

Ledgers:

Provision for Depreciation			
	$		$
Disposal	XXX	Balance b/d	XXX
Balance c/d	XXX	Income Statement	XX
	XXX		XXX
		Balance b/d	

Disposal of an asset:

Entries:

	Debit	Credit
Dispoal A/c	XX	
Furniture A/c		XX

	Debit	Credit
Provision for Depreciation A/c	XX	
Dispoal A/c		XX

	Debit	Credit
Bank	XX	
Dispoal A/c		XX

	Debit	Credit
Income Statement	XX	
Dispoal A/c		XX

OR

	Debit	Credit
Disposal A/c	XX	
Income Statement		XX

Ledger:

Non-Current Asset			
	$		$
Bal b/d	XX	Disposal	XX
Bank	XX	Bal c/d	XX
	XX		XX
Bal b/d	XX		XX

Disposal			
	$		$
Non-Current Asset account	XX	Bank	XX
		Provision for Depreciation	XX
Income Statement (Gain)	XX	Income Statement (Loss)	XX
	XX		XX

Bad debts

It is an amount owing to a business which will not be paid by the credit customer

Double Entry:

	Debit	Credit
Bad debts	XX	
Trade Receivable		XX

Ledgers:

Bad Debts

2013	$	2013	$
31 Dec Debtor	xx	31 Dec Income statement	xx

Debtor (Mr. A)

2013	$	2013	$
1st Jan Bal b/d	xx	31 Dec Bad debts	xx

Provision for doubtful debts:

At the end of their financial year, many businesses try to anticipate the amount which will be lost because of bad debts. This ensures that the profit for the year is not overstated and the amount of trade receivables in the statement of financial position is shown at a realistic value.
This is an application of the principle of prudence. By maintaining a provision for doubtful debts, a business also observed the principle of matching. The amount of sales for which the business is unlikely to be paid is regarded as an expense of the year in which those sales are made (rather than an expense of the year in which the debt is actually written off)

Double entry:

	Debit	Credit
Income Statement	XX	
Provision for Doubtful Debts		XX

Ledger:

Provision for doubtful debts

2013	$	2013	$
31 Dec Bal c/d	xx	31st Dec income statement	xx
		2014	
		1st Jan bal b/d	xx

Increase in provision for doubtful debts:

Double entry:

	Debit	Credit
Income Statement	XX	
Provision for doubtful debts		XX

Ledger:

Provision for doubtful debts

2013	$	2013	$
		1st Jan bal b/d	xx
31 Dec Bal c/d	xx	31st Dec income statement	xx
		2014	
		1st Jan bal b/d	xx

Decrease in provision for doubtful debts:

Double entry:

	Debit	Credit
Provision for doubtful debts	XX	
Income Statement		XX

Ledger:

Provision for doubtful debts

2013	$	2013	$
31st Dec income statement	xx	1st Jan bal b/d	xx
31 Dec Bal c/d	xx		
		2014	
		1st Jan bal b/d	xx

Bad Debts Recovered:

A debt that has written off as bad mat be recovered at a later date if the accounts receivables becomes able to pay. The debt must be recovered once more on the sales account by a journal entry. The debtors account will be debited and a bad debts recovered account credited with the amount recovered. The amount received from the accounts receivables may then be credited to his account and debited in the cash book.

Q. Explain why a trader might decide to set up a provision for doubtful debts.

As he wants to prepare himself for the losses likely to arise in future (prudence concept). Moreover as future bad debts relate to current year sales so they are offset against current year income (matching concept) to show more reliable value for accounts receivable in statement of financial position & as a result true and fair view is given in the accounts.

Q. Describe factors that a business should consider when determining the amount to be provided for in a provision for doubtful debts.

o Past experience relating to collection from accounts receivable.
o resent market and industry conditions.
o Classifications of accounts receivables according to their ages (ageing schedule). o Specific knowledge about a customer.
o he state of the economy.
o Consistency concept. (Business should be consistent in their policies)
o omparing with previous years or with the competitors.

Q. Explain why business should include the provision for doubtful debts in his accounts?

o o avoid overstating trade receivables.
o o apply the prudence & matching principle.
o To eflect the true and fair view.
o o avoid overstating profit for the year.

Q. Suggest ways to reduce the risk of bad debts.

- Obtain references from new credit customers
- Fix a credit limit for each customer
- Issue invoices and statements promptly
- Follow up overdue accounts promptly
- Supply goods on a cash basis only

Q. Suggest a way in which the amount of a provision for doubtful debts may be determined.

- Percentage of the total amount owing by credit customers
- Estimating which individual credit customers will not pay their accounts
- Considering the length of time the debts have been outstanding
- Estimate, based on experience, of amount lost each year from bad debts

Q. Explain how maintaining a provision for doubtful debts is an example of the application of the principle of prudence.

- Ensures that the profit for the year is not overstated by anticipating losses
- Ensures that the trade receivables are shown at a realistic level in the statement of financial position

<u>Bad debts recovered</u>

Debtor	DR.	
Bad debts recovered		CR.

Bank	DR.	
Debtor		CR.

Accruals & Pre-Payments

Prepaid expense:

Expenses paid in advance. It becomes current asset

Accrued expense:

Expenses due but not yet paid. It becomes current liability

Prepaid income:

Income received in advance. It becomes current liability

Accrued income

Income due But not yet received. It becomes current assets mass

28.1 The financial year of M. Hussey ended on 31 December 2009. Show the ledger accounts for the following items including the balance transferred to the necessary part of the financial statements, also the balances carried down to 2010:

(*a*) Motor expenses: Paid in 2009 £800; Owing at 31 December 2009 £100.
(*b*) Insurance: Paid in 2009 £900; Prepaid as at 31 December 2009 £70.
(*c*) Stationery: Paid during 2009 £400; Owing as at 31 December 2008 £200; Owing as at 31 December 2009 £300.
(*d*) Business rates: Paid during 2009 £2,000; Prepaid as at 31 December 2008 £180; Prepaid as at 31 December 2009 £160.
(*e*) Hussey sublets part of the premises. He receives £1,600 during the year ended 31 December 2009. Willis, the tenant, owed Hussey £190 on 31 December 2008 and £210 on 31 December 2009.

28.2A W. Hope's year ended on 30 June 2011. Write up the ledger accounts, showing the transfers to the financial statements and the balances carried down to the next year for the following:

(*a*) Stationery: Paid for the year to 30 June 2011 £240; Inventory of stationery at 30 June 2010 £60; at 30 June 2011 £95.
(*b*) General expenses: Paid for the year to 30 June 2011 £470; Owing at 30 June 2010 £32; Owing at 30 June 2011 £60.
(*c*) Rent and business rates (combined account): Paid in the year to 30 June 2011 £5,410; Rent owing at 30 June 2010 £220; Rent paid in advance at 30 June 2011 £370; Business rates owing 30 June 2010 £191; Business rates owing 30 June 2011 £393.
(*d*) Motor expenses: Paid in the year to 30 June 2011 £1,410; Owing as at 30 June 2010 £92; Owing as at 30 June 2011 £67.
(*e*) Hope earns commission from the sales of one item. Received for the year to 30 June 2011 £1,100; Owing at 30 June 2010 £50; Owing at 30 June 2011 £82.

Accounting Ratios

Impotant Formulas:

-> Sales - Cost of sales = Gross profit
or
Sale = Cost of Sales + Gross profit
or
Cost of sales = Sales - Gross profit

-> Cost of Sales = Opening inventory + Purchases - Closing inventory
-> Gross profit - Expenses = Net profit
or
Gross profit = Expenses + Net profit
or
Expenses = Gross profit - Net profit

Ratios are prepared in order to analyse and interpret the final accounts of a business in order to assess its performance and progress. There are three types of ratios:

1. **Profitability Ratios**
2. **Liquidity Ratios**
3. **Efficiency Ratios**

Profitability Ratios:

Profit Mark-up refers to Profit as a percentage of Cost of Sales. Gross Profit Mark-up expresses Gross Profit as a percentage of Cost of Sales, whereas Net Profit Mark-up refers to Net Profit as a percentage of Cost of Sales.

Profit Margin refers to Profit as a percentage of Sales. Gross Profit Margin expresses Gross Profit as a percentage of Sales, whereas Net Profit Margin refers to Net Profit as a percentage of Sales.

Profitability Ratios	Formula
• Gross Profit Margin	$\frac{\text{Gross Profit}}{\text{Sales}}$ X 100
• Net Profit Margin	$\frac{\text{Net Profit}}{\text{Sales}}$ X 100
• Net Profit Mark-up	$\frac{\text{Net Profit}}{\text{Cost of Sales}}$ X 100
• Gross Profit Mark-up	$\frac{\text{Gross Profit}}{\text{Cost of Sales}}$ X 100

Liquidity Ratios:

These ratios are used to check whether the business will be able to pay its debts urgently if the need arises and will not go bankrupt. It tests how much liquid, that is solvent the business is.

Liquidity Ratios	Formula
• Working Capital	Current Assets – Current Liabilities
• Current Ratio	$\frac{\text{Current Asset}}{\text{Current Liability}}$
• Acid Test Ratio	$\frac{\text{Current Asset – Inventory}}{\text{Current Liability}}$

-Current Ratio: This expresses the liquidity of the business. The ideal Current Ratio falls between 1:1.5 and 1:2. Lower than 1:1.5, the business is thought to be in a position to face insolvency.

-Acid Test Ratio: This is a much better check on liquidity as it excludes inventory from Current Assets. This is done due to the reason that inventory takes time to be sold and therefore, might not be that much liquid. The ideal ration lies between 1:1 and 1:1.5.

Efficiency Ratios:

These ratios are used to check how efficient the business is in employing its resources and using its investment in order to make a gain.

Efficiency Ratios	Formula
• Return on Capital Employed	$\frac{\text{Profit}}{\text{Capital Employed}}$ X 100
• Inventory Turnover	$\frac{\text{Cost of Sales}}{\text{Average Inventory}}$

Capital Employed = Total Asset - Current Liability or Non Current Liability + Capital

Average Inventory = (Opening Inventory + Closing Inventory) / 2

$$\text{Trade receivable turnover} = \frac{\text{Trade Reccivale}}{\text{Credit Sales}} \times 365$$

$$\text{Trade Payable turnover} = \frac{\text{Trade Payable}}{\text{Credit Purchases}} \times 365$$

Sole Trader

Format for Income Statement:

Gravity Institute			
Income Statement			
For the year ended, 31 Dec _______.			
	$	$	$
Revenue (Sales)		XXX	
Less: Return Inwards		(XX)	XXX
Less: Cost of Sales			
Opening Inventory		XX	
Add: Purchases		XX	
Less: Return Outwards		(X)	
Add: Carriage Inwards		XX	
		XXX	
Less: Closing Inventory		(XX)	(XXX)
Gross Profit			XXX
Add: Other Income			
Discount Received		XX	
Gain on disposal		XX	
Decrease in Provision for Doubtful Debts		XX	XX
			XXX
Less: Expenses			
Carriage Outward			
Provision for Depreciation		XX	
Bad Debts		XX	
Bank Interest		XX	
Increase in Provision for Doubtful Debts		X	
Loss on Disposal		X	(XX)
Net Profit/Loss			XXX

Format for Statement of Financial Position:

Gravity Institute			
Statement of Financial Position			
As at 31 Dec _______.			
	$	$	$
Non-Current Assets:			
Building		XXX	
Less: Aggregate Depreciation		(XX)	XXX
Equipment		XXX	
Less: Aggregate Depreciation		(XX)	XXX
			XXX
Current Assets:			
Inventory		XXX	
Trade Receivable	XX		
Less: Provision for Doubtful Debts	(X)	XX	
Other receivable		XX	
Cash		XX	
Bank		XX	XXX
			XXX
Capital & Liabilities:			
Capital at start			XX
Add: Net Profit			XX
			XX
Less: Drawings			(XX)
Capital at end			XX
Non current Liability			
Bank Loan			XX
Current Liability			
Trade Payables		XX	
Bank overdraft		XX	
Others payable		XX	XX
			XX

SOLE TRADERS

A sole trader – also known as a sole proprietorship – is a simple business arrangement, in which one individual runs and owns the entire business.

Advantages of sole trader :-

- You keep all the profits
- Start-up costs are low
- Maximum privacy
- Establishing and operating your business is simple
- It's easy to change legal structure later if circumstances change
- Can easily wind up your business.

Disadvantages of sole trader :-

- Unlimited liability for debts as there's no legal distinction between private and business assets
- Capacity to raise capital is limited
- All the responsibility for making day-to-day business decisions is yours
- Retaining high-caliber employees can be difficult
- It can be hard to take holidays.

Difference between trading and service business

Trading business:

- Trading firms are businesses that buy goods which will be resold to its buyers.
- Trading firms usually have inventories of goods to be resold.

Service business:

- Service firms do not have these inventories.
- Service firms derive their revenue from services which they provide to customers. For example, the revenue of accounting firms relate to fees from conducting audits in organizations.

Q. Suggest *disadvantages* of raising funds by means of a bank loan.

- Loan interest to pay every year.
- Loan interest to pay irrespective of profits.
- Loan to be repaid by given date.

Q. Suggest ways of raising long-term funds.

- Introduce additional capital
- Take a partner
- Convert to a limited company
- Mortgage the premises
- Borrow from family and friends
- See if government grants are available

Manufacturing Accounts

ZAID Manufacturing			
Manufacturing Account			
For the year ended, 31 Dec ________.			
		$	$
Direct RM Consumed:			
Opening Inventory (RM)			
Add: Purchase of RM		XX	
Less: Purchase Returns of RM		(XX)	
Add: Carriage Inwards on RM		XX	
		XXX	
Less: Closing Inventory (RM)		(XX)	XXX
Add: Direct Labour/Factory Wages			XXX
Direct Factory Overheads/ Direct Expense			XXX
Prime Cost			XXX
Add: Indirect Factory Overheads			
Supervisors Salaries & Wages		XX	
Insurance		XX	
Indirect Overheads		XX	
Rent		XX	
Heat & Light		XX	
Depreciation of Factory Equipment		XX	XXX
Add: Change in Work-In-Progress			
Opening Inventory (WIP)		XX	
Less: Closing Inventory		(XX)	XXX
Cost of Production			XXXX

Changes to Income Statement & Statement of Financial Position:

The formats for Income Statement and the Statement of Financial Position somewhat remain identical to that of a sole trader except for few minor changes.

In the Income Statement, the Cost of Sales appears like this:

	$	$	$
Cost of Sales:			
Opening Inventory (FG)		XX	
Add: Cost of Production		XX	
Add: Purchase (FG)	XX		
Less: Purchase Return (FG)	(XX)	XX	
		XXX	
Less: Closing Inventory (FG)		(XXX)	XXX

In the Statement of Financial Statement, the Current Assets section appears like this:

	$	$	$
Current Assets:			
Inventory – Raw Materials	XX		
– Work In Progress	XX		
– Finished Goods	XX	XXX	
Trade Receivable		XX	
Other Receivables		XXX	
Bank/Cash		XXX	
		XXX	

Partnership

Partnership refers to a type of business where two or more individuals, or even separate businesses agree to work together under a single business in order to achieve profits. Normally, a maximum limit of 20 partners is permissible but in the case of banks, one can admit only 10.

Whenever these partnerships are made, stress is put on drafting a **Partnership Agreement** in order to avoid possible future disputes, which clearly states the terms of the partnership such as:

- Names of the partners.
- Profit and Loss sharing ratio.
- Amount of capital contributed by each partner.
- Rate of interest on capital and drawings.
- Salaries of partners and the maximum limit for drawings.

Partnership: Capital & Current Account

In the case of Sole Traders, as far as capital was concerned, there was only one account known as Capital account. However, in a partnership, two such accounts are kept, one is the Capital account itself and a new account referred to as Current Account.

Capital Account: This account is the same as the ones in Sole Trader businesses with an increase in capital of the business on the credit side and a decrease or withdrawal of capital on the debit side.

Current Account: This account is specifically kept to record the expenses of each partner as well as income. Income appears on the credit side while expenses appear on the debit side. Debit balance of the current account is a negative balance which is to be subtracted in Statement of Financial Position while a credit balance is a positive balance and is added. The format for the Current Account is as follows:

Current Account					
	Wajahat	Fahd		Wajahat	Fahd
Opening Balance	XX	XX	Opening Balance	XX	XX
Drawings	XX	XX	Interest on Capital (1)	XX	XX
Interest on Drawings (5)	X	X	Interest on Loan (2)	X	X
Loss Share	XX	XX	Salaries (3)	X	X
			Commission (4)	XX	XX
			Profit Share	XXX	XXX
Balance c/d	XX	XX	Balance c/d	XX	XX
	XXX	XXX		XXX	XXX
Balance b/d	XX	XX	Balance b/d	XX	XX

1. Interest on Capital: As it is set as a percentage of the amount of capital invested by each partner, it is an income for the partner and it serves as an incentive for partners to invest more so they can receive more interest. It is not shown under Other Income in the Income Statement and only appears in the Current Account.

2. Interest on Loan: This refers to the interest the business pays on the loan that is provided by the partner. Although an expense of the business and appearing in the Expenses section of the Income Statement, it is an income for the partners and thus, appears on credit side. A 5% Interest on Loan is charged if no percentage is set in the agreement.

3. Salaries: Some partners usually work in their businesses and not just invest. Therefore, they are sometimes entitled to a certain salary for their services, in addition to receiving the profits of the partnership.

4. Commission: This is a bonus provided to partners usually when they bring in more clients than the others or for showing great progress in the partnership.

5. Interest on Drawings: It is set as a percentage of the Drawings of each partner, it is an additional expense for each partner and is charged in order to discourage partners from drawing excessively from the partnership.

Partnership: Appropriation Account

Appropriation account is the extension of the Profit/Loss account, also known as Income Statement, when the business whose Income Statement is being drafted is a partnership business. Just as the name suggests, this account's purpose is to appropriate, or divide, the net profit amongst the partners. It continues directly after the Income Statement and has the following format:

Format for Appropriation Account:

SHAH Partnership			
Appropriation Account			
For the year ended, 31 Dec ________.			
	$	$	$
Net Profit			XXX
Add: Interest on Drawings			
Fahd		XX	
Wajahat		XX	XXX
Less: Interest on Capital			
Fahd		XX	
Wajahat		XX	(XXX)
Less: Bonus/Commission			
Fahd		XX	
Wajahat		XX	(XXX)
			XXXX
Profit/Loss Shared:			
Fahd		XXX	
Wajahat		XXX	XXXX

Advantages of a partnership:

o Additional finance is available

o Additional knowledge, experience and skills are available

o Responsibilities are shared among the partners

o Risks and losses are shared among the partners

o Discussions can take place before decisions are taken o Holiday or sickness is covered by a partner.

Disadvantages of a partnership:

o Profits are to be shared among the partners

o Decisions have to be recognized by all partners

o Decisions may take longer to put into effect

o One partner actions on behalf of the business are binding on all the partners

o Disagreements can occur

o All partners are responsible for the debts of the business.

Q. What if there is no partnership agreement?

In absence of partnership agreement, partnership Act 1890 will come under consideration and the contents of Partnership Act 1890 are:

o No interest on capital

o No interest on drawings

o No salary to partners

- o No bonus to partners
- o No commission to partners
- o No partner to be treated as dormant partner
- o Interest on loan by the partner at the rate of 5%
- o Residual profits to be distributed amongst partners equally.

Q. Explain possible reasons why the partners decided to change their business into a limited company.

- o Limited liability
- o Access to greater sources of finance
- o Favorable terms available for large amount of loan

Q. What are the causes of partnership dissolution.

- o Dissolution by Agreement
- o Dissolution by Notice
- o Insolvency of Partners
- o Commitment to Illegal Business
- o Death of a Partner
- o Expiry of Term
- o Completion of Work or Contract
- o Resignation of Partner

Q. Explain why partnerships may keep both Capital Accounts and Current Accounts.

Capital Accounts: Similar to a sole trader each member of the partnership business has their own capital Accounts in the nominal ledger. These usually record permanent increase or decrease in the capital invested by the individual partner. Capital accounts prepared in the way are referred to as a fixed capital accounts. Capital accounts are maintained separately so that partners can exactly know their investment in the business to help decide on long term issues.

Current Account: Each member of a partnership business also has a current Account. Anything which the partner becomes entitled to such as interest on capital, interest on loan, partner’s salary is credited to this account. Anything which the partner is charged with such as drawing and interest on drawings is debited to this account. Current account are maintained to show routine ad day to day adjustments about interest on capital, salary, commission etc. current account balances roughly specify a limit. To which drawing s may be made, if drawings exceed the limit, the balance becomes debit and act as a precaution.

Q. State differences between a partner's capital account and a partner's current account.

CAPITAL ACCOUNT	CURRENT ACCOUNT
Capital account is fixed	Current account is fluctuating
Capital account not used for day to day transactions	Current account used for day to day transactions
Capital account normally only varied by agreement between the partners	Current account varies with the actions of individual partners.

Q. What is Profit and Loss Appropriation account?

This account shows the distribution of profits amongst the partners in the form of interest, salary, bonus , commission and share of profits.

Q. State four *advantages* a partnership has compared with a limited company.

- In company there is a limited liability which means shareholder, personal property is never at stake unlike partnership.
- Companies have perpetual existence as they are registered as a legal person unlike partnership.
- In a partnership limited funds are available while a company is in a better position to raise more finance.
- In partnership partners can never sell their share of investment without the consent of other partners but that is not the case in a company.

Q. State two reasons why a partner's current account may have a debit balance?

- A partner's current Account may have a debit balance because the partner may have drawn more from the business than the profits allocated to the partner.
- The business may have made a loss.

Q. State reasons why the partners receive interest on capital.

- To reward the partner investing more capital
- To encourage partners to invest in the business

Q. State reasons why the partners are charged interest on drawings.

- To discourage the partners from making drawings
- To discourage drawings early in the financial year
- To help the cash flow of the business

Q. State advantages of being a partner rather than a sole trader.

- Additional finance is available
- Additional knowledge, skills and experience are available
- The risks are shared The losses are shared
- The responsibilities are shared
- Discussions can take place before decisions are taken

Q. State one reason why a partnership agreement should be drawn up when a partnership is formed.

To avoid misunderstandings and disagreements in the future.

Q. Discuss problems, which may arise in a partnership but would not occur in a limited company.

• Partnership is dissolved with the death or retirement of any partner while that is not the case in limited company which remains in existence even if any shareholders changes.

• Partnership has limited amount of funds as compared to limited company which is a quite large organization to undertake large business venture.

• Partnership has unlimited liability as every partner is personally liable for all the debts of the business while limited company as the name suggests has limited liability which means that shareholders personal property is never at stake.

Company Accounts

Are partnerships and sole traders the only type of business organizations we see in our daily life? Some of you might think so. But we are missing another type of business organization that is in place amidst us. Such a business organization is called **Limited Companies** or **Limited Liability Companies.**

Limited Companies: Purpose and Types

These organizations are called so because the liability of the owners of such organizations is limited to the extent of their investment. Unlike a sole trader or partnership, the owners and the business are a separate identity in the eyes of the law and thus, the owners cannot be sued for the actions of the company. Such organizations are owned by shareholders who buy shares of the company as proof of ownership. There are two types of such companies:

1. **Private Limited Company:** This type of limited company issues its shares privately to friends, family members and employees only.

2. **Public Limited Company:** This type of limited company is permitted to issue shares publicly to anyone who can buy them and thus, does not have a maximum number of shareholders.

One very important thing to understand when studying the working of limited companies is that in such business organizations, the owners do not run the day to day operations of the business. They appoint **Directors** which manage the company for them and make all decisions. This is also sometimes referred to as the Diversity of Ownership from Control.

Dividends: Purpose & Types

These are payments made to owners of a company as a reward for investing in the company. These are made from the profits of the company after all expenses have been deducted from revenue. It has the following types:

1. **Interim Dividend:** These are issued during the financial period.

2. **Final Dividend:** These are issued at the end of the financial period.

3. **Proposed Dividend:** These are announced by directors but not yet issued. They are considered as a liability.

Shares: Purpose & Types

As stated before, shares are ownership certificates awarded to shareholders as proof that they own a part of the company. However, there are two types of shares that a shareholder might buy:

1. **Preference Shares:** Such shares are entitled to a fixed rate of dividend which is always given to its shareholders before ordinary shareholders receive anything. Although this gives them an advantage of having the first hand over profits and their dividends not varying from year to year, it does take away their right to vote at **AGM – Annual General Meeting** where shareholders meet every year in order to choose the directors of the company.
   These shares have two further categories:

   - **Cumulative Preference Shares:** In the case where the company does not make enough profit to pay the full dividend on these shares, the amount of dividend unpaid will be carried forward to the next year and will be due on the company to be paid to its shareholder in the following year.
   - **Non- Cumulative Preference Shares:** In the case where the company does not make enough profit to pay the full dividend on these shares, the amount of dividend unpaid will not be carried forward to the next year and the company will not be required to pay them in the following year.

2. **Ordinary Shares:** Such shares are entitled to dividends after the preference shareholders have received this. The amount is not fixed and varies from year to year depending on the director's goals and the company's performance.

Types of Capital:

When considering the financial statements of a limited company, there are various types of capital shown in it from the three above sources:

1. **Authorized Share Capital:** This is the total of the share capital that the company is allowed to issue to its shareholders. This type is no longer require to be shown in the Statement of Financial Position.

2. **Issued Share Capital:** This is the total of the share capital that the company has already issued to its shareholders.

3. **Called up Capital:** This is part of issued capital which the company has asked shareholders to deposit to the company. When issuing shares, full payment is not always asked for and usually come in installments.

4. **Paid up Capital:** This is part of Called up Capital that the shareholders have paid.

Sources of Capital: Types & Differences

Unlike other business organizations, Limited Companies rely on three key sources which serve as and form capital of the business. These sources are:

1. **Ordinary Shares**
2. **Preference Shares**
3. **Debentures**

Differences		
Ordinary Shares	**Preference Shares**	**Debentures**
Owned by shareholders.	Owned by shareholders.	Long-term Loan to a company. Also known as "Loan stock".
Are paid dividends.	Are paid dividends.	Are paid Interest.
Owners of the company.	Creditor of the company.	Creditor of the company.
Can vote at AGM.	Cannot vote at AGM.	Cannot vote at AGM.
No fixed rate of dividend.	Fixed rate of dividend.	Fixed rate of interest.
Cannot accumulate dividends.	Can/Cannot accumulate dividends depending on type.	Cannot accumulate interest; has to be paid.
Last one to get paid back on liquidation.	Get paid back after debentures on liquidation.	First one to get paid upon liquidation.
Paid dividends after preference shareholders.	Paid dividend from profits after deducting interest.	First to receive interest as it is treated as an expense.

Reserves: Purpose & Types

This refers to profits that are not apportioned as dividends to shareholders and instead, are kept in the business. This is done in order to fulfill any of the following objectives:

- To increase working capital.
- To pay future dividends.
- To fund business expansion and growth of operations.
- To keep for times when the business might suffer a loss.

There are two types of Reserves:

1. **Revenue Reserves:** These occur as a result of undistributed profit being kept in the business. These represent increases in company's wealth and are kept to distribute as profits to shareholders.

2. **Capital Shares:** These occur not as a result of undistributed profit, but occur on the revaluation of capital assets and sum received from the issuance of share (also known as **Share Premium**). These are also known as Un-Distributable Reserves.

Q. State advantages & disadvantages of limited liability companies over sole trader or partnership.

Advantages:

o Limited liability as shareholders would not be required to pay any dues of the business from their personal property.

o Company being a legal person continues to exist despite death or retirement of any share holder.

o Limited company being large entity is in a better position to raise large loan on favorable term than sole trader.

o Company can issue shares to general public to raise finance.

Disadvantages:

o Too many legal formalities to be formed

o Higher taxation than partnership and sole trader

o Accounts needs to be published for general public.

Statement of Changes in Equity:

Just like there is an appropriation account when making financial statements of Partnership businesses, we need to create a Statement Of Changes In Equity when making Financial Statements of Limited Companies. Its purpose is to show the appropriation of Company Profits between shareholders and reserves of the company. It is as follows:

SHAH LIMITED				
Statement of Changes in Equity				
For the year ended 31 Dec ____.				
	Share Capital	General Reserve	Retained Profit	Total
	$	$	$	$
Balance at start	XXX	XXX	XXX	XXX
Profit for the year	--	--	XX	XX
Transfer to General Reserve		XXX	(XXX)	--
Dividend Paid (Interim)	--	--	(X)	(X)
Dividend Paid (Final)	--	--	(XX)	(XX)
Balance at end	XXX	XXX	XXX	XXX

Changes to Statement of Financial Position:

The only change one has to make when putting up the Statement of Financial Position of a Limited Company are in the Finance By section which are as follows:

Capital, Reserves & Non Current Liability	$	$	$
Issued Share Capital:			
Ordinary Share Capital		XXX	
Preference Share CapiTal		XXX	XXX
Retained Profit at the end of year			XXX
General Reserve			XXX
Debentures			XXX
			XXX

Single Entry & Incomplete Records

In normal questions, in order to calculate profit of a business, we would require the drafting of the Income Statement, but in Incomplete Records, because some information is usually missing, we apply the straight formula:

Profit/Loss= Closing Capital – Opening Capital – Additional Investment + Drawings

Opening Capital equals to all assets less liabilities, present at the start of the accounting year while **Closing Capital** equals to all assets less liabilities, present at the end of the accounting period.

Finding Sales and Purchases:

At times, when the question does not provide us with the total sales or purchases of a business, we might be confused as how to calculate them. Always remember, that **Total Sales** equals **Credit Sales** as well as **Cash Sales.**

Credit Sales are those sales that are made to customers on credit. **Cash Sales** are those sales that are made to customers and paid for at the same time.

Although Credit Sales can easily be found by drawing up the SLCA, we can use a simple formula to save time:

Credit Sales = Closing T. Receivables – Opening T. Receivables + Payment from Debtors + Bad Debts + Return Inwards + Discount Allowed

Same as in the case of Sales, **Total Purchases** comprises of Credit as well as Cash Purchases. The same formula can be changed above to find purchases:

Credit Purchases = Closing T. Payables – Opening T. Payables + Payment to Creditors + Bad Debts + Return Outwards + Discount Received

Finding Income and Expenses:

Sometimes, it is possible to get paid in advance for an income which we were to recive next year. It is also possible that we might pay our cook two months in advance. As per the matching concept, neither the income we received in advance nor the two months advance salary are to be included in the financial year. Therefore, when dealing with Incomplete Records, it is necessary to find the correct amount of an expense and revenue and not what was incurred.

Finding Income is easier by simply drawing up the T-account, instead of deriving a formula:

Income Account					
Jan 1	Accrued b/d	XXX	Jan 1	Prepaid b/d	XXX
Dec 31	Income Statement	XX		Bank	XX
Dec 31	Prepaid c/d	X	Dec 31	Accrued c/d	X
		XXX			XXX

Just like in the case of income, we can draw up an expense account:

Expense Account					
Jan 1	Prepaid b/d	XXX	Jan 1	Accrued b/d	XXX
	Bank	XX	Dec 31	Income Statement	XX
Dec 31	Accrued c/d	X	Dec 31	Prepaid c/d	X
		XXX			XXX

Income & Expenditure Account

Non-Profit Making Organizations are such businesses that's main aim is to provide recreational facilities to its members, charities and other welfare activities rather than to make a profit. Accounting for such organizations is also known as **Club Accounting** because almost all clubs that are not for profit organizations tend to apply such methods.

Receipts & Payments Account:

In Club Accounting, this account specifically exists for the sole purpose of providing a summary of the cash/bank inflows and outflows for the period. It includes all capital and receipts income and expenditures. Also provides closing cash/bank balances.

Income & Expenditure Account:

In Club Accounting, this account replaces the Income Statement. Just like what it replaces, the main purpose of the Income & Expenditure Account is to match the payments of the period with the receipts earned from the same period. It only records revenue receipts and expenditures.

DIFFERENCE	
Receipts & Payments Account	Income & Expenditure Account
• It is a Cash/Bank summary.	• It is a Surplus/Deficit summary.
• It includes all types of receipts and expenditures.	• It only include Revenue income and expenditure.
• It reveals cash/bank balance	• It reveals surplus/deficit

- **Surplus** is the term used in place of Profit when receipts exceeds payments.
- **Deficit** is the term used in place of Loss when payments exceed receipts.

Subscriptions: Purpose & Treatment

One may be thinking as to how will a non-profit organization expect to pay its expenses and charge its members if it is to not make profit. This is done through **Subscriptions** which is the main source of income for a non-trading organization. It is a fixed payment made by the members each year to the organization. Just like any Income account, a Subscription account also has Arrears and Prepayments:

- **Subscription in Arrears:** This refers to subscription that was due to a member but has not yet been received. It is an asset for the organization.

- **Subscription in Advance:** This refers to subscription that was not due but a member paid the organization in advance. It is a liability for the business

The format for the Subscription account is the same as an Income account. But instead of transferring the amount due for the year in the Income Statement, we transfer it to Income & Expenditure account.

Other sources of Income for the organization include:

- **Entrance Fees:** This is a one-time payment by members when they are admitted to the club. It is also credited to Income & Expenditure account.

- **Bar Profit:** Some clubs tend to operate bars to provide drinks for their members. The profit earned from such sales is also credit as Income to the Income & Expenditure account.

- **Donation:** These are treated as Income by the organization and credited to the Income & Expenditure account if not stated as capital receipts.

- **Legacy:** It is treated as a Capital Receipt and is shown in the Statement of Financial Position.

Subscription

2013		x	2013		x
Jan 1st	Accrued b/d	xx	Jan 1st	Prepaid C/d	xx
2013	Income & Expenditure	xx	2013	Bank	xx
2013	Prepaid	xx	2013	Accrued C/d	xx

ACCOUNTING POLICIES

Accounting policies are the rules used by an entity to ensure that transactions are recorded properly and financial statements produced correctly. These policies ensure that accounting activities are handled consistently over time.

Objectives of Accounting Policies :

- **Reliability :** Financial information is reliable only if it can be depended on to represent actual events, if it is free from error, if it free from bias.
- **Understandability : Understandability** is the concept that financial information should be presented so that a reader can easily comprehend it.
- **Comparability :** Following these standards will allow for inter-firm and intra-firm comparisons. This allows us to check the progress of the firm and its position in the market.
- **Relevance :** Relevance in accounting means the information we get from the accounting system will help the end users to take important decisions. End users may be managers, employees, investors , lenders etc.

INVENTORY VALUATION

Inventory is stock of goods which is to be valued at lower of cost or Net Realizable Value according to the prudence concept.

Cost :

The cost of inventory is the actual purchase price of the goods plus any additional costs incurred in bringing the goods to their present position and condition.

Net Realizable Value :

Net realizable value (NRV) is the cash amount that a company expects to receive.

Net realizable value = Expected selling price – total selling cost

- ✓ At the time of inventory valuation nothing is to be recorded at selling price , it should be either at NRV or lower cost.
- ✓ As per prudence concept, lower value is to be recorded
- ✓ **IAS 2** states that inventory must be valued at lower of cost or NRV.

Q. State the basis on which the business should value their closing stock.

At lower of cost of NRV

Q. State the difference between cost and net realizable value.

Cost is the actual purchase price plus any additional costs incurred in bringing the inventory (stock) to its present condition and position.	**Net realizable value** is the estimated receipts from the sale of the inventory (stock), less any costs of completing or selling the goods.

COMPUTERISED ACCOUNTING SYSTEM

Computerized Accounting involves making use of computers and accounting software to record, store and analyze financial data as it has more advantages than disadvantages when compared with manual accounting system.

ADVANTAGES OF COMPUTERISED ACCOUNTING SYSTEM

♣ Using accounting software it becomes much easier for different individuals to access accounting data outside of the office, securely.

♣ Using accounting software, the entire process of preparing accounts becomes faster.

♣ Because the calculations are so accurate, the financial statements prepared by computers are highly reliable.

♣ Computerized accounting is more efficient than paper-based accounting, than naturally, work will be done faster and time will be saved.

♣ Computerized systems can produce invoices, purchase orders and other documents more quickly than manual accounting system.

♣ Many reports are automatically updated and instantly available.

DISADVANTAGES OF COMPUTERISED ACCOUNTING SYSTEM

♣ It can be costly to staff accountants familiar with specific computerized accounting software and programming.

♣ Computerized systems are costly to purchase

♣ Accounting software data requires extra levels of security to prevent problem like fraud

♣ If your computer crashes or data is corrupted by a virus, you won't be able to use your accounting software until the problem is fixed

♣ Accounting software requires you to take the time to learn how to use it

♣ It is even easier to mistype a number in computerized accounting system.

Information and Communication Technologies (ICT).

ICT refers to technologies that provide access to information through telecommunications. It is similar to Information Technology (IT). For **example**, personal computers, digital television, email, robots etc.

BENEFITS OF ICT IN ACCOUNTING AND BOOK KEEPING

- **Accuracy**
  Computers perform calculations without errors irrespective of such calculations being simple or extremely complex. However, care should be observed to input the right information.

- **Speed of processing information**
  Computers have the ability to process huge volumes of data very rapidly. Reports such as account balances, control accounts, trial balance, income statement and balance sheet can be obtained at few clicks. Also, reports can be processed in different formats to suit the needs of the users.

- **Ability to process high volumes of information**
  Computers have the ability to do the jobs that would require several workers had a manual system been used. Examples include preparation of control accounts, financial statements and preparing payroll. It only requires the right software to be used.

- **Performing reconciliations**
  Accounting software allows reconciliations to be performed automatically and rapidly. These include reconciling cash book balance with balance on bank statement and reconciling control account balances with balances from sales ledger and purchases ledger.

- **Ease and capacity of information storage**
  Computers provide virtually unlimited space for storing data on discs (hard disks, removable disks and even on the internet). These require very little space and may retain information for years. Besides, information can be safeguarded by making backups (keeping same information on different disks). Using computers reduces considerably the use of filing cabinets.

- **Security**
  Information on computers are considered to be safe. This is because access to information can be restricted by using passwords. Also, in some accounting software which allows multi-users, it is easy to trace which user has performed what transaction. This reduces the risk of fraud.