Accounting definition

Accounting can be defined as the process of collecting, recording, summarizing and communicating the financial information of a business

Accounts are the records in which this financial information is recorded.

Keeping the most basic records is called Book Keeping
The Profession responsible for collecting, recording, summarizing and communicating the financial information is known as Accountancy profession. For example an Accountant

Book Keeping

Book keeping is the art of recording the financial information. For example keeping the record sale of goods

What's difference between Accounting and Book Keeping?

Book keeping only involve in recording the financial information while accounting collects, records, summarizes and communicates the financial information

Booking is just one basic phase of accounting the recording phase

Why should we keep Accounts?

Man has been keeping accounts for thousands of years because they help to keep track of money, by showing where did money come from and how we have spent it

Different fields of accounting or branches of accounting

Financial accounting
It is the general accounting field engages in recording and communicating financial information

Cost accounting
It is specialized field of accounting involves in controlling the cost of production and distribution

Management accounting
It concerns in selecting best method of accounting among various alternatives

Government accounting
It is generally single entry system used in recording government transactions e.g. recording revenue, expenditure, taxes and preparing budget

Auditing
It is the examination of accounting records to check the fairness and accuracy

Objectives and functions of accounting

- First and the foremost objective of accounting is to maintain accounts to tack inflow and outflow of money and to keep financial information safe
- By keeping accounts businesses protects their properties because accounts help in tracking misappropriation and frauds
- Legal requirements of a country for various reasons. For example it serves as a base for income tax calculation

- Accounting information is helpful in communicating the profitability, financial position or financial results of a business entity to interested parties or Stake holders

Stakeholders, interested parties or parties interested in accounting information

- First off, the business owner want to know the financial position of business whether the business is in profit or in loss
- Investors because they want to invest in the business (e.g they purchase shares, bonds etc.)
- Loan provider, banks and creditors want to know the business profitability and financial position
- Management of business needs information for the decision-making
- Business employees want to know the business stability, future prospects and business scope for their own welfare in the business organization
- Government for the income tax purpose and government agencies for various other purposes

Book keeping

For recording financial information, an accountant has to enter information in accounts. Entering information about a financial transaction in accounts is called entry-making. There are two main systems for making or passing entries in the accounts: Single entry system and double entry system

Single Entry

Where only one effect or aspect of a financial transaction is recorded

Double Entry

An Entry-making technique or a system of recording financial information where two effects or aspects of every financial transaction are recorded in accounts

Example of Double Entry

Good sold for cash. In this case, the increase in sales (revenue) will be recorded in sales account and increase in cash will be recorded in cash account. Therefore, there are two aspects or effects of this transaction first one is Increase in sales or revenue and second is increase in cash, both will be recorded.

Basic Terms of Accounting

- **Business**
- In general term any activity undertaken for purpose of earning profit

- **Capital**
- Capital represents cash and resources introduced by the owner(s) of the business to set up or to run the business

- **Drawing**
- Drawing represents cash and resources withdrawn by the owner of business for personal use

- **Owner**
- The person(s) who starts a business by introducing capital

- **Transaction**
- Any dealing between two persons that can be measured in money. For example sale of good by business is a transaction

- **Account**
- A record or log used to record the transactions of business

- **Invoice**
- Any written evidence of occurrence of a transaction like invoice for purchase of goods on credit

- **Trade discount**
- A discount given by seller to buyer on listed price of good

- **Cash discount**
- A discount for quick or prompt payment of credit. For example a company has purchased goods on credit and if it makes payment of credit within specific period time, the seller would give the company cash discount on quick payment

- **Stock**
- Goods or commodities remaining unsold at the end of accounting period (Generally 1 year)

- **Creditor or Account payable**
  A person, business or an organization from which the business has purchased goods or services on credit

- **Debtor or Account receivable**
  A person, business or an organization to which the business has sold goods or services on credit
- **Accounting heads or type of accounts**

  Every financial transaction affects at least one head of accounting. For example cash received from debtor, this transaction has two effects i.e increase in cash (asset) and decrease in debtor (asset). Following are the five accounting heads

- **1. Assets**
- Assets are the tangible or intangible resources controlled or owned by the business to get future economic benefits

- **Examples of assets**
- Cash, A/C receivable or debtors, notes receivable, building, plant and machinery, stock of goods, bonds and share or any kind of financial securities, patents, copyrights, franchises, goodwill, trademarks, trade names, prepaid expenses, earned or Accrued incomes etc.

- **2. Expenses or losses**
- Gross outflow of economic benefits which can be measured in money for getting services or goods. Technically expenses are events by which assets are decreased or liabilities are increased.

- **Examples of Expenses**

- Purchase of goods or services, rent, employee wages or salaries, factory leases and depreciation expenses, heating and electricity expense, repair and renewal of machinery and plant, freight and demurrage expense etc.
- **3. Income or gains**
- Gross inflow of economic benefits that can be measured in money for providing services or goods. Technically incomes are events by which assets are increased or liabilities are decreased.
- **Examples of incomes**
- Sale of goods or services, commission, discount received, profit on the sale fixed asset etc.
- **4. Liabilities**
- These are the obligations of business arisen by past transaction or event
- **Examples of liabilities**
- A/C Payable or creditor notes or bills payable, accrued interest and commission, bank loan, mortgage loan, issued bonds, unearned income, accrued tax etc.
- **5. Capital or owner's equity**
- The investment in business to set up or to run the business either in the form of cash, cash equivalent, assets or economic resources by the owner(s) of business
- **Examples of capital**
- Investment of cash or assets (machinery, plant, vehicle etc.) to start a business
- Injection of cash in running business to enlarge its operations which is known as Fresh capital

Types of Business Entities

- **1. Profit Oriented / Commercial Entities**
- Profit oriented or commercial entities are those entities/organizations whose main aim of carrying out business is to earn profit for the owner or owners of the business organization
- **Sole Proprietorship**
- Where one person (owner) start a business and risks and returns rest with a single owner
- **Partnership**
- Wherein two or more persons owned a business and all partners (owners) of a firm/business are jointly and severally liable to repay the liabilities of the firm. This implies that in case of bankruptcy of firm/business, the personal properties of partners can be used for the repayment of debts or liabilities of the business as well
- **Companies or Corporate**
- Companies are separate legal entities formed under the Companies Ordinance or law of a country. In case of a company the liability of owners (shareholders) is limited. Limited liability implies that the personal property of shareholders or owners won't be used for the repayment of debts or liabilities of the company even through company gets bankrupted

- **2. Non Profit Oriented Entities**
- Non-profit oriented entities are those business entities or concerns where the main purpose of doing business is not to earn profits for the owners / sponsors but to provide benefits to general public or to carry out a social cause
- NGOs Non-Government Organizations
- Trusts
- Societies

Separate Entity Concept

This concept forms the basis of accounting principles or concepts. It implies that for the purpose of accounting 'the Business is treated independently from the Owners'.

This means that although anything owned by the business belongs to the owner(s) of the business and anything owed by the business is payable by the owner(s) but for accounting purpose we assume that the business is independent of its owners

EXAMPLE

If a business purchases a machine or piece of equipment, it will own and obtain benefits from that Equipment. Likewise, if a business borrows money from 'someone' it will have to repay the money. This Someone includes even owner of the business. The treatment of business independently from its owners is called the 'Separate Entity Concept'

Accounting cycle

An accounting cycle is the sequence in which financial data is recorded until it becomes the part of financial statements at the end of accounting period. In other words, it's a sequence of steps to record financial information in precise manners. For example accounting cycle is preparing journals, preparing ledger accounts, preparing trial balance, passing adjusting entries and at the end of accounting period preparing financial statements (such as Income statement, Balance sheet, Cash flow statement etc)

Accounting cycle includes these major steps:

1. Identifying the financial transaction
2. Preparing the documents for transactions such a sales invoice
3. Journalizing the transactions
4. Posting the transactions from journal to ledger account
5. Preparing the trial balance to check the accuracy of accounts
6. Adjusting the entries if there are mistakes or omissions in recording transactions in any book of accounts
7. Preparing financial statements (such as Income statement, Balance sheet, Cash flow statement etc)
8. Posting closing entries to ledger account
9. Preparing 'after closing trial balance' to check the debit balance is equal to credit balance

- **The Double Entry system - Debit and Credit**

- **Debit and Credit**

Debit and Credit are the two alphabets of accounting (like in English ABC..). Debit and Credit represent the two aspects of a transaction and this is known as double entry system

- As we know every financial transaction has two effects something always "gives" and something always "receives" we have to record the both aspects of a transaction. Double entry (Debit and Credit) simply implies that each transaction should be recorded twice in the books of accounts.

- **For example** a business has purchased equipments for $2500, in this case equipments (Debit) should be recorded in equipment account and cash (Credit) in cash account. Therefore, there are double aspects of that transaction

- **Accounting heads or type of accounts**

Every financial transaction affects at least one head of accounting. For example cash received from debtor, this transaction has two effects i.e increase in cash (asset) and decrease in debtor (asset). Following are the five accounting heads

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- **2. Expenses or losses**
- Gross outflow of economic benefits which can be measured in money for getting services or goods. Technically expenses are events by which assets are decreased or liabilities are increased.

- **Examples of Expenses**
- Purchase of goods or services, rent, employee wages or salaries, factory leases and depreciation expenses, heating and electricity expense, repair and renewal of machinery and plant, freight and demurrage expense etc.

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- Gross inflow of economic benefits that can be measured in money for providing services or goods. Technically incomes are events by which assets are increased or liabilities are decreased.

- **Examples of incomes**
- Sale of goods or services, commission, discount received, profit on the sale fixed asset etc.

- **4. Liabilities**
- These are the obligations of business arisen by past transactions or events

- **Examples of liabilities**
- A/C Payable or creditor notes or bills payable, accrued interest and commission, bank loan, mortgage loan, issued bonds, unearned income, accrued tax etc.
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- **5. Capital or equity**
- The investment in business to set up or to run the business in the form of cash, cash equivalent, assets or economic resources by the owner(s) of business
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- **Examples of capital**
- Investment of cash or assets (machinery, plant, vehicle etc.) to start a business
- Injection of cash in running business to enlarge its operations which is known as Fresh capital

How to Debit and Credit

As you know, accounting has five types of accounts (i.e. Assets, Expenses, Income, Liabilities and Capital), we debit and credit when there is increase or decrease in Assets, Expenses, Income, Liabilities and Capital.

We Debit when there is:

- an increase in **Assets**
- an increase in **Expenses**
- a decrease in **Income**
- a decrease in **liabilities**
- a decrease in **Capital**

We Credit when there is:

- a decrease in **Assets**
- a decrease in **Expenses**
- an increase in **Income**
- an increase in **liabilities**
- an Increase in **Capital**

Procedure of debiting and crediting accounts

Find out which are the two or more accounts involved in the transaction

1. Find out which type of accounts these are
2. Find out either there is an increase or a decrease in these accounts

EXAMPLE No.1

Transaction: Started business with cash $50,000

In this transaction:

1) There are two accounts involved Cash and Capital
2) Types of accounts are Cash=Asset and Capital=Capital or owner equity
3) There is an increase in Cash and Increase in Capital

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Cash	**$50,000**	
Capital		**$50,000**

EXAMPLE No.2

Transaction: Purchased machinery for cash $50,000

In this transaction:

1) There are two accounts involved Machinery and Cash
2) Types of accounts are Cash=Asset and Machinery=Asset
3) There is a decrease in Cash and an Increase in Machinery

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Machinery	**$50,000**	
Cash		**$50,000**

EXAMPLE No.3

Transaction: Purchased Goods for $2000

In this transaction:

1) There are two accounts involved purchases and Cash
2) Types of accounts are Cash=Asset and Purchases=Expenses
3) There is an increase in purchases and a decrease in Cash

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Purchases (Goods)	**$2000**	
Cash		**$2000**

EXAMPLE No.4

Transaction: Sold goods for $5000

In this transaction:

1) There are two accounts involved Sales and Cash
2) Types of accounts are Cash=Asset and Sales=Income
3) There is an increase in sales and Cash

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Cash	**$5000**	
Sales (Goods)		**$5000**

EXAMPLE No.5

Transaction: Purchased goods for $3000 on credit from Mr.Z

In this transaction:

1) There are two accounts involved Purchases and Creditor or account payable(i.e Mr.Z)
2) Types of accounts are Creditor=liability and Purchases=Expenses
3) There is an increase in Purchases and Creditor

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Purchases (Goods)	**$3000**	
Creditor (Mr. Z)		**$3000**

EXAMPLE No.6

Transaction: Sold goods for $5000 on credit to Mr. Z

In this transaction:

1) There are two accounts involved Sales and Debtor or Account Receivable(i.e Mr.Z)
2) Types of accounts are Debtor=Asset and Sales=income
3) There is an increase in sales(income) and Debtors

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Debtor (Mr. Z)	**$5000**	
Sales		**$5000**

EXAMPLE No.7

Transaction: Cash $2500 paid to Mr. Z for goods purchased on account

In this transaction:

1) There are two accounts involved Cash and Creditor or account payable(i.e Mr.Z)
2) Types of accounts are Cash=Asset and Creditor=liability
3) There is a decrease in Cash and Creditors

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Creditor (Mr. Z)	**$2500**	
Cash		**$2500**

EXAMPLE No.8

Transaction: Cash $200 Received From Mr. Z for goods sold on account
In this transaction:
1) There are two accounts involved Cash and Debtor or account receivable (i.e Mr.Z)
2) Types of accounts are Cash=Asset and Debtor (Mr.Z)=Asset
3) There is an increase in Cash and a decrease in Debtors

Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Cash	**$200**	
Creditor (Mr. Z)		**$200**

EXAMPLE No.9

Transaction: Paid salary $5000 to an employee
In this transaction:
1) There are two accounts involved Cash and Salary
2) Types of accounts are Cash=Asset and Salary =Expense
3) There is a decrease in Cash and an increase in Salaries expenses
Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Salary expenses	**$5000**	
Cash		**$5000**

EXAMPLE No.10

Transaction: Received $4000 as commission from a Firm
In this transaction:
1) There are two accounts involved Cash and Commission
2) Types of accounts are Cash=Asset and Commission =Income/Revenue
3) There is an increase in Cash and Commission income
Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Cash	**$4000**	
Commission income		**$4000**

EXAMPLE No.11
Transaction: $10,000 withdrawn by owner for his personal use
In this transaction:
1) There are two accounts involved Cash and Drawings
2) Types of accounts are Cash=Asset and Drawings=Capital/Owner equity
3) There is a decrease in Cash and Capital
Therefore, the double entry should be:

DESCRIPTION	DEBIT	CREDIT
Drawings	**$10,000**	
Cash		**$10,000**

Book of original entries - General journal

Books of original entries

Books of original entries are books in which we first record the transactions. We record entries in them according to the nature of transactions and entries are made to them on daily basis

Need for Books of original entries

In the course of business, source documents (For example invoices, credit notes and debit notes etc..) are created. The details of these source documents need to be summarized, as otherwise the business may forget to make payment or ask for payment of cash or even accidentally pay twice. In other words business needs the record of source documents of transactions to track what's going on. These kinds of records are made in books of original entries

What are the kinds of Books of original entries?

There are many books of original entries used to record financial activities of a business and transactions are recorded in them according to the nature of transactions

1. General journal or Day book **-** For recording general double entries
2. Sales Journal or Sales day book **-** For recording credit sales
3. Purchase journal or purchase day book **-** For recording purchases on credit
4. Sales return journal or sale return day book **-** For recording sales return
5. Purchase return journal or purchase return day book **-** For recording purchases return
6. Cash receipts journal **-** For recording all kind of cash receipts
7. Cash payments journal **-** For recording all kind of cash payments
8. Cash book **-** For recording cash receipts and payments

The term Journal is also known as day book.

Now we are in position to discuss our first book of original entries The General journal.

General Journal

General journal is also referred to as Day book or Book of original entries. General journal is the place where a business first records the transactions. General journal is most commonly used to record general economic events or transactions of an enterprise

Journalizing

The process of recoding business transaction in a journal

The Standard format of a General Journal is given below:

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT

Date column:
Date column is used to record the date on which a transaction occurs
Description column:
The name of accounts and concise explanation of a transaction is entered in Description column.
Post reference or Folio:
This column is completed when posting are made into ledger accounts
Debit and Credit:
The amounts to be debited or credited is entered in these columns

How to debit and credit

There are five types of accounts: Assets, Expenses/Loses, Liabilities, Incomes/Gains and Capital

We debit an Account when there is:

1. **Increase in Assets** for example increasing in debtors, goods, notes receivable, Building, machinery etc
2. **Increase in Expenses** for example increase in rent, salaries, depreciation expenses etc
3. **Decrease in Liabilities** for example decrease in Creditor, bills payable, bank loan, bonds payable etc
4. **Decrease in Incomes** for example decrease in sales, commission, dividend, discount received etc
5. **Decrease in Capital** for example decrease in owner equity, share capital etc

We Credit an Account when there is:

1. **Increase in Assets** for example increasing in debtors, goods, notes receivable, Building, machinery etc

2. **Increase in Expenses** for example increase in rent, salaries, depreciation expenses etc
3. **Decrease in Liabilities** for example decrease in Creditor, bills payable, bank loan, bonds payable etc
4. **Decrease in Incomes** for example decrease in sales, commission, dividend, discount received etc
5. **Decrease in Capital** for example decrease in owner equity, share capital etc

If you are still wondering how to debit and credit, check out our topic Debit and Credit

EXAMPLE No.1 Simple Double entries

December 3.	Paid rent for factory building $50,0000
December 5.	Paid cash to Mr.Z and Co. $200 for goods purchased on credit
December 7.	Paid cash $500 for telephone bills
December 20.	Commission $1000 received for selling goods of G man

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Dec. 3	**Rent expenses**		**$50,000**	
	Cash			**$50,000**
Dec. 5	**Creditor (Mr. Z an Co.)**		**$200**	
	Cash			**$200**
Dec. 7	**Telephone expenses**		**$500**	
	Cash			**$500**
Dec. 20	**Cash**		**$1000**	
	Commisssion income			**$1000**

Explanation **(It is not the part of Journal or double entries)**

Paid rent for factory building $50,0000
Since Business has incurred Rent expense or we can say that there is an increase in expenses and for that business is now paying cash or there is a decrease in business's cash and therefore we debited rent expense and credited cash

Paid cash to Mr.Z and Co. $200 for goods purchased on credit
Firm had purchased goods on credit or increased its liabilities and it's business responsibility to repay the creditor which the firm did on the 5th December. As a result there is a decrease in cash (Asset) and decrease in creditor (liability). Therefore, creditor is debited and cash is credited.

Paid cash $500 for telephone bills
Because the firm is paying its telephone bills and as we know telephone bills is a expense. Therefore, there is an increase in expenses and a decrease in cash as a result bills expenses are debited and cash is credited.

Commission $1000 received for selling goods of G man
The firm is getting or recognizing commission (Income) or there is an increase in income which is always credited and firm is getting commission in the form cash. So, there is an increase in cash which is debited

EXAMPLE No.2 Goods in Trade

Generally, business maintain two different accounts for goods purchased and goods sold in the ordinary course of trade. Whenever goods are purchased for the purpose reselling them, these goods are debited to Purchases Account and when goods are sold, they are credited to sales accounts. Thereby, businesses use words sales and purchases rather than the word goods for the purpose of making double entries

December 3.	Goods Sold to Mr. A on credit worth $50,0000
December 5.	Goods Purchased on account from Mr. X and Co. for $70,000
December 7.	Received cash from Mr. A
December 12.	Paid cash to Mr. X and Co. for goods purchased on account
December 22.	Sold goods to Deadman for cash $5000

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Dec. 3	**Debtor (Mr. A)**		**$50,000**	
	Sales			**$50,000**
Dec. 5	**Purchases**		**$70,000**	
	Creditor (Mr. X and Co.)			**$70,000**
Dec. 7	**Cash**		**$50,000**	
	Debtor (Mr. A)			**$50,000**
Dec. 12	**Creditor (Mr. X and Co.)**		**$70,000**	
	Cash			**$70,000**
Dec. 22	**Cash**		**$5000**	
	Sales			**$5000**

EXAMPLE No.3 Sales Return and Purchase Return

Sales Return or Return inward
When goods sold by the business are returned back by the customer for defects in goods or any other reason, these goods are debited to Sales Return or Return inward account

Purchase Return or Return outward
When goods purchased by the business are returned to supplier for defects in goods or any other reason , these goods are credited to Purchase Return or Return inward account

Following are the transactions of a cotton agency

January 3.	Bought cotton on account form XYZ Co. $100,000
January 5.	Sold cotton on credit to B Berry $5000
January 22.	Returned faulty cotton to XYZ Co. $1000
January 25.	Defective cotton returned by B Berry costing $350

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Jan. 3	Purchases		$100,000	
	Creditor (XYZ and Co.)			$100,000
Jan. 5	Debtor (B Berry)		$5000	
	Sales			$5000
Jan. 22	Creditor (XYZ and co.)		$1000	
	Purchases return			$1000
Jan. 25	Sales return		$350	
	Debtor (B Berry)			$350

EXAMPLE No.4 Drawing, Charity, Loss of goods, Distributing goods as sample

Whenever the following events take place, the purchase account is credited

- Goods drawn by owner for personal use
- Goods given as charity
- Goods distributed as free sample
- Goods lost by fire or any other reason

Following are the transactions of a cement company

January 3.	Owner of company used cement for construction his own house costing $5000
January 5.	10 bags of cement given as charity for the construction of a school worth $2000
January 22.	Three bags of cement were stolen $800
January 25.	15 bags of cement given as free sample $4000
January 28.	Some cement lost by fire costing $10,000

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Jan 3	**Drawings**		**$5000**	
	Purchases			**$5000**
Jan. 5	**Charity**		**$2000**	
	Purchases			**$2000**
Jan. 22	**Lost by theft**		**$800**	
	Purchases			**$800**
Jan. 25	**Free samples**		**$4000**	
	Purchases			**$4000**
Jan. 28	**Lost by fire**		**$10,000**	
	Purchases			**$10,000**

EXAMPLE No.5 Treatment of Discounts

There are two kinds of discount (1) Trade discount (2) Cash discount

Trade Discount
Trade discount is an allowance or a deduction made from the list price of goods at the time when goods are being purchased or sold. There is no need to open a separate trade discount account because accountants enter discounted price of goods in purchase and sales accounts

Cash Discount
A discount on quick or prompt repayment of credit. For example a business purchases goods on credit and if it makes repayment of credit within a specific period of time, seller would like provide the business with cash discount on quick repayment. Accountants, therefore, prepare a separate account for cash discount

January 3.	Purchased goods on account from Deadman $2000; subject to 2% trade discount
January 5.	Purchase furniture for cash $2000 and seller gave 5% trade discount because of bulk purchase
January 22.	Sold goods for cash $500 less 2% trade discount
January 25.	$5000 was payable to Mr. Johnny Bravo was settled after deducting 2% cash discount
January 26.	Paid $5000 to one of the accounts payable the BS-Store and cash discount was $500
January 28.	A debtor from whom $4000 was receivable, repaid his debt after getting 3% cash discount
January 29.	$3000 was receivable from Xman, we got paid after allowing 5% cash discount
January 30.	There was $5500 payable to Super Co. for goods purchased on credit, was paid and cash discount was $500

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Jan. 3	Purchases		$1960	
	Creditor (Deadman)			$1960
Jan. 5	Furniture		$1900	
	Cash			$1900
Jan. 22	Cash		$490	
	Sales			$490
Jan. 25	Creditor (Johnny bravo)		$5000	
	Discount received Cash			$100 $4900
Jan. 26	Creditor (BS-Store)		$5500	
	Discount received Cash			$500 $5000
Jan. 28	Discount allowed Cash		$120 $3880	
	Debtor			$4000
Jan. 29	Discount allowed Cash		$150 $2850	

	Debtor (Xman)			$3000
Jan. 30	Creditor (Super Co.)		$5500	
	Discount received			$500
	Cash			$5000

EXAMPLE No.6 Compound Double Entry

Whenever two or more transactions complete on the same date and one or more accounts are common (either on Debit or Credit side) in all transactions, it is good to pass a compound double entry instead of passing two or more entries

January 3.	Deadman started with cash $50,000, furniture costing $10,000 and machinery $50,000
January 5.	Paid rent for firm's building $6000, salaries $20,000, office supplies $1000
January 22.	Sold goods on credit to Gman $5000, to Johnny Bravo $2000 and to Deadman 10,000
January 25.	$5000 and $6000 were payable to B Berry and Johnny bravo and payments were made
January 26.	Bought goods and machinery for cash $5000 and $40,000 respectively
January 28.	Received commission = $600 and dividend = $9000

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Jan. 3	Cash		$50,000	
	Furniture		$10,000	
	Machinery		$50,000	
	Capital			$110,000
Jan. 5	Rent expenses		$6000	
	Salaries expenses		$20,000	
	Office supplies		$1000	
	Cash			$27,000
Jan. 22	Debtor (Gman)		$5000	
	Debtor (Johnny Bravo)		$2000	
	Debtor (Deadman)		$10,000	
	Sales			$17,000
Jan. 25	Creditor (B Berry)		$5000	
	Creditor (Johnny bravo)		$6000	

	Cash		$11,000
Jan. 26	Purchases Machinery	$5000 $40,000	
	Cash		$45,000
Jan. 28	Cash	$9600	
	Commisssion income Dividend		$600 $9000

Preparing Ledger Accounts

Ledger Account

(Also known as **"T" Account** and **Account)**
Having passed the double or journal entries, the next step is to post these double or journal entries into Ledger accounts. Ledger account or an account is simply the classification of double entries which we have made in General Journal or any other journal. In an account we bring together all similar entries in one place. For example a company has purchased goods on 4th and 7th January, we would put both entries in purchases account because of their similar nature i.e. the purchases and therefore an account shows net increase or decrease in the balance of similar entries / items (in the aforementioned example there was an increase in purchases balance)

Example of accounts is payable or creditor account, purchases account, sales accounts, receivable or debtor account, cash account, bank account, machinery account, building account, vehicle account etc

Each account is divided into Debit and Credit portions. Debit is the left hand side of an account and credit is the right hand side of an account. An account looks like English alphabet "T" which is why a ledger account is also referred to as "T" account

Account's Title

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT

An Account has three main parts:

1. Title is the name of account
2. Debit is on the left hand side
3. Credit is on the right hand side

Posting

In Accounting the word "posting" implies that the process of posting or recording double or journal entries into an account

Classification of accounts

1) Real accounts or balance sheet accounts

These are the accounts of assets, liability and capital. These accounts remain open even after the end of an accounting period (e.g one year). Examples of these accounts include accounts of machinery, plant, creditors, debtors, bill payable, bonds, fixed deposits, capital etc.

2) Nominal accounts

These are the accounts of revenues and expenses. These accounts are closed after the end of an accounting period (e.g one year). Examples of these accounts include accounts of Salaries, rent, depreciation, discount received, discount allowed, interest earned, commission received, sales return etc.

EXAMPLE

December 3.	Started business with cash $200,000
December 4.	Purchased goods on credit from Mr. Z and Co. worth $2000
December 5.	Paid cash to Mr. Z and Co. $2000 for goods purchased on credit
December 7.	Paid cash $500 for telephone bills
December 20.	Commission $1000 received for selling goods of G man

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Dec. 3	**Cash**		**$200,000**	
	Capital			**$200,000**
Dec. 4	**Purchases**		**$2000**	
	Creditor (Mr. Z and Co.)			**$2000**
Dec. 5	**Creditor (Mr. Z and Co.)**		**$2000**	
	Cash			**$2000**
Dec. 7	**Telephone expenses**		**$500**	
	Cash			**$500**
Dec. 20	**Cash**		**$1000**	
	Commisssion income			**$1000**

Now lets create our First Ledger account

First of all we would create an account for cash because it's the first item in General journal. Since we are going to create an account for cash, we would write Cash in the place "Title" (or name) of account

Cash account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 3 Dec. 20	Capital Commission income	$200,000 $1000	Dec. 5 Dec. 7	Creditor (Mr. Z and Co.) Telephone expenses Balance c/d	$2000 $500 198500
	TOTAL	$201,000		**TOTAL**	$201,000

Wohooo, we have created our first Account!

Explanation or how the cash account was prepared?

Look at the General Journal, for the first transaction (on December 3) we have debited cash and credited capital. Since we are creating a cash account, we have to check if cash is debit or credit. In the first entry "Cash" is debit and therefore we would record this transaction on the Debit side of our cash account and because "Capital" is on the opposite side (credit side) of cash, we would record capital in the "Description" column of Cash Account and lastly would repeat this procedure for all cash related transactions

Procedure of recording transactions in an account

In the Journal entries
Look for the item for which you are creating an account if it is debit or credit
If the item is debit, record the transaction on the debit side of account and vice versa
Record the opposite item in the Description column of account

What's Balance c/d

Balance c/d is short for Balance Carried forward (ending balance of an account), it is the balance that we would carry forward in the next accounting period (for example an year). In the next accounting period it would become Balance b/d (b/d is short brought forward) that would be the opening balance of our account.

How to calculate Balance c/d or ending balance of an account

1. Add up Debit side and then Credit side of the account
2. Find the difference between Debit and Credit side total balances. The difference would be Balance c/d
3. Write Balance c/d on the smaller side of account

In the above example

1. Debit totalled to $201,000 and Credit side added to 2500
2. The difference is 201,000-2500=198500. Therefore balance c/d is 198500
3. Since credit side is smaller (2500), we would write balance c/d on credit side
4. We are done

5. **Preparing Ledger Accounts**
6. Our second ledger Account

   We would now create a Capital account because it's the second element in our General journal. The procedure of preparing a capital account is same as of Cash account

   Capital account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
	Balance c/d	$200,000	Dec. 3	Cash	$200,000
	TOTAL	$200,000		**TOTAL**	$200,000

8. Third Account

   Nominal accounts

9. These are the accounts of revenues and expenses. These accounts are closed after the end of an accounting period (e.g one year). Examples of these accounts include: accounts of Salaries, rent, depreciation, discount received, discount allowed, interest earned, commission received, sales return etc..
10. **Important to note:** Since we are going to create a Purchases expenses account (a nominal account), we won't use the words "Balance c/d " and "Balance b/d" rather that we would use Income statement or Profit and loss account. Because these accounts are closed after the end of an accounting period and their balances are transferred to income statement contrary to Real accounts where balances are transferred to Balance sheet. Don't worry about Income statement and Balance sheet, we will cover them later on

    Purchases account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 4	Creditor (Mr. Z and Co.)	$2000		Income statement (BF)	$2000
	TOTAL	$2000		**TOTAL**	$2000

12. *BF=Balancing figure*
    The only difference in this account is the use of word "Income statement" in the place Balance c/d. However, the procedure of posting transactions in this account is same.
13.
14.

    Fourth account
15.
    Creditor account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 5	Cash Balance c/d	$2000 Nil	Dec. 4	Purchases	$2000
	TOTAL	$2000		**TOTAL**	$2000

17.

    Fifth Account

    Tel. Expenses account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 7	Cash	$500	Dec. 7	Income statement	$500
	TOTAL	$500		**TOTAL**	$500

19.
20.

    Sixth and the last Account

    Commission income account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 20	Income statement	$1000	Dec. 20	Cash	$1000
	TOTAL	$1000		**TOTAL**	$1000

EXAMPLE No.2

Johnny Bravo set up business selling Air Conditioners, trading under the name of "kings cool shop" . He put $500,000 in his business (First transaction). Following are the transactions occurred in the first trading month.

January 1.	Started business with cash $500,000
January 2.	Purchased Air Conditioners on credit $200,000
January 3.	Paid rent of shop for the period amounting to $3000
January 4.	Raised loan from bank $100,000
January 7.	Purchase of Shop fittings (for cash) $2000
January 9.	$4000 paid to the trade account payable
January 13.	Sale of Air Conditioners on credit $10,000
January 16.	$700 paid as Interest on bank loan
January 19.	$3000 received from a debtor (Account receivable)
January 26.	Withdrawal of cash on account of profit $5000 by the owner of the business

First off we have to record double entries in General Journal, after that we would put these transactions in Ledger Accounts

General Journal ↓

DATE	DESCRIPTION	FOLIO	DEBIT	CREDIT
Jan. 1	Cash		**$500,000**	
	Capital			**$500,000**
Jan. 2	Purchases		**$200,000**	
	Creditor			**$200,000**
Jan. 3	Rent expenses		**$3000**	
	Cash			**$3000**
Jan. 4	Cash		**$100,000**	
	Bank loan			**$100,000**
Jan. 7	Shop fittings		**$2000**	
	Cash			**$2000**
Jan. 9	Creditor		**$4000**	

	Cash		$4000
Jan. 13	Debtor	$10,000	
	Sales		$10,000
Jan. 16	Interest expenses	$700	
	Cash		$700
Jan. 19	Cash	$3000	
	Debtor		$3000
Jan. 26	Drawings	$5000	
	Cash		$5000

Here are the **ledger accounts** for above mentioned transactions

Back to General journal ↑

Cash account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 1 Jan. 4 Jan. 19	Capital Bank loan Debtor	$500,000 $100,000 $3000	Jan. 3 Jan. 7 Jan. 9 Jan. 16 Jan. 26	Rent expenses Shop fittings Creditor Interest expenses Drawings Balance c/d	$3000 $2000 $4000 $700 $5000 588,300
	TOTAL	$603,000		**TOTAL**	$603,000

Back to General journal ↑

Capital account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
	Balance c/d	$500,000	Jan. 1	Cash	$500,000
	TOTAL	$500,000		**TOTAL**	$500,000

Back to General journal ↑

Purchases account

DEBIT CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 2	Creditor	$200,000		Income statement	$200,000
	TOTAL	$200,000		TOTAL	$200,000

Back to General journal ↑

Creditor account

DEBIT CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 9	Cash Balance c/d	$4000 $196,000	Jan. 2	Purchases	$200,000
	TOTAL	$200,000		TOTAL	$200,000

Back to General journal ↑

Rent expenses account

DEBIT CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 3	Cash	$3000		Income statement	$3000
	TOTAL	$3000		TOTAL	$3000

Back to General journal ↑

Bank loan account

DEBIT CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
	Balance c/d	$100,000	Jan. 4	Cash	$100,000
	TOTAL	$100,000		TOTAL	$100,000

Back to General journal ↑

Shop fittings account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 7	Cash	$2000		Balance c/d	$2000
	TOTAL	$2000		**TOTAL**	$2000

Back to General journal ↑

Debtor account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 13	Sales	$10,000	Jan. 19	Cash Balance c/d	$3000 $7000
	TOTAL	$10,000		**TOTAL**	$10,000

Back to General journal ↑

Sales account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
	Income statement	$10,000	Jan. 13	Debtor	$10,000
	TOTAL	$10,000		**TOTAL**	$10,000

Back to General journal ↑

Interest expenses account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 16	Cash	$700		Income statement	$700
	TOTAL	$700		**TOTAL**	$700

Back to General journal ↑

Drawings account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 26	Cash	$5000		Balance c/d	$5000
	TOTAL	$5000		TOTAL	$5000

Books of original entries - Specialized Journals

When a business is small, it can keep all transactions record in one general journal or day book. However, as the business grows, its scale of financial activities grows as well and more day to day financial transactions take place. As you know a business needs to record the detail of transaction as much as possible, for a large business it's impossible to record all financial transactions in one book because it needs lot pages of a book to enter large number of transactions and it is difficult to find a specific transaction and to detect an error in recording the transactions and even the single book would be too hard to handle and manage

The simple solution to this problem is the use of more than one book to record the details of transactions. When a business uses more than one book to record transactions, it puts together all the similar transactions in a book. In each book, we don't record and mix transactions of different nature.

Books of original Entries

As we know books of original entries are the books in which we first record the transactions. These Specialized journals or day books are part of books of original entries. Thus, we have separate books for each kind of transaction. For example sale of goods will be recorded in sales journal or sales day book

The Terms day book and Journal

Most of the people find themselves confused while reading the terms journal and day book. Both Journal and Day book are the same thing. We can use either term.

Types of specialized journal

- **Sales Journal or Sales day book** - For recording credit sales
- **Purchase journal or purchase day book** - For recording purchases on credit
- **Sales return journal or sale return day book** - For recording sales return
- **Purchase return journal or purchase return day book** - For recording purchases return
- **Cash receipts journal** - For recording all kind of cash receipts
- **Cash payments journal** - For recording all kind of cash payments

Sales journal or sales day book

Sales journal is used to record the entries or transactions for credit sales. Remember that sales journal is only used to record entries for credit sales not for cash sales and sales return

Simple double entry for credit sales

Debit--> Debtor-Customer's name/description

Credit--> Sales

DATE	INVOICE	CUSTOMER/ACCOUNT DEBITED	FOLIO	AMOUNT $

Date Column: is used to record the date of credit sale
Invoice Column: is used to record the No. of invoice issued
Customer Column: is used to record the name of customer that purchased your goods
Folio Column: records reference to sales ledger account
Amount Column: Amount of credit sales that was made

EXAMPLE

Record the following transactions of XYZ store in a sales journal for the month of march, 2011

March 1.	Sold goods to Mr. X worth $50 on credit invoice No. 342
March 21.	The store sold goods to Mr.Y for $100 on account and issued Invoice No. 343
March 26.	Sold goods to Mr. Z for $250 on credit Invoice number: 344
March 30.	Goods of worth $222 were sold to Mr. G on account, invoice#345

Sales journal

DATE	INVOICE	CUSTOMER/ACCOUNT DEBITED	FOLIO	AMOUNT $
Mar. 1 Mar. 21 Mar. 26 Mar. 30	342 343 344 345	Mr. X Mr. Y Mr. Z Mr. G		50 100 250 222
Mar. 31		**TOTAL**		622

Books of original entries - Specialized Journals

Purchase journal or Purchase day book

Purchase journal is used to record the entries or transactions for credit purchases. Remember that purchase journal is only used to record entries for credit purchase not for cash purchase and purchase return.

Simple double entry for credit purchase

Debit--> Purchases

Credit--> Creditor-Supplier's name/description

DATE	INVOICE	SUPPLIER/ACCOUNT CREDITED	FOLIO	AMOUNT $

Date Column: is used to record the date of credit purchase
Invoice Column: is used to record the No. of invoice received
Supplier Column: is used to record the name of supplier from whom you did purchase the goods
Folio Column: records reference to purchases ledger account
Amount Column: Amount of credit purchases that was made

EXAMPLE

Record the following transactions of XYZ store in a Purchase journal for the month of march, 2011

March 1.	Purchased goods from Mr. X worth $50 on credit invoice No. 342
March 21.	The store Purchased goods From Mr. Y for $100 on account and received Invoice No. 343
March 26.	Purchased goods From Mr. Z for $250 on credit; Invoice number: 344
March 30.	Goods of worth $222 were purchased from Mr. G on account, invoice#345

Purchase journal

DATE	INVOICE	SUPPLIER/ACCOUNT CREDITED	FOLIO	AMOUNT $
Mar. 1	342	Mr.X		50
Mar. 21	343	Mr.Y		100
Mar. 26	344	Mr.Z		250
Mar. 30	345	Mr.G		222
Mar. 31		**TOTAL**		622

Sales return journal or sale return day book

When a business makes sales to customers, it's possible that some customers will return the sold goods because of defects, substandard goods or any other reason. When a customer returns the sold goods, it is recorded in sales journal and from sales journal it is transferred to sales ledger account.

Sales journal is used to record the entries or transactions for sales return or return inward.

Simple double entry for credit sales:

Debit--> Sales return or return inward

Credit--> Debtor-Customer's name/description

DATE	CREDIT NOTE	CUSTOMER/ACCOUNT CREDITED	FOLIO	AMOUNT $

Date Column: is used to record the date of sales return
Credit note Column: is used to record the No. of Credit note issued
Customer Column: is used to record the name of customer that returns your goods
Folio Column: records reference to sales return ledger account
Amount Column: Amount of sales return

EXAMPLE

Record the following transactions of XYZ store in a sales return journal for the month of march, 2011

March 1.	Returned goods by Mr. X worth $50 and credit note No. 342 was issued
March 21.	Mr. Y returned some goods due to defects worth $100 and issued Credit note No. 343
March 26.	Goods worth 150 were returned by Mr. Z, Credit note number: 344
March 30.	The defective goods of worth $222 were returned by Mr. G, invoice#345 issued

Sales return journal

DATE	CREDIT NOTE	CUSTOMER/ACCOUNT CREDITED	FOLIO	AMOUNT $
Mar. 1 Mar. 21 Mar. 26 Mar. 30	342 343 344 345	Mr. X Mr. Y Mr. Z Mr. G		50 100 150 222
Mar. 31		**TOTAL**		622

Purchase return journal or purchase return day book

When we purchase goods for the purpose the reselling them, it's likely that some of the goods would be defective and therefore, we return these defective goods to supplier. When we return goods to supplier, we record these purchases return in purchase return journal

Purchase return journal is used to record the entries or transactions for purchases return

Simple double entry for credit purchase

Debit--> Creditor-Supplier's name/description

Credit-->Purchases return or return outward

DATE	DEBIT NOTE	SUPPLIER/ACCOUNT DEBITED	FOLIO	AMOUNT $

Date Column: is used to record the date of credit purchase
Debit note Column: is used to record the No. of debit note received
Supplier Column: is used to record the name of supplier to whom you returned goods
Folio Column: records reference to purchases return ledger account
Amount Column: Amount of purchases return

EXAMPLE

Record the following transactions of XYZ store in a Purchase return journal for the month of march, 2011

March 1.	Returned goods to Mr. X worth $50 and Debit note No. 342 was received.
March 21.	Debit note No. 343 for $100 was received for returning defective goods to Mr. Y
March 26.	Purchases returned value $150 to Mr. Z and debit note # 344 was received
March 30.	Goods of worth $222 were returned to Mr. G, invoice#345

Purchases return journal

DATE	DEBIT NOTE	SUPPLIER/ACCOUNT DEBITED	FOLIO	AMOUNT $
Mar. 1 Mar. 21 Mar. 26 Mar. 30	342 343 344 345	Mr. X Mr. Y Mr. Z Mr. G		50 100 150 222
Mar. 31		**TOTAL**		622

Cash receipt journal

Cash receipt journal is a specialized journal in which all cash receipts are recorded for example cash received from debtor will be recorded in cash receipt journal.

Simple double entry for cash receipt

Debit--> Cash

Credit-->Debtor or account receivable or any other account

DATE	ACCOUNT CREDITED	FOLIO	CASH	DISCOUNT	SALES	DEBTOR	SUNDRY

Date Column: is used to record the date of cash receipt related transaction or when business receives cash
Account Credited Column: is used to record the source from where business has received cash payment or the credit side of double entry. For example a business has received cash from a debtor, Cash=Debit and Debtor=Credit therefore Debtor will be recorded in Account credited column
Folio Column: records reference to cash ledger account
Cash Column: is used to record the amount of cash received.
Discount Column: if any cash discount allowed, it will be recorded in it
Sales Column: In the case of cash sales the amount of sales will be recorded in it
Debtor Column: If cash was received from a debtor, the amount of cash that was received from debtor is recorded under this column
Sundry Accounts Column: is filled in for those accounts which don't have special column in cash receipt journal. For example, interest and commission received, cash received from the sale of a fixed asset like building, furniture, vehicle etc.

EXAMPLE

Following are the transactions of Jackfield Ltd for the month of march 2011.

March 1.	The owner of Jackfield Ltd introduced fresh capital $10,000 to the business
March 15.	Received cash from cash sales $500
March 18.	Cash $500 received from a debtor Mr. Z and discount allowed was $100
March 22.	Sold old equipments for $200
March 30.	Received cash $300 as commission for sales service

Cash Receipt Journal

DATE	ACCOUNT CREDITED	FOLIO	CASH	DISCOUNT	SALES	DEBTOR	SUNDRY
Mar. 1 Mar. 15 Mar. 18 Mar. 22 Mar. 30	Capital Sales Debtor-Mr. Z Equipment Commission		10,000 500 500 200 300	 100	 500	 600	10,000 200 300
	TOTAL		11,500	100	500	600	10,500

Cash payment journal

Cash payment journal is a specialized journal in which all cash payments are recorded. For example, cash paid to creditor will be recorded in cash payment journal.

Simple double entry for cash receipt

Debit--> Creditor or expenses or any other relevant account

Credit--> Cash

DATE	ACCOUNT DEBITED	FOLIO	CASH	DISCOUNT	Purchases	DEBTOR	SUNDRY

Date Column: is used to record the date of a cash payment related transaction or when business pays cash
Account debited Column: is used to record name of the person or organization to which the business has paid cash or Debit side of double entry. For example a business has paid cash to a creditor, Creditor=Debit and Cash=Credit and therefore creditor will be recorded in Account debited column
Folio Column: records reference to cash ledger account
Cash Column: is used to record the amount of cash paid.
Discount Column: if any cash discount received, it will be recorded in it
Purchases Column: In the case of cash purchases the amount of purchases will be recorded in it
Creditor Column: If cash was paid to a creditor, the amount of cash that was paid to creditor is recorded under this column
Sundry Accounts Column: It is filled in for those accounts which don’t have special column in cash payment journal. For example, interest and commission paid, cash paid for the purchase of a fixed asset like building, machinery etc.

EXAMPLE

Following are the transactions of Jackfield Ltd for the month of march 2011.

March 1.	The owner of Jackfield Ltd withdrew $2000 from the business for his personal use
March 15.	Paid cash for cash purchases $500
March 18.	Cash $500 paid to a creditor Mr. Y and discount received was $100
March 22.	Purchased equipment for cash $1000
March 30.	Paid cash $300 as commission for sales service rendered by J Corporation

Required: Using the above information prepare a Cash payment journal

Cash payment Journal

DATE	ACCOUNT CREDITED	FOLIO	CASH	DISCOUNT	Purchases	DEBTOR	SUNDRY
Mar. 1	Drawings		2000				2000
Mar.15	Purchases		500		500		
Mar.18	Creditor-Mr. Y		500	100		600	
Mar.22	Equipment		1000				1000
Mar.30	Commission		300				300
Mar.31	**TOTAL**		4300	100	500	600	3300

Books of original entries - Cash Book

Cash Book

A Cash book is a book of original entries used to record the transactions related to cash and bank. In other words cash book is a cash receipt and cash payment journal put together in one book. Cash book contains cash column as well as bank column to record cash and bank account related transactions. However, it's not the hard and fast rule, cash book can only be used to record cash related transactions (where there is a small business that doesn't use a bank account).

Firms use cash books because it’s easier to record all cash and bank account related transactions in one book than to record them in three different accounts cash account, bank account and discount account and it’s easy to find out that how much money received and paid on particular date with the help of cash book. Moreover, cash book provide more detail of a transaction than a normal ledger account

EXAMPLE

A Cash book of X.Y.Z superstore for the month of January.
(means that this book records all cash and bank related transactions which took place in the month of January)

X.Y.Z Superstore
Cash Book
For the month of January 2011

Dr.
(Debit) **Cr**
. (Credit)

Date	Descriptio n	Foli o	Discoun t	Cash	Bank	Date	Descriptio n	Foli o	Discoun t	Cash	Bank
Jan. 1 3 24 25	Balance b/d Debtor- Allen Bank Commissio n		 45	2000 0 2000 500	3000 0 300	Jan. 6 8 10 15 18 24 27	Creditor- Aw Co. Rent Expenses Wages Salaries Office expenses Cash Machinery Balance c/d		30 15	 200 300 500 2150 0	1000 3000 500 5000 2080 0
31	**TOTAL**		45	2250 0	3030 0	31	**TOTAL**		45	2250 0	3030 0

Folio column
This column is filled in when we post transactions from cash book to ledger account. It is used as reference for double entries in accounts
Discount column
It is used to record discount received from supplier and discount allowed to customers
Cash column
It is filled in for transactions related to receipts and payments of cash
Bank column
It is used for recording transactions related to receipts and payment of cash through bank account e.g receiving and making payments via cheques

EXAMPLE No. 2

Drawing up a cash book of whole seller business X.Y.Z whole seller for month of February, 2011

Balance brought down from the last month Cash $20,000, Bank $50,000

February 1.	Paid rent by cash $2000
February 2.	Received cash $1000 from j brown and discount allowed $100
February 7.	Received cheque for $5000 from Mr. B and discount $200
February 9.	Paid by cheque $4000 to a creditor S man
February 15.	Purchased goods and paid by cheque $5000

February 16.	Paid $500 for sundry expenses by cheque
February 20.	Cash sales of $4000 paid direct into bank account
February 26.	J berry paid us $3000 for good purchased on credit last month
February 29.	Withdrawn cash $3000 and goods worth $2000 for personal use

X.Y.Z Whole seller
Cash Book
For the month of February 2011

Dr.
(Debit) **Cr.**
(Credit)

Date	Description	Folio	Discount	Cash	Bank	Date	Description	Folio	Discount	Cash	Bank
Feb. 1 2 7 20 26	Balance b/d J brown Mr. B Sales J berry		 100 200	2000 0 1000 3000	5000 0 5000 4000	Feb. 1 9 15 16 29	Rent exp. S man Purchases Sundry exp. Drawings Balance c/d			2000 3000 1900 0	 4000 5000 500 4950 0
31	**TOTAL**		300	2400 0	5900 0	31	**TOTAL**			2400 0	5900 0

Cash paid into bank and withdrawn from bank

Businesses need sufficient cash reserves to pay off day to day expenses and in some cases businesses have cash reserves more than their needs. Therefore, firms withdraw and deposit cash into their bank account frequently

When business receives or has cash and pay into business bank account

This transaction has the following effects

There is a decrease (-) in the asset which is Cash
There is an increase (+) in the asset which is Bank in this case

Therefore, double entry should be:

Bank -------> Debit

Cash -------> Credit

When business need liquid cash for paying expenses or any other needs and withdraw cash from business bank account

This transaction has the following effects

There is an increase (+) in the asset which is cash
There is a decrease (-) in the asset which is bank in this case

Therefore, the double entry should be:

Cash -------> Debit

Bank -------> Credit

EXAMPLE

June 1.	A receipt of $5000 form a debtor MR. M
June 3.	The Receipt of $5000 deposited in the bank account
June 5.	$600 withdrew from bank for sundry expenses

Cash Book

Dr.
(Debit) **Cr.**
(Credit)

Date	Description	Folio	Discount	Cash	Bank	Date	Description	Folio	Discount	Cash	Bank
Jun. 2	Mr. M			5000		**Jun. 3**	**Bank**			**5000**	
3	**Cash**				**5000**	**5**	Cash				**600**
5	**Bank**			**600**							

Did you notice? we have posted a single transaction on both sides of cash book because these kinds of transactions effect both debit and credit sides
Bank overdraft

A Business can borrow money from bank with the help of bank overdraft. It implies that the business can withdraw money from its bank account more than it has deposited in the account.

In other words, banks give you a chance to withdraw more money than you have in your account. For example if a business has $5000 in its bank account, it can withdraw more than $5000. The excessive amount would be the bank overdraft (a current liability) of business and thereby business will have to pay off that liability.

In the case of overdraft Balance c/d is always on the debit or receipt(s) side of a cash book indicating that we have withdrawn more than we have deposited in our bank account

Cash Book

Dr.
(Debit) **Cr.**
(Credit)

Date	Description	Folio	Discount	Cash	Bank	Date	Description	Folio	Discount	Cash	Bank
Jan. 1 3 27	Balance b/d Debtor M. berry	 200		5000 3000	5000 1000	Jan. 6 8 9 17	Sundry exp. Drawings Creditor Equipments			2000 2000	1000 3000 2000 3000
	Balance c/d				**3000**		Balance c/d		200	4000	
31	**TOTAL**			8000	9000	31	**TOTAL**			8000	9000

$**3000** is the overdraft (liability) of the business will be shown in balance sheet in the category of current liabilities
Books of Account and Source Documents

Books of Account

• Books of secondary entries

• Books of original entries

• Main Ledger

- Debtor control a/c
- Creditor Control a/c
- Rent expenses a/c
- Depreciation a/c
- Building a/c

a/c=Account

• Subsidiary Ledger

- Debtors a/c
- Creditors a/c
- Stock or inventory a/c

and other informal ledger accounts to keep the record and to monitor the business activities

• Credit transactions

- Purchase journal
- Sales journal
- Sales return journal
- Purchases return journal

• Cash Transactions

- Cash book
- Cash receipts journal
- Cash payments journal

Books of account

Books of account refer to the records or books in which all financial information (transactions) of a business or an entity is recorded and maintained. For example, a journal is a book of account because it is used to record financial information of a business. Similarly, sales ledger account, purchase ledger account, cash book, general journal, purchase journal etc are examples of books of accounts.

The process of recording financial information or transactions in the books of account is known as bookkeeping. Whereas, the person that records the financial information of a business in the books of account is called bookkeeper

Books of account are the records of transactions or financial information of a business which is why books of account are important for a business's decision making, strategies formulating, evaluating the financial performance and making sure that business is complying with the rules of regulatory bodies

Examples of books of account:

Books of account are mainly consist of Books of original entries and Books of secondary entries

Books of original entries contain:

1. General journal or Day book - For recording general double entries..... keep on reading
2. Sales Journal or Sales day book - For recording credit sales..... keep on reading
3. Purchase journal or purchase day book - For recording purchases on credit..... keep on reading
4. Sales return journal or sale return day book - For recording sales return..... keep on reading
5. Purchase return journal or purchase return day book - For recording purchases return..... keep on reading
6. Cash receipts journal - For recording all kind of cash receipts..... keep on reading
7. Cash payments journal - For recording all kind of cash payments..... keep on reading
8. Cash book - For recording cash receipts and payments..... keep on reading

Books of secondary entries include:

Main ledger accounts such as debtor control account, creditor control account, building account, depreciation account, rent account, sales account, purchases account etc.

Subsidiary ledger accounts such as debtors accounts, creditors accounts, stock account and other ledger accounts to keep memorandum

These all journals and ledger accounts are collectively referred to as books of account

Explanation of Books of Account

Books of original entries

Books of original entries are books in which we first record the transactions. We record entries in them according to nature of transactions and entries are made to them on daily basis

Books of original entries are used because business wants to record the detail of transactions or economic events as much as possible

Examples of books of original entries are as follows:

1. General journal or Day book - For recording general double entries..... keep on reading
2. Sales Journal or Sales day book - For recording credit sales..... keep on reading
3. Purchase journal or purchase day book - For recording purchases on credit..... keep on reading

4. Sales return journal or sale return day book - For recording sales return..... keep on reading
5. Purchase return journal or purchase return day book - For recording purchases return..... keep on reading
6. Cash receipts journal - For recording all kind of cash receipts..... keep on reading
7. Cash payments journal - For recording all kind of cash payments..... keep on reading
8. Cash book - For recording cash receipts and payments..... keep on reading

Benefits of books of original entries

The requirement for Books of original entries is significant because businesses need more information of a transaction than an account can provide. For example if a business sells goods on credits to Mr. Z, business would like to record all his contact details and personal details.

Moreover, In the course of business, source document (such as invoices, credit notes and debit notes etc..) are created. The detail of these source documents need to be summarized, as otherwise the business may forget to make payment or ask for the payment of cash or even accidentally pay twice. In other words, businesses need the record of source documents of transactions to track what's going on. These kinds of records are made in books of original entries.

Books of secondary entries

Books of secondary entries are all those books of account that don't record transactions in the first place. As opposed to this, they record the transactions which have already been recorded by the books of original entries (like cash book, journal etc)

In other words, books of secondary entries use the already recorded data or they don't record original financial information rather than they use the previously recorded transactions from books of original entries. For example accountants record transactions in journals and then they transfer these transactions to ledger accounts which are the books of secondary entries

Examples of books of secondary entries

Main ledger accounts such as debtor control account, creditor control account, building account, depreciation account, rent account, sales account, purchases account etc.

Subsidiary ledger accounts such as debtors accounts, creditors accounts, stock account and other ledger accounts to keep memorandum

Benefits of Books of secondary entries

The main benefit of ledger account is: it helps summarize and group together different transactions related to the same item or person which is helpful in preparing financial statements because while preparing financial statement we need the total increase or decrease in an item or a person account during an accounting period. For example if you think of sales, while preparing income statement we would be interested in total amount of sales made during this accounting and this figure can be extracted from sales account

The other benefits are listed below:

By classifying different transactions into related accounts, it helps in the preparation of trial balance to check the arithmetic accuracy of our accounting record

Separate ledger helps avoid different types of errors and it's easier to check the accuracy of accounting record when similar transactions have been compiled together into a single related account

Separate ledger account of an item that groups many transactions can be helpful in tracing the specific pattern of increase or decrease in that item and figuring out the reasons for the same which would be a messy task without ledger accounts

rocedure of recording transactions in the books of account

The job of recording transactions in the books of account is basically delegated to a bookkeeper. Just because it is the job of bookkeeper to record every transaction doesn't mean bookkeeper can blindly enter any transactions in the books of accounts. On contrary, there is a lengthy procedure that a bookkeeper has to follow before he/she can record a transaction. First of all, a bookkeeper needs an evidence of the transaction and secondly, bookkeeper requires authority or permission to enter a transaction in the books of account

Source documents such as utility bills, invoices, memos, notes, credit notes, receipts etc provide the evidence of a transaction's occurrence

Whereas, a bookkeeper can obtain permission to record a transaction in the books of account from a higher authority such as accounts manager, controller, supervisor etc

To illustrate this, consider the example in which production manager of ABC Company requires a machine in the production department

Step No. 1
Production manager will sent a purchase requisition to generally manager

Step No. 2
General Manager after getting satisfied approves the purchase requisition. Now, Purchase requisition goes to the purchase department

Step No. 3
Purchase department places a purchase order to a supplier/vendor/seller for the purchase of machine

Step No.4
The supplier/vendor/seller sends the machine and issues a purchase invoice

Step No. 5
All documents including purchase invoice are given to the bookkeeper of ABC Company. He uses these sources documents to prepare a voucher and gets it signed or approved by the general manager to enter the transaction in the books of account

Some important sources documents

Invoice

Invoice is also known as bill. An invoice is a commercial document issued by the seller (or

business) to a buyer stating the name and description of products, quantity of goods, agreed price of goods etc.

If goods are being purchased on credit, invoice may indicate the max days or months to repay the debt

Invoice is a legal document which means it can be served as an evidence of sales contract engagement

An Invoice provides the basis or evidence to record sales of goods or purchases of goods/services in the books of account

> What are the contents of an invoice?

> What are the applications of a sales invoice for a business?

Credit note

Also referred to as credit memorandum or credit memo

A credit note is a written instrument or document sent by business to the customer for agreeing to take back the goods which are being returned by the customer. Business or seller will then return money either the full or partial price of goods.

Credit note No. is entered in sales return journal and it is useful for a business in its future transactions

A credit note provides the basis or evidence to record sales return or return inward in the books of account

> What are the details that a credit note provides?

Debit note

Also referred to as debit memorandum or debit memo

A debit note is a written instrument or document sent by the customer to a business describing reasons and giving the full details of goods being returned by them.

Debit note No. is entered in purchase return journal and it is useful for a business in its future transactions.

A debit note provides the basis or evidence to record purchases return or return outward in the books of account

In addition to these, there are several more source documents that provides a bookkeeper with the evidences of transactions for example, utility bill acts like a sources document for recording electricity expenses, salaries of employees might be evidenced by payrolls and transactions related to lease can be proved by contract papers

> What details does a debit note show?

> What is the difference between debit note and credit note?

Bank Reconciliation Statement

A business frequently needs to pay funds into and out of the bank account for the purpose of making and receiving payments. Business records these transactions in its cash book while at the same time bank also records these inflow and outflows of cash.

If all transactions recorded in cash book are same as entered by bank in its records, the balance in business's account as shown by cash book and the balance in the account of business shown by bank would be same. But that is not, generally, the case. Usually there are items which have not been recorded by business in its cash book and there may be items which have not been entered in records held by bank. Therefore, there is difference of balances appearing in cash book and bank statement (Generally, in the case of current Account).

The bank statement

The statement issued by bank and sent it to the customer (business) showing the customer's account balance and detail of transactions through bank

The most common causes of different balances appearing on cash book and shown by bank statement

1) Errors or mistakes
Mistakes in calculation or in recording receipts and payments of cash which are most likely made by the business in its cash book, but banks make mistakes as well.

2) Omissions
Bank might deduct charges and fee for its service and interest on overdraft which you are not informed about until you receive the bank statement

3) Time difference
There are cheques that you have received and deposited into your bank account but bank has not yet cleared these cheques (banks need time to process cheques). So, though your record shows that cash has been received but it is not being shown in bank statement prepared by bank

Similarly, you made payment via cheque and you have deduced some cash from cash book but the person that received the cheque have not yet banked this cheque for a while. Therefore, it has not been deducted by bank and bank statement didn't show that deduction. Even that person has banked the cheque, the bank needs some time to clear it

The bank reconciliation statement

Bank reconciliation statement is the comparison of a bank statement (sent by bank) with the cash book (prepared by the business).

The difference between the balance in the cash book and balance appearing on bank statement will be due to the errors or mistakes, omissions, and timing difference. So, we need to explain and identify reasons for difference in balances

Why is the bank statement so important to prepare?

A bank statement is needed to explore, identify, explain and to account for the difference between the cash book and bank statement balances

Important Terms used in bank reconciliation statement

Pass Book
It's a statement of depositor's account in the bank ledger. Cheques drawn and paid into the bank are recorded in this book.

When cash or cheque paid into the bank, it is credited in the passbook. When cheque issued or cash withdrawn from bank account, it is debited in the passbook

The bank statement
A statement issued by bank and sent it to the customer (business) showing the customer's account balance and detail of transactions through bank

Unpresented cheques
Cheques drawn or paid by business and credited in cash book but these cheques have not yet been presented to bank for payment

Uncollected or uncredited cheques
Cheques received by business, paid into bank and debited in cash book but not yet cleared by bank and entered in its record. So, these cheques will not appear in bank statement

Dishonoured cheque
Cheque deposited or presented by customer that is not credited by bank for any reason like signature of customer does not match, insufficient funds etc

Bank charges
Banks charges are all kinds of charges or fees charged by the bank to its customer (Account holder). These charges include charges for providing the account, interest on overdraft, charges on transactions etc...

Standing order
A business can order bank to pay certain amount of money regularly at stated date to an individual or organization. For example a firm can ask bank to pay $500 as insurance premium on 5th of every month

Direct debits
In contrary to instructing your bank to pay certain amount money, you give permission to a person or an organization to obtain money directly from your account

The common items you need to look at while preparing bank reconciliation statement.

Adjustments to cash book

Dividend received and paid into business bank account but not yet enterered in cash book by business

Bank charges for its services, interest on overdraft charged by bank

Payment made from business bank account through standing order and direct debit.

Business paid cheque or received cheque and deposited in bank account but the cheque has been dishonored by the bank. The information of dishonor cheque might not yet received by businesses

Adjustments to bank statement

Cheques drawn or paid by business and credited in cash book but these cheques have not yet been presented to bank for payment (are called unpresented cheques)

Cheques received by business, paid into bank and debited in cash book but not yet cleared by bank and entered its record. So, these cheques will not appear in bank statement (are called uncollected or credited cheques)

EXAMPLE

On 31 January 2008 a company's cash book shown a credit balances of $500 on its current account which did not agree with the bank statement balance. While performing reconciliation the following items were identified.

These items were not recorded in the cash book
Bank charges $100
Transfer from deposit account to current account $700

These item were not recorded in Bank statement
Unpresented cheques $200
Outstanding lodgements $300

It was also discovered that the bank had debited the company's account with a cheque for $400 in error.

Requirement: what was the original balance on the bank statement?

To find out the original balance of bank statement, we first need workout the adjusted/correct balance of cash book

Cash Book

DESCRIPTION	AMOUNT	DESCRIPTION	AMOUNT
Transfer from Deposit Account	$700	Balance b/d Bank charges Balance c/d (**Adjusted**)	$500 $100 $100
TOTAL	$700	**TOTAL**	$700

Bank Reconciliation statement

Balance as per Cash book (Adjusted)	**100**
Add: Unpresented cheques	**200**
Less: Outstanding lodgements	**(300)**
Error by Bank	**(400)**
Balance as per Bank statement (Original)	**(400)**

Accounting Concepts and Conventions

In preparing accounts and financial statements, accountants follow certain fundamental assumptions, rules, principles or conventions. These rules or principles are more commonly known as accounting concepts

Going concern Concept

The enterprise or business is normally viewed as going concern. It means that a business will continue operating or running for foreseeable future (at least for next 12 months). It is assumed that the business has neither intention nor necessity of liquidation or of curtailing the scale of its operations

This concept assumes that when preparing normal set of accounts, the business will continue for at least next 12 months and it will not go into liquidation or scale down its operations

The benefits of going concern concept is that assets of business will not be valued at "break up value". Break up value is the value of business's assets at the time when a business is forced to sell its asset because of its liquidation. Break up value is normally less than normal market value or price of the assets

However, an enterprise has to disclose the fact that it is going to liquidate in next 12 months and business has to value its assets at break up value

EXAMPLE

A business was commenced on 1st January and it has purchased 5 vehicles, each costing $7000. During the year, the business managed to sell 3 vehicles at the price of $8000 each. How should the remaining 2 vehicles be valued in the following circumstances?

A) There is a sufficient evidence that the business would be liquidated in the next year
B) Business would continue its operations in the next year

Solution

In the first case (A) Since there is a evidence that business won't be continued, business should disclose that its going to discontinue its operation and all asset will be valued at break up price that is less than market price

In the second case (B) because business has an intention to carry on its operations, the asset should be valued on going concern basis, thereby, value of each vehicle should be $7000 in the balance sheet of the business

Importance of Going concern Concept

It serves as the basis for the preparation of financial statement since financial statements are highly influenced by the continuity or discontinuity of a business

The calculation of depreciation expenses are affected by the estimation of successful future operation of a business

In case of a business is going to discontinue its operations, assets need to be valued at breakup value which is commonly less than the market value of assets

Accrual Concept

An accounting concept under which revenues and costs or expenses are recorded as they are earned or incurred and they are not recorded when money is received or paid

EXAMPLE

If a business purchases goods on credit, it should record this transaction at the date of purchase not the time of payment of money it owes and same treatment with revenues is expected

In another example, wherein a business has to pay $2000 as telephone prepaid charges but at the end of accounting period, business has only used the service for $500 and remaining $1500 pertaining to the next year. In this case, business has to record only $500 as expense because it has incurred only that amount of expenses

A business sell goods on credit for $200. In this situation, it should record that $200 as income even though the business is still unpaid for the sale of goods

Importance of Accrual Concept

It helps determine the true and fair financial performance and position of an entity since real expenses and incomes are counted regardless of the date as to when was money paid or received

Accrual concept guides the calculation of true net income or loss for an accounting period

Accrual basis of accounting helps management of a business to evaluate and analyze the true financial position of the business. Thereby, it helps management to predict the future financial position of the company

Strategy formulation and implementation require accurate financial data of an organization such as real figure of net income or loss for an accounting period. During strategy implementation phase, company establishes annual financial objectives and devises financial policies

Recognition Concept

An item can be recognized as an asset of business when:

A) When it is sure that the future economic benefits of that item will flow to business
(I.e. the item will help generate income for business)

B) The cost of that item can be measured reliably

(I.e. we can say that an equipment costs 10,000 to business)

Consistency Concept

To maintain consistency, the presentation and classification of items in accounts or in the financial statements should stay same from one period to another accounting period, except where:

A) There is a significance change in the financial operations or business of a company and review of financial statement indicates that a more appropriate method of presentation should be adopted

B) A change required by GAAPs

EXAMPLE

It is an accounting principle that fixed assets will be depreciated over their useful life; a company is free to use any method of depreciation to depreciate its assets. If a company selects straight line depreciation method, it is assumed that the company will follow this method of depreciation in the subsequent accounting periods as well. Any change in the method of depreciation will result in inconsistency and affect net profit of the company.

Materiality Concept

According to materiality concept or principle all MATERIAL ITEMS should be disclosed in the financial statements.

What are material items?

Information about an item is material if its omission or misstatement could influence the financial decision of the users taken on the basis of that information

EXAMPLE

A company has purchased paper pins for $5. Since this item is immaterial, it could be treated as expenses in income statement and company would not show this item as an asset in balance sheet even though company knows the fact that paper pins will be used more than one year or an accounting period

Offsetting Concept

According to this concept, an entity can't offset assets and liabilities against each other unless:

A) offsetting required by accounting GAAPs

B) Gain, losses and expenses arising from same or similar transactions and these transactions are not material

EXAMPLE

Example of offsetting can be regarded as when a company set off debtor against same creditor because it's debtor and creditor is a same person, therefore, it is permitted to some extend. However, a company can't off set a debtor with some other creditors

Comparability Concept

One of the key characteristic of financial statements implies that the user of financial statements can compare the financial statements of an entity with the other enterprise's financial statements to analyse and evaluate their performance and financial position and to identify trends in an entity's performance with reasonable convenience.

Comparability is simply the quality of a financial statement that enables anyone to compare financial statement with other financial statements of the same company or financial statement of other companies with the similar business

EXAMPLE

An investor can compare the balance sheet of a company with the balance sheet of other company

A government agency can compare the year 2001 income statement of a firm with year 2002 income statement

Tax agency can compare the year 2001 income statement of a company with the year 2002 income statement of that company

Important to note:

- Financial statements should be so prepared that they disclose the financial policies of an enterprise to enable the user of financial statements to differentiate the accounting policies that will help in making a valid comparison between the similar items in the account of different firms
- The enterprise should change the financial policies when they become inappropriate for the firm because the comparability is not the same as uniformity
- Corresponding information of upcoming financial periods should be disclosed to enable user of financial statements to make comparison over time

Prudence Concept

The prudence concept implies that the company should include a degree of caution in the exercise of judgments needed under the condition of uncertainty. In other words, assets and incomes should not be overstated while liabilities and expenses should not be understated

Prudence is caution exercised while preparing accounts and financial statements. However, it's not permitted to create secret or hidden reserves using prudence as justification

EXAMPLE

A Company started trading on January 1 and sold goods costing $50,000 on credit and at the end of the year, accounts receivable was $40,000. The company estimated that It is less likely to get paid from some debtors who owes debts amounting to $5000 out of $40,000 receivable

The company is now going to create a provision for doubtful debts of $5000. Sales will be shown in income statement at the full value i.e. $10,000 but the provision for doubt full debts will be expensed out in income statement. Since that $5000 is uncertain to be realized in the form of cash, prudence concept signifies that $5000 should not be included in the income of the company

Substance over form Concept

Substance over form indicates that transactions or items should be presented in conformity with their substance and economic reality not merely on their legal form

EXAMPLE

A Company got a vehicle on lease. Now the company is using that vehicle to transport its goods to the customers and getting economic benefits in the form of income. Since the vehicle is in the control of company, the company needs to show vehicle in its balance sheet as an asset contrary to the fact that company is not the legal owner of the vehicle

Understandability Concept

The users of financial statements or accounts should be able to understand financial statements. They are assumed to have some business, economics and accounting knowledge to be able to apply themselves to study the financial information properly. Complex matters should not be left out of financial statements simply because they are hard to understand if it is relevant information.

Relevance Concept

According to this concept information in the financial statements should be relevant

What's relevant information?

The information is relevant if it affects the decision making of the users

Note that same information could be relevant to one report but irrelevant to another report

EXAMPLE

A user of financial statement has two alternatives to finance the company buying shares or bonds of the company. The company should present information in financial statements in such a way that it can help user in his decision. In other words, company should provide user with relevant information to help the user in decision making

Completeness Concept

Financial information should be complete and financial statements show information of each and every item, event and transaction of an entity within the restrictions of materiality and cost to be reliable to use. Any omission of any economic event, transaction or an item may cause confusion or mislead users of financial statements.

Timeliness Concept

The publication or presentation financial statements should not be delayed.

If the publication of financial statements is delayed too long after balance sheet date, their usefulness would be diminished.

A balance between timeliness and the provision of reliable information must be maintained. Information may become irrelevant if there is a delay in reporting it. Information might be

reported on a timely basis at the time when not all aspects of the transactions are known, thus compromising reliability.

If every detail of a transaction is known, it may be too late to publish the information and therefore, it would become Irrelevant. The overriding consideration is how best to satisfy the economic decision-making need of the users.

Accounting Concepts and Conventions

Objectivity Concept

See neutrality

Neutrality Concept

Financial information should be neutral and bias free

Information must be free from bias to be reliable. Neutrality is lost if the financial statements are prepared so as to influence or affect the user to make a decision in order to get a predetermined outcome or result.

Reliability Concept

Information would be reliable when it is free from errors, bias and it is complete.

Users of financial statements assume that financial statements have been audited which implies that they are accurate and bias free. so, the company should double check and get audited their financial statements before publication

Faithful representation Concept

Financial statements must express faithfully the transactions they purports to present in order to be reliable. There is a risk that this may not be the case not because of bias, but due to inherent difficulties in identifying the transactions or finding an appropriate method of measurement or presentation. Where measurement of the financial effects of an item is so uncertain, companies are not supposed to recognize such an item, for example “internally generated goodwill”.

OTHER IMPORTANT ACCOUNTING CONCEPTS AND CONVENTIONS

Stable monetary unit Concept

Financial statements are expressed in terms of a monetary unit (for example dollar, Euro, pound). According to this accounting concept, it is assumed that value of monetary unit will not change

In practice the value, of course, change and it would be misleading if you compare current accounts with previous accounts. The value of a currency usually varies at the time high inflation rate

The Money measurement Concept

According to this principle, accounts will only be prepared for those items to which a monetary value can be assigned

EXAMPLE

In the balance sheet assets and other items are presented in some monetary value i.e. machinery and plant = $500000

Importance of Money measurement Concept

Implementation of this concept results in uniformity of financial statements prepared by different companies, if all of them are following the same monetary unit (such as dollar)

This concept helps accountants to determine materiality of an item i.e. whether an item worth reporting in financial statements or not

It helps in comparing the financial statements prepared by the different companies and financial statements for one accounting period with financial statements for another accounting period

Assigning monetary or money value to an item is the prerequisite to understand the worth of an entity or its assets

Historical cost Convention

This implies that transactions are recorded at original cost at the time when they are occurred.

EXAMPLE

ABC Company had purchased a vehicle 5 year ago for $5000. Now the company can present that vehicle at $5000 (as the cost of asset) in its current balance sheet.

Accounting Concepts and Conventions

Duality Concept

According to this concept, every transaction has two effects or aspects and we have to record the both effects or aspects of the transaction

As we know every financial transaction has two effects something always "gives" and something always "receives" we have to record the both aspects of a transaction. Double entry simply implies that each transaction should be recorded twice in the books of accounts

EXAMPLE

A firm purchased equipments for $2500. In this case, equipments should be recorded in equipment account and cash in cash account. Therefore, there are double aspects of that transaction and we can say that increase in Firm's equipments (Asset) and decrease in cash (Asset) of firm

Importance of Duality Concept

Reproduction of accounts from incomplete record is possible due to the fact that commercial accounting is done on the basis of double entry system and there are always high chances that one aspect of the financial transactions would be available to the business which can be used to produce accounts and financial statements

Duality or Double entry system helps trace out errors and mistakes in recording the transactions or economic events in the books of accounts

Implementation of double entry system helps identify different type financial frauds, embezzlements and misappropriations because recording a transaction twice in the books of accounts makes it difficult to commit misappropriation

Pursuing duality concept results in the availability of full information about assets, liabilities, capital, income and expenses

It is because of double entry system that the trial balance can be prepared to check the arithmetic accuracy of accounts

Separate Entity Concept or Business entity concept

This concept forms the basis of accounting principles or concepts. It implies that for the purpose of accounting 'the Business is treated independently from the Owners'.

This means that although anything owned by the business belongs to the owner(s) of the business and anything owed by the business is payable by the owner(s) but for accounting purpose we assume that the business is independent of its owners

EXAMPLE

If a business purchases a machine or piece of equipment, it will own and obtain benefits from that Equipment. Likewise, if a business borrows money from 'someone' it will have to repay the money. This Someone includes even owner of the business. The treatment of business independently from its owners is called the 'Separate Entity Concept'

Importance of Business entity concept or Separate Entity Concept

Business entity concept is significant since it forms a base or foundation for other accounting concepts or principles

Business entity concept helps determine the true and fair view or financial position of a business by making a business as an independent entity which implies that personal property of owners does not get counted while preparing the financial statements

It is helpful in determining the true figure of profit or loss for an accounting period since owner's personal expenses and revenues are overlooked

Adjusting Entries

Accrual Concept

An accounting concept which dictates that revenues and costs/expenses should be recorded as they are earned or incurred and they shouldn't be recorded when money is received or paid.

In other words, according to this concept or principle an accountant of business should record expenses and revenues in the books of accounts when these expenses and revenues are incurred or earned not when the money is paid as expense or money is received as income

EXAMPLES:

Prepaid Expenses
For example a business has to pay $2000 as telephone prepaid charges, but at the end of accounting period the business has only used up the service for $500 and remaining $1500 pertaining to the next year. In this case, business has to record only $500 as expense because it has incurred only that expense

Accrued expenses
Another example wherein a business has used service of telephone worth $500 and at the end of accounting period it has not yet paid this expense, the business is now required to record $500 as expense because it has incurred that amount of expense

Unearned income
A telephone company has received $1000 as telephone fee in advance from one of its customers, but at the end of accounting period the customer has used telephone service for $400. Since the customer has used up telephone service for $400 at the end of accounting period, the company can only record $400 as revenue not $1000 because company has, actually, earned $400

Accrued income
A telephone company has provided the service for $2000 and at the end of accounting period the customer has used service costing $2000, but he has paid $1500. Since the company has earned $2000, It will record the full $2000 as revenue

Adjusting Entries

Since the normal journal or double entries are made when transactions take place and with the actual amount of money paid or received, we need to make some adjusting entries at the end of accounting period (e.g. a year) to convert the amounts of these transactions into accrual basis of accounting in the books of accounts. Accrual basis accounting is the principle of recording expenses and revenues in a period to which these expenses and revenues actually relate

Why do we need to make adjusting entries?

As previously mentioned the adjusting entries are required to allocate the expenses and revenues to the appropriate financial period (e.g. a year)

Let’s assume a business needs to pay $3000 telephone bills for a year

Business paid 2500$ in the start of year and recorded this transaction. At the end of the year business owes $500

Business used the expense = $3000
Business paid the expenses=$2500

Now assume that business paid $3500 in the start of year and recorded this transaction. This payment include $500 advance for the next year

Business used the expense =$3000
Business paid the expense=$3500

In both cases, the business was supposed to record only $30,000 respectively, but the business has recorded $2500 and $3500 at the time of payment. What to do now? Obviously, at the end

of accounting period business will make one or more adjusting entries in its books of accounts to rectify these expenses balances and to show the correct balances of expenses and revenues in its financial statements

There are four main types of adjusting entries:

1) Outstanding/Accrued/Payable/Unpaid Expenses
Expenses incurred but not yet paid by the business

2) Prepaid/Paid in advance/Un-expired Expenses
Expenses paid but not yet incurred by the business

3) Outstanding/Accrued/receivable Revenue
Revenue or income earned but not yet received by the business

4) Unearned/Received in advance Revenue
Revenue received but not yet earned by the business

Accrued expenses

Also referred to as outstanding expenses, Payable expenses and Unpaid Expenses

These expenses have been incurred by a business but the business has not yet paid them

For example a firm used a building for a month but the building rent amounting to $5000 is still unpaid at the end of financial or accounting period. Since the firm has used up this expense (i.e. rent expense), it is required to record $5000 as expenses in full and $5000 is known as accrued expense

Nature of Accrued Expenses

Accrued expenses are the liabilities of a business because the entity has to pay these expenses and these expenses will decrease the future economic benefits of the business

Double entry for accrued expenses

DEBIT = Expenses Account

CREDIT = Accrued expenses Account

This is a an adjusting entry, it will adjust the amount of expenses that should be recorded in the books of accounts for the current accounting period

Example:

XYZ enterprise manufactures micro chips for tablets and desktop computers. On 1st January, 2012 they got the new connection of telephone. The telephone bills are payable at the end of every 3 months

Following is the detail of telephone bill payments by XYZ enterprise

Amount of Expenses	Expense due on	Expenses paid on
$500 $500 $500 $500	31 March 2012 30 June 2012 30 September 2012 31 December	31 March 2012 3 July 2012 8 October 2012 6 January 2012

Requirement: You are required to calculate the amount expenses pertaining to this accounting period or The amount of expenses that should be charged for the year ended on 31 December, 2012

Solution:

These double or journal entries were made by business at the time of expenses payments

On March 31, 2012 the company paid cash for the use telephone services

DESCRIPTION	DEBIT	CREDIT
Telephone expenses	**$500**	
Cash		**$500**

On July 3 The company again paid $500 to the telephone company

DESCRIPTION	DEBIT	CREDIT
Telephone expenses	**$500**	
Cash		**$500**

On 8 October 2012 The company paid $500 for the use of telephone service

DESCRIPTION	DEBIT	CREDIT
Telephone expenses	**$500**	
Cash		**$500**

On 6 January 2012 Company paid $500 after the end of accounting period. Since the company has used up these expenses in this accounting period, these expenses are related to this period and should be recorded in this period. Therefore, company made an adjusting entry for these accrued expenses on 31 December, 2012

The following adjusting entry was made on 31 December, 2012 to allocate expenses to this accounting period

DESCRIPTION	DEBIT	CREDIT
Telephone expenses	**$500**	
Accrued Telephone expenses		**$500**

Now you just have to post the above journal entries in Telephone account to find out the "Total telephone expenses" for this accounting period

Telephone expenses A/C*

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31 Jul. 3 Oct. 8 Dec. 31	Cash Cash Cash Accrued telephone ex.	$500 $500 $500 $500	Dec. 31	Income statement (BF*)	**$2000**
	TOTAL	$2000		**TOTAL**	$2000

$2000 is "Total amount of expenses" that should be charged to this accounting. These expenses will be shown in income statement

**A/C=Account*
**BF=Balancing figure*

Prepaid expenses

Also known as paid in advance expenses and Un-expired Expenses

These expenses have been paid in advance but the business has not yet incurred or used up these expenses.

For instance a company had telephone expenses amounting to $2000 and made an entry for these expenses in its books, but at the end of accounting period the company used the telephone service for $500. Since the remaining $1500 pertain to next accounting period, they must be considered as prepaid expenses and these $1500 expenses should not be included in telephone expenses for this accounting period

Nature of Prepaid expenses

Since prepaid expenses have future economic benefits and these expenses are resources of the business, prepaid expenses are treated as Assets of the business

Double entry for prepaid expenses

DEBIT = Prepaid expenses account

CREDIT = Expenses account

Example

Mr. Z started a bakery business on 1st January 2012. A building which was on rent was used for the purpose of business. The rent of building was payable at the start every 3 months in advance

The detail of rent expense payments is as follows:

Amount of Expenses	Expense due on	Expenses paid on
$500 $500 $500 $500 $500	31 March 2012 30 June 2012 30 September 2012 31 December 2012 31 March 2013	3 January 2012 27 march 2012 29 June 2012 2 October 2012 27 December 2012

Requirement: You are required to calculate the amount expenses pertaining to this accounting period or The amount of expenses that should be charged in income statement for the year ended on 31 December, 2012

Solution:

These double or journal entries were made by business at the time of expenses payments

On **3 January 2012** Mr. Z paid cash $500 for the use of building which was an advance payment

DESCRIPTION	DEBIT	CREDIT
Rent expenses	**$500**	
Cash		**$500**

On **27 march 2012** Mr. Z again paid $500 to the building's owner in advance

DESCRIPTION	DEBIT	CREDIT
Rent expenses	**$500**	
Cash		**$500**

On **29 June, 2012** Mr. Z paid $500 for the use of building that payment was made in advance

DESCRIPTION	DEBIT	CREDIT
Rent expenses	**$500**	
Cash		**$500**

On **2 October, 2012** Mr. Z paid telephone expenses for 3 months in advance

DESCRIPTION	DEBIT	CREDIT
Rent expenses	**$500**	
Cash		**$500**

On **27 December 2012** Mr. Z paid $500 before the end of accounting period. Since the business has not used up these expenses in this accounting period, these expenses are not related to this period and should be recorded in the next period not in this accounting period. Therefore, the business has made an adjusting entry for these prepaid expenses on 31 December, 2012 which excludes these expenses from total rent expenses for this year

The following adjusting entry was made on 31 December, 2012 to allocate expenses to this accounting period

DESCRIPTION	DEBIT	CREDIT
Prepaid Rent expenses	**$500**	
Rent expenses		**$500**

Now you just have to post the above journal entries in Telephone account to find out the "Total telephone expenses" for this accounting period

Rent expenses A/C*

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Jan. 3	Cash	$500	Dec. 31	Income statement (BF*)	**$2000**
Mar. 27	Cash	$500	Dec. 31	Prepaid expenses	$500
Jun. 29	Cash	$500			
Oct. 2	Cash	$500			
Dec. 27	Cash	$500			
	TOTAL	$2500		**TOTAL**	$2500

$2000 is "Total amount of expenses" that should be charged to this accounting. These expenses will be shown in income statement

**A/C=Account*
** BF=Balancing figure*

Accrued Revenue

Also known as outstanding revenue, receivable revenue and earned revenue

Revenues or incomes which have been earned by a business but not yet received

For example a telephone company has provided services worth $1000 to a person, but that person has not yet paid the telephone charges ($1000) which means $1000 is still receivable from that person. Since the company has earned that telephone fee, the company will consider the $1000 as income or revenue (Accrued income)

Nature of accrued income or revenue

Accrued revenue is a resource of the business that possesses the future economic benefits for the business. Therefore, accrued revenue is always accounted as an asset of the business

Double entry for Accrued revenues

DEBIT = Accrued revenues account

CREDIT = Revenues account

Example

XYZ Construction Company owns a big building. The building was useless for the XYZ construction company. Therefore, the management of company decided that they should rent building to another business and they did so on 1st January, 2012. The rent of building was receivable at the end every 3 months

Here is the detail of rent receipts by the company

Amount of Income	Income due on	Income received on
$500	31 March 2012	7 April 2012
$500	30 June 2012	6 July 2012
$500	30 September 2012	9 October 2012
$500	31 December 2012	8 January 2012

Requirement: You are required to calculate the amount income pertaining to this accounting period or the amount of income that should be charged in income statement for the year ended on 31 December, 2012

Solution:

These double or journal entries were made by business at the time of expenses payments

On 7 April 2012 Company received cash $500 as rent of building

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Rent income		**$500**

6 July 2012 XYZ Company again received rent $500 at the end of another 3 months

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Rent income		**$500**

9 October 2012 Another payment of $500 received by company

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Rent income		**$500**

On 8 January, 2012 Mr. Z paid telephone expenses for 3 months in advance

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Rent income		**$500**

8 January 2012 XYZ construction company received $500 after the end of accounting period. Since the business has earned this income in this accounting period, the income is related to this period and should be recorded in the this period not in the next accounting period. Therefore, the business has made an adjusting entry for accrued income on 31 December, 2012 which include this income in the total rent income of this year

The following adjusting entry was made on 31 December, 2012 to allocate income to this accounting period

DESCRIPTION	DEBIT	CREDIT
Accrued Rent income	**$500**	
Rent income		**$500**

Now you just have to post the above journal entries in the rent income account to find out the "Total rent income" for this accounting period

Rent income A/C*

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 31	Income statement	**$2000**	Apr. 7 July. 6 Oct. 9 Dec. 31	Cash Cash Cash Accrued income	$500 $500 $500 $500
	TOTAL	$2000		**TOTAL**	$2000

$2000 is "Total amount of income" that should be charged to this accounting. This income will be shown in income statement or profit and loss account

**A/C=Account*
** BF=Balancing figure*

Unearned Revenue

Also referred to as received in advance revenue

Revenues or incomes which have been received by business. However, the business has not yet earned them
For example a firm received rent of building amounting to $3000 on 1st December for 3 month in advance. 31 December is the date of closing the accounting period. Therefore, only one month rent pertains to this accounting period i.e. $1000 and remaining $2000 must be treated as unearned income or revenue

Nature of unearned revenue

Since it decreases the future economic benefits of a business and creates obligation for the business to earn this revenue by providing services or products, unearned revenue is considered as a liability

Double entry for unearned revenue

DEBIT = Revenue account

CREDIT = unearned revenue account

Example

ABC Telephone Company provides telephone service. The telephone fee is receivable for every 3 months in advance

Following is the detail of telephone fee receipts by the company from a customers

Amount of Income	Income due on	Income received on
$500	31 March 2012	1 January 2012
$500	30 June 2012	28 March 2012
$500	30 September 2012	24 June 2012
$500	31 December 2012	2 October 2012
$500	31 March 2013	26 December 2012

Requirement: You are required to calculate the amount income pertaining to this accounting period or the amount of income that should be charged in income statement for the year ended on 31 December, 2012

Solution:

These double or journal entries were made by the business at the time of expenses payments

1 January 2012 Company received cash $500 as the telephone fee

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	

Telephone income		**$500**

28 March 2012 ABC Company again received telephone fee $500 at the end of another 3 months

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Telephone income		**$500**

24 June 2012 Another payment of $500 received by company

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Telephone income		**$500**

On 2 October, 2012 The customer paid telephone expenses amounting to $500 in advance

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Telephone income		**$500**

At 26 December 2012, the telephone received $500 in advance as telephone fee

DESCRIPTION	DEBIT	CREDIT
Cash	**$500**	
Telephone income		**$500**

On 26 December 2012 the ABC Telephone company received $500 in advance. Since the business has not earned this income in this accounting period, the income is not related to this period and should not be recorded in the this period. Therefore, the business has made an adjusting entry for the unearned income on 31 December, 2012 which excludes this income from the "total telephone income" for current year or accounting period

The following adjusting entry was made on 31 December, 2012 to allocate income to this accounting period

DESCRIPTION	DEBIT	CREDIT
Telephone income	**$500**	
Unearned telephone income		**$500**

Now you just have to post the above journal entries in the telephone fee income account to find out the "Total telephone fee income" for this accounting period

Telephone income A/C*

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Dec. 31 Dec. 31	Unearned income Income statement (BF)	$500 **$2000**	Jan. 1 Mar. 28 Jun. 24 Oct. 2 Dec. 26	Cash Cash Cash Cash Cash	$500 $500 $500 $500 $500
	TOTAL	$2500		**TOTAL**	$2500

$2000 is "Total amount of income" that should be charged to this accounting. This income will be shown in income statement or profit and loss account

**A/C=Account*
** BF=Balancing figure*

Financial statements - Income Statement

Financial statements

The term financial statements implies that statements prepared or produced at the end of accounting period (for example at the end of an year) for the purpose of communicating the financial information of a business's activities to its stakeholders

Financial statements are produced in structured manners and in specific form to present relevant information

Different types of financial statements

Income statement or profit and loss account

A statement that shows revenues, expenses and net income or profit. In short, it reflects the operations of a business in a financial period

Balance sheet or statement of financial position

A statement which presents assets, liabilities and capital of a business. All in all, it represents the financial position of a business

Cash flow statement or statement of cash flow

A statement that presents the cash and cash equivalents receipts and cash payments during a specific accounting period by the business

Statement of changes in equity

A statement that shows the changes in the capital or equity of a business during an accounting period

Accounting policies and explanatory notes

Accounting policies adopted while preparing financial statements

Uses or Applications of financial statements

1. The owner (or owners) of business want to know the financial position of business either business is in profit or in loss
2. Investors because they want to invest in business (e.g. they purchase shares, bonds etc.)
3. Loan providers, banks and creditors want to know the profitability and financial position of a business
4. Management of business needs financial information for the decision-making
5. Business's employees want to know the stability, future prospects and scope of business for their own welfare in business organization
6. Government for the income tax purpose and government agencies for various other purposes

Income statement

(Also referred to as operating statement or statement of operations, profit and loss statement (P and L or P&L), statement of financial performance, earnings statement.)
Income statement is a statement that shows **revenues**, **expenses** and the **net income/loss** of a business for an accounting period (for example an year). It represents the profitability of a company

Revenues

Revenues are the gross inflow of economic benefits during a period arising in the ordinary course of business and this inflow of economic benefits results in increase in the capital of the business

EXAMPLES
Sales of goods and services, interest and commission income, profit on the sale of fixed assets, discount received, dividend receipts etc...

Expenses

Expenses are the gross outflow of economic benefits during a period arising in the ordinary course of business and this outflow of economic benefits results in decrease in the capital of the business

EXAMPLES
Purchases of goods, rent expenses, salaries, wages, interest expenses, loss in the sales of fixed assets, electricity and heating expenses, carriage, freight, telephone bills, transportation costs, loss of raw material during production process, discount and allowance on sales of goods and services etc…

Net income

Net income is the excess of revenues over expenses in a specific accounting period.

Net loss

Net loss is the excess of expenses over revenues in a specific accounting period.

Net income and Net loss

Total revenues less total expenses is the figure of net profit or net loss
Net Profit or Net loss = Total Revenues – Total Expenses

EXAMPLE

For example a business earn $1000 & its expenses are $500. Therefore, Its profit will be $500 ($1000-$500).

In the above example, if its expenses were $1000 & its revenues were $500. Business net loss would be $500 ($1000-$500)

Let's prepare a simple income statement to help clear these concepts
For example on December 31, 2011 a company's trial balance shows that total revenues balance = $1000 on the credit side and total Expenses balance = $500 on the debit site of the trial balance.

Required: From the above information, prepare an income statement for the year ended on 31 December, 201

The Simple Income statement
For the year ended on 31 Dec, 2011

Total Revenues	**$1000**
Less:Expenses	**$500**
****Net income****	**$500**

Format of an Income Statement

	Amount	Amount	Amount
Sales		50,000	
Less: Sales return	2000		
Sales discount	1000	3000	
Net Sales			47000
Less: Cost of goods sold			
Opening stock or inventory		10000	
Add: Purchases		6000	
Less: Purchase return	2000		
Discount received	1000	3000	
Add: Freight	1000		
Carriage inward	1000	2000	
Goods available for sale		15000	

Less: closing stock		9000	
Cost of goods sold			6000
Gross profit on sales			41000
Less: Operating expenses			
Selling expenses			
Salaries of sales wokers	500		
Advertisement expeneses	500		
Commission paid for sales	1000		
Total selling expenses		2000	
Administrative expenses			
Office salaries	1000		
Rent of builing	1000		
Depreciation expenes	2000		
Insurance expenses	1000		
Total administrative expenses		5000	
Total operating expenses			7000
Income from operations			34000
Less: Other expenses			
Dividend		1000	
Interest paid		2000	
Total other expenses			3000
			31000
Less: Other income			
Interest received		1000	
Divident received		2000	
Discount received		3000	
Commission received		1000	
Total other income			7000
Net Income			38000

The components of income statement are discussed below

Sales

Sales are the revenue against the sale of the products or services of a business. In case of a service business, there will be Income against Services Rendered instead of Sales

Cost of Goods Sold

Cost of goods sold is the expenses incurred in purchasing or manufacturing the products which a business is selling and any other necessary expense incurred in bringing the product in saleable condition.

Examples of these expenses are listed below:

- Purchase price of raw material or goods sold
- Tax expense and freight paid on the purchase of raw material or goods
- Cost of carriage inward or transportation of purchased items or raw material
- Wages paid to employees or labours to manufacture goods or to provide services
- Other factory overheads incurred to convert raw material to saleable products

Gross profit or loss

Total sales of goods or services less cost goods sold or services rendered
Gross profit or Gross loss = Sales – Cost of goods sold or services rendered

Operating expenses

Operating expenses are ongoing business expenses which are incurred in connection with main operations or activities of the business

There are two main types of operating expenses

- Administrative Expenses
- Selling Expenses

Administrative expenses

Expenses which are incurred for the administration of organization and these expenses are not directly related to a specific function (like selling or manufacturing) of the organization

Examples of administrative expenses include:

- General office expenses
- Payment of utility bills
- Repair & maintenance of office equipment and vehicle.
- Payment of rent
- Salaries of employees

Selling Expenses

Selling expenses are directly related to sales of goods or services. These are the expenses which are either incur for the marketing or advertisement of goods and services or for the distribution of goods and services to customers

Examples of selling expenses include:

- Transportation cost or carriage outward for selling goods or services
- Advertisement expenses
- Salesperson's commission
- Salaries of employees that are directly involve in selling goods or services

Other incomes

Other incomes are the gains or revenues from the activities which are not the normal course of business or normal operations of business

Examples of other incomes include:

Interest received on loan, dividends received, commission from sales of other firm’s goods, profit on profit and loss sharing account

Other expenses

Other expenses are the losses and expenses that a company incurs on activities which are not the normal course of a business or normal operations of a business

Examples of other incomes include:
Interest paid on loan, commission paid, dividends paid, discount allowed other debts etc.

We can summarize Income statement in a mathematical equation

Net_Profit/loss=(Sales-Sales return-Discount allowed)-[opening stock+(purchases-Purchases return-Discount received)-closing stock]-Operating expenses-other expenses+other Incomes
Financial statements - Balance sheet

Balance sheet

A statement that lists the detail of Assets, liabilities and capital. Balance sheet represents the financial position of a business at a specific date. It contains the balances of assets, liabilities and capital accounts as opposed to income statement that shows the details of revenues and expenses of a business earned and incurred during a specific accounting period

Things you should know about a Balance sheet

- Balance sheet is prepared at the end of accounting period of a business after the preparation of income statement
- Balance sheet is not an account; it is a report or statement like income statement, statement of cash flow and statement of changes in equity
- Balance sheet discloses the financial position of a business unlike the income statement which shows the profitability of a business
- Balance sheet consists of two parts or sides the assets side and liabilities + capital side. Both sides should be equal Assets=Capital+liabilities
- If you subtract current liability from current assets, it will come up the figure of net working capital which shows the business's resources in a form that is readily convertible into cash
- You should not write "account" after each item (like rent expenses account) in Balance sheet

Format of a Balance sheet

X.Y.Z Company
Balance Sheet
As on 31 Dec, 2011

ASSETS	AMOUNT	LIABILITIES+CAPITAL	AMOUNT
Current Assets		**Capital** (opening)	$30,000
Cash in hand	$2000	Add: Net income	$5000
Cash at bank	$5000	Add: Fresh Capital	$1000
Bills receivable	$1000	Less: Drawings	$5000
Supplies	$1000	**Capital** (closing)	$31000
Account receivable	$2000	**Long term Liabilities**	

Prepaid rent expense	$3000	Mortgage loan	$11000
Intangible Assets		Bank loan	$12000
Copy right	$4000	**Short term liabilities**	
Trade mark	$5000	Account payable	$1000
Goodwill	$7000	Bills payable	$4000
Fixed Assets		Rent payable	$1000
Land	$9000	Outstanding interest expense	$2000
Building	$8000		
Vehicles	$5000		
Plant and machinery	$7000		
Long term investments			
Investment in mutual fund	$1000		
investment in Govt. securities	$2000		
TOTAL	$62000	**TOTAL**	$62000

Assets

Assets are tangible or intangible resources or things that are controlled by a business entity and posses the future economic benefits for the entity. Assets are presented in balance sheet at their book value or carrying value

Examples of Assets
Plant and machinery, Cash, Securities, money orders, cherub, bank drafts buildings, vehicles, inventories, equipments, precious metals, debtors, prepaid expenses etc

Current assets

Cash or easily coverable into cash within the short period of time (e.g. 3 months) for example cash, inventory, debtors, prepaid expenses etc

Long-term investments

Investment for more than 12 months and not intended to be sold in near future

Examples

- Investments in securities like bonds, shares, debentures etc..
- Investments in special funds (for example mutual fund, sinking funds or pension funds).
- Investments in fixed assets that are not for business operations (for example building held for sale).

Fixed assets

Assets that will be used more than 12 months For example land, buildings, machinery, furniture, tools etc.

Intangible assets

Non-touchable assets for example patents, franchises, copyrights, trade names, goodwill, trademarks, Preliminary expenses etc.

Tangible assets

Touchable assets for example equipments, currencies, buildings, real estate, vehicles, inventories or stock, metals etc.

Fictitious assets

Fictitious assets are those assets that don't have realisable value (sale value). Fictitious assets are expenditures which provide future economic benefits over a long period of time. All fictitious assets can be classified as intangible assets but all intangible assets (copy rights, trade mark) can't be considered as fictitious assets

Examples
Preliminary expenses of a company, discount on issuance of debentures and shares, underwriting commission etc.

Reserves

Also known as Reserve fund, contingencies reserve etc

Funds that are kept aside for meeting some expected and unexpected losses or contingencies of a business. The fund kept apart will not be drawn by the business's owner for his/her personal use

Liabilities

Liabilities are the obligations (like debts or loans payable) of a business entity that result in outflow of assets in future which eventually decrease economic benefits of a business.

Examples
Creditors/accounts payable, bank loan, mortgage loan, Salaries Payable, Accrued interest expenses, Bills payable, Advances from Customers and other outstanding expenses and unearned incomes

Current liabilities

Current liabilities are also known as short term liability. These liabilities are payable in short period of time (for example these liabilities are payable in twelve months)

Examples
Trade Creditors or accounts payable, Short Term Borrowings of a business, Salaries Payable, Accrued rent expenses, Bills payable Advances from Customers

Non-current liabilities

Also known as long term liabilities. These liabilities are payable after a long period of time (for example these liabilities are payable after twelve months)

Examples
Bank loan, mortgage loan, debentures and other long term bank loans that are payable after 12 months

By convention, the liabilities that are payable within the 12 months are classified as current or short term liabilities and those liabilities that are payable after 12 months can be considered as non-current or long term liabilities

0 Comments

Cash flow statement

For any business entity it is important to ensure that:

- Sufficient profits or earnings are being made to compensate owner of the business and to finance the business activities
- There is sufficient availability of cash to a business so that the business can use it at the time of its needs. For example a business needs funds for paying off its creditors and expenses

The information regarding the profitability of a business is provided by the income statement or profit and loss account

The information concerning the financial health or financial position of a business can be obtained by observing the Balance sheet

The information related to cash or funds availability and movements of cash is acquired by preparing a Cash flow statement of that business

Cash flow statement

It is one of the most important financial statements which provides the information about the movement of cash into and out of business during a certain accounting period. In other words cash flow statement is a simple financial statement that let you know how a business has generated cash and how it has spent the cash during an accounting period. An accounting period can be a month, half year, year or whatever time period.

Cash

Cash includes the cash available to a business or cash in hand plus the business's cash available at bank in the form of demand deposit

Cash = Cash in hand + Cash at bank

Cash Equivalents

Cash equivalents are current assets which can be converted into cash within 3 months such as short term debtors, notes receivable, and short term investments with maturity up to three months

Liquidity

Liquidity of an asset can be defined as the ease with which an asset can be converted into a mean of payment i.e. money or cash
An Asset is said to be liquid if it can be converted into cash or money easily at any time

A business has more liquidity if it has more cash and liquid assets such as short term investments, short term debtors, demand deposits etc.

Profitability

Profitability is the amount of earnings or profits a business has made by selling its goods or services

More profitability implies that more profits are being made from business activities

Is liquidity same as profitability of a business entity?

No, not at all. Liquidity is not same as profitability of a business. Liquidity concerns with the availability of cash and cash equivalents while profitability is related to the amount profits or earnings made by a business

Example:

- A Person started a business with cash $1000
- He purchased Goods for that $1000
- He sells these Goods for $2000 on credit
- After three months he draws income statement of his business
- According to income statement, his business made a profit of $1000 ($2000-$1000=$1000 of profit, Assuming no other expense). Though, his business has made $1000 profit but his business has no cash available

Conclusion, **Profitability=$1000 and Liquidity=0**

Cash flow statement shows where cash comes from and where it goes during a period

To better understand this we have to list down some of the business's activities that bring cash into business and that take the cash out of the business

These activities bring cash into the business

1. Sales of Fixed assets
2. Decrease in stock or inventory level
3. Decrease in Debtor
4. Fresh capital introduction
5. All kind of profits
6. Loan received
7. Increase In creditors

These activities take cash out of business

1. Purchase of Fixed assets
2. Increase in stock or inventory level
3. Increase in Debtor
4. Drawings or withdrawals of capital
5. All kind of losses
6. Loan repaid
7. Decrease in creditors

Explanation of these activities

1. Business receives cash for the sales of fixed assets and business pays cash for the purchase of these assets

2. Decrease in stock brings cash into the business because reduction in stock implies that business has sold some of its stock which in turn brings cash into business and increase in stock means business has purchased stock or goods which takes out business cash

3. Decrease in debtor brings cash into business because some debtors has repaid business cash and Letting the debtors grow implies that limiting cash inflows

4. Fresh capital will definitely brings cash into business because the owner or owners are introducing cash into the business in the form of capital and drawings implies that cash is being taken out of business by the owner or owners

5. Profit brings cash and losses make the cash goes out of business

6. Since loans are received in the form of cash, they will bring cash into business and if business repays these loans, the business funds or cash will reduce

7. Increase in creditors means business has obtained cash from creditors which is an inflow of cash and decrease in creditors implies that business has repaid the creditors which takes the cash out of the business

The Format of **Cash flow statement:**

X.Y.X Enterprise
Cash flow statement
For the year ended on 31 Dec, 2011

Operating activities		
Net profit of the year	200,000	
Adjustment for non-cash items		
Depreciation expenses	1000	
Increase in the provision for doubtful debts	2000	
Gain on the sale fixed asset	(2000)	
Operating cash flow before movement in working capital	**201000**	
Decrease in debtors	3000	
Decrease in stock or inventory	2000	
Increase in prepaid rent expense	(1000)	
Decrease in creditors or accounts payable	(5000)	
Cash generated by operations	**200,000**	
Tax paid	(10,000)	
Interest paid	(5000)	
Net cash from operation activities		**185,000**
Investing activities		
Cash payment to acquire a fixed asset	(15,000)	
Cash receipt from the sale of a fixed asset	5000	
Net cash flow from investing activities		**(10,000)**
Financing activities		
Fresh capital introduction	10,000	
Drawings or withdrawals by the owner	(5000)	
Bank loan taken in the year	15000	

Mortgage loan taken in the year	20,000	
Repayment of an old bank loan in the year	(10,000)	
Net cash from financing activities		**30,000**
Net increase in cash and cash equivalent		**225,000**
Cash and cash equivalent at the beginning of year		(150,000)
Cash and cash equivalent at the end of year		**75000**

Components of cash flow statement have been discussed below:

There are three main components of a cash flow statement

1) Operating activities
2) Investing activities
3) Financing activates

Operating activities

These are the main revenue producing activities of a business i.e. the activities of a running business that produce revenue for a business

What do operating activities indicate?

Operating activities are crucial for determining the success of a business's activities. Negative cash flow from operating activities indicates the revenue is less than the expenses which are incurred to generate this revenue.

Examples of operating activities

- Increase or decrease in debtors
- Increase or decrease in notes receivable
- Increase or decrease in stock
- Increase or decrease in stock/inventory
- Increase or decrease in prepaid expenses
- Increase or decrease in creditors
- Increase or decrease in notes payables
- Increase or decrease in accrued expenses

Adjustments to net profit or net loss figure

As you know income statement is based on accrual concept or principle of accounting not the cash basis of accounting. Income statement includes some items that don't concern with the movement of cash flows in the accounting period covered by cash flow statement. For example depreciation expenses are included in income statement but it doesn't affect the cash flows of a business, this is just a bookkeeping entry. Since cash flow statement is based on cash accounting not accrual, you have to adjust some non cash items included in the income statement

The detail of these adjustments to net profit or net loss has been discussed below:

Depreciation Adjustment

Depreciation expenses don't affect the cash flows of a business. These expenses are deductions in income statement for the requirements of prudence principle. Since these expenses are subtracted from income statement, the amount of these expenses should be added back to net income or net loss for the purpose of preparing a cash flow statement

Provisions for doubtful debt Adjustments

Provisions for doubtful debt don't affect the movement of cash in the accounting period related to cash flow statement. Provisions for doubtful debts are similar to the provision for depreciation or depreciation expenses. Provisions for doubtful debts are charged to income statement. Therefore, these provisions should be added back to net income or loss if there is an increase in these provisions whereas these provisions are deduced from net income or loss figure in the cash flow statement if there is a decrease in these provisions

Profit or loss on the sales of fixed assets Adjustment

For example a machine with book value of $5000 is sold for $6000
In this case, $600 is the cash inflow and profit on sale is equal to $1000. Because of the fact that $1000 is a book profit and doesn't bring cash into the business (since the business will not get extra cash over $6000), these kinds of profits will be deducted from net profit or loss figure for the sake of preparing cash flow statement

In contrary to that the losses on sales of fixed assets are treated as the addition back to net income or loss in the cash flow statement

To sum up profits will be deducted from net income or loss figure. Losses will be added back to net income or loss because these profits or losses are not related to the cash flows of a business.

Here is the operating activities part of cash flow statement

Operating activities	
Net profit of the year	200,000
Adjustment for non-cash items	
Depreciation expenses	1000
Increase in the provision for doubtful debts	2000
Gain on the sale fixed asset	(2000)
Operating cash flow before movement in working capital	**201000**
Decrease in debtors	3000

Decrease in stock or inventory	2000
Increase in prepaid rent expense	(1000)
Decrease in creditors or accounts payable	(5000)
Cash generated by operations	**200,000**
Tax paid	(10,000)
Interest paid	(5000)
Net cash from operation activities	**185000**

Investing activities

Investing activities include all cash flows that are related to the purchase and disposal of fixed and long term assets

These activities expand or reduce the scale of production of a business

What do investing activities indicate?

If a business purchases more fixed assets as compare to the disposal of these long term assets or investment, it indicates the business is expanding or it is enlarging its operations

On the other hand, if a business is disposing more fixed assets as compare to purchasing or investing in fixed assets, it signifies that the business is contracting or it is diminishing its operations

Examples of investing activities

- Cash payments for the purchase of property, plant and equipment (which are fixed assets)
- Cash payments for the construction of fixed assets
- Cash payment for the purchase of other long term assets for example Shares, debentures etc.
- Cash receipt from sales or disposals of fixed assets
- Cash receipt from the sales or disposals of other long term assets for example Shares, debentures etc.

Investing activities	(15000)
Cash payment to acquire a fixed asset	5000
Cash receipt from the sale of a fixed asset	**10,000**
Net cash flow from investing activities	

Financing activities

Financing activities include all cash flows that arise as a result of financing the business activities

A business can finance and start its activities or purchase its long term asset only from two sources one is from Capital and other is from Debts (these are long term debts or liabilities) Financing activities include cash movements caused by introduction of capital by owner (or owners) or getting long term debts and increase or decrease in capital and long term debts.

Examples of financing activities

- Introduction of capital by owner
- Injection of fresh capital in the running business
- Drawing or withdrawals by owner
- Bank loans (long term debt)
- Mortgage loans (long term debt)
- Discharge of or decrease in Bank loan or mortgage loan

Financing activities	
Fresh capital introduction	10,000
Drawings or withdrawals by the owner	(5000)
Bank loan taken in the year	15000
Mortgage loan taken in the year	20,000
Repayment of an old bank loan in the year	10,000
Net cash from financing activities	**50,000**

Procedure of Preparing Cash Flow

Step No.1
We begin preparing cash preparing cash flow statement from the figure of net profit or loss (taken from income statement)

Step No.2
Then, we made Adjustments for non cash items which are included in the net profit or loss such as Depreciation, Provisions, and Gains/losses on the sales of fixed assets etc. and it will give us the figure of "Operating cash flows before movements in working capital"

Step No.3
Then, we work for the working capital movements i.e. increase or decrease in items of current assets and liabilities, we will add and deducts these item (But cash will not be include in it) and will get the figure of "Cash from operating activities" after that

Step No.4
Now we have to add or subtract the investing and financing activities in "Cash from operating activities" to come across the figure of "net increase or decrease in cash and cash equivalent during the year or period"

Step No.5
Then we will, finally, add opening balance of cash and cash equivalents to "net increase or decrease in cash and cash equivalent during the year or period"

Step No.6
And that's it. We got the figure of closing balance of cash and cash equivalent

Remember that while preparing cash flow statement:

- Always add an inflow of cash and cash equivalents
- Always subtract an outflow of cash and cash equivalents

EXAMPLE

Following are the balance sheets of X.Y.Z Enterprise at the date of December 31, 2010 and December 31, 2011.

Description	31-12-2010	31-12-2011
Assets		
Current assets		
Cash (overdraft)	(100,000)	(485,000)
Debtor	450,000	500,000
Prepaid insurance expenses	100,000	50,000
Stock	400,000	650,000
Non current assets		
Machinery	100,000	250,000
Land	0	350,000
Other fixed assets	1050,000	1050,000
Accumulated depreciation expense	(75,000)	(175,000)
	1,925,000	**2,190,000**
Capital and liabilities		
Capital (opening)		
Net Profit	1,250,000	1,400,000
Drawings	200,000	275,000
Capital (closing)	(50,000)	(100,000)
	1,400,000	1,575,000
Current or short term liabilities		
Accrued rent expense		
Creditors	125,000	100,000
	400,000	515,000
	1,925,000	**2190,000**

Other information:

1) The business purchased land at the cost of $350,000
2) Machinery purchased during year costing 250,000
3) Machinery disposed or sold for 60,000. It had cost $100,000 and book value $40,000
4) Depreciation expenses on all fixed assets (including machinery) for the year 2011 was 160,000

Requirement: You are required to prepare a Cash flow statement for the year ended on 31 December 2011

SOLUTION:
X.Y.Z Enterprise
Cash flow statement
For the year ended on 31 Dec, 201

Operating activities		
Net profit of the year	275,000	
Adjustment for non-cash items		
Depreciation expenses	160,000	
Gain on the sale of machinery	(20,000)	
Operating cash flow before movement in working capital	415,000	
Increase in debtors	(50,000)	
Increase in stock or inventory	(250,000)	
Decrease in prepaid insurance expense	50,000	
Increase in creditors or accounts payable	115,000	
Decrease in accrued rent expenses	(25,000)	
Net cash from operation activities		**1,290,000**
Investing activities		
Purchase of machinery	(250,000)	
Sale or disposal of machinery	60,000	
Land brought	(350,000)	
Net cash flow from investing activities		**285,000**
Financing activities		
Drawings or withdrawals by the owner	(100,000)	
Net cash from financing activities		**(100,000)**
Net increase in cash and cash equivalent		**(385,000)**
Cash and cash equivalent at the beginning of year		**(100,000)**
Cash and cash equivalent at the end of year		**(485,000)**

Explanation:
Net profit for the year
Net profit for the year=275,000

The amount of profit made during the year. This figure is taken from 31 December 2011 Balance sheet

Depreciation expenses

Total depreciation expenses for year=$160,000

The total amount of depreciation expenses on all fixed assets. Since the depreciation expenses is a non-cash item, we have added them back to net profit figure

Gain on sale or disposal of machinery

The business disposed or sold machinery for $60,000 which had book value =40,000. Therefore, the gain on sale of machinery must be $20,000 (100,000-40,000=60,000).

Gain or loss on disposal of fixed asset = Market value of a fixed asset – Book value of a fixed asset

In this case

Gain on disposal of fixed asset = 60,000 – 40,000

Gain on disposal of fixed asset = 20,000

Gain on disposal of fixed assets is a non-cash item which is why we subtract the figure of gain from net profit in cash flow statement

Increase in debtors

Stock on 31 December, 2010 = 450,000
Stock on31 December, 2011 = 500,000

Debtors on 31 December, 2010 were 450,000 and on 31 December, 2011 they are at 500,000. Therefore, debtors have increased by 50,000 (450,000-500,000=50,000) which is an outflow of cash

Increase in stock or inventory

Stock on 31 December, 2010 = 400,000
Stock on31 December, 2011 = 650,000

Therefore, Increase in stock: 400,000-650,000 = 250,000 which indicates that business has brought goods and it is an outflow of cash

Decrease in prepaid insurance expense

Prepaid expenses on 31 December, 2010 = 100,000
Prepaid expenses on 31 December, 2011 = 50,000

Hence, decrease in prepaid expenses: 100,000-50,000 = 50,000 which signifies that the business has decreased its prepaid expenses which reduce the outflow of business cash

Increase in creditors or accounts payable

Creditors on 31 December, 2010 = 400,000
Creditor's on31 December, 2011 = 515,000

Consequently increase in creditors: 400,000-650,000= 115,000 which indicates that business is getting cash from creditors and therefore, this figure is added in the cash flow statement

Decrease in accrued rent expenses

Accrued expenses on 31 December, 2010 = 125,000
Accrued expenses on31 December, 2011 = 100,000

As a result, Increase in creditors: 125,000-100,000= 25,000 which points out that business is paying cash and therefore, this figure is subtracted in the cash flow statement

Purchase of machinery

Cash payment for the purchase of machinery =250,000

Purchase of fixed asset will definitely decrease the business cash. Thus, an outflow of cash

Sale or disposal of machinery

Cash receipt for selling machinery= 60,000

Sale of bring cash into business that's why it is an inflow of cash

Land brought

Purchase of land =350,000

Treatment of land is same as machinery because both are fixed assets

Drawings

Drawings = 100,000

Since the owner is withdrawing some cash out of business, it is an outflow of cash and outflow of cash is always considered as a subtraction in cash flow statement

Rectification of Errors - Errors not affecting Trial Balance agreement

In accounting, each and every economic event or transaction is recorded in the books of accounts. Sometimes, accountants mistakenly omit or forget to record some entries. In some other cases, accountants do record all entries. However, entries are recorded in the wrong account or accounts are being credited / debited with wrong amounts. Whatever the case might be, we have to correct these errors otherwise our financial statements will not reflect the true and fair view of business. This is what we do in "rectification of errors" i.e. correcting mistakes that we have made while passing entries in the accounts.

Errors that don't affect the agreement of a trial balance

Though, we had made some mistakes while recording entries in accounts, the debit side and credit side of a trial balance are still equal. We would discuss theses types of errors in this chapter

Rectification or correction of errors

Well, accountants do not correct errors by

- Tearing out accounts
- Crossing values or amounts of accounts
- Using chemicals or erasers / removers
- Throwing them away or burning them
- Destroying them using weapons of mass destruction

In contrary to this, accountants simply make some double or journal entries which automatically correct errors

The entry used to correct errors is referred to as **rectifying entry**

Different types of errors which don't affect the trial balance agreement

1 Error of omission
Wherein the full transaction is omitted from the books of accounts. For example sold goods to Mr. Z for $100. We neither entered this transaction in sales account nor have we entered in Mr. Z account

2 Error of commission
Kind of error where we have entered the correct amounts but in wrong person's account. For example sales of goods to Mr. A were entered in Mr. B account

3 Error of principle
This type of error takes place when an item is entered in wrong head or class of accounts. For example purchase of fixed asset is entered in expenses account or sale of fixed asset such as building is entered in sales account

4 Error of compensation
Errors that cancel the effects of each other. For example we might overstate purchases account by $20 and we can overstate sales account by $20 as well. Since we have added $20 to both debit and credit sides of trial balance, the agreement of trial balance is still intact.

5 Error of complete reversal of entries
These errors occur when we debit and credit the two or more aspects of a transaction wrongly using correct figures or amounts. For example we have received cash $500 from Mr. Z. The correct entry should be Cash=Debit and Mr. Z=Credit but we have recorded as Mr. Z=Debit and Cash=Credit. However, the trial balance appears to be balance.

6 Error of original entry
Entering wrong original figure or amount in accounts. For example, a purchase of $100 was entered as $200 in the books of accounts. A $30 sale to Mr. Z was wrongly entered as $50 in sales account and Mr. Z account

7 Error of transition
Error of transition can be defined as switching the sequence of digits of amount or figure of a transaction. For example sales amount to $123 were entered as $321. A purchase of equipment worth $72 was entered as $27 in equipment account and cash account respectively.

This is one of the most common errors and it's very hard to trace. When both debit and credit of a transaction is affected by the error of transition, trial balance's debit and credit sides would be equal

Examples of rectifying entries

Rectifying entry for errors of omission

Error: A purchase of office equipment worth $5000 was completely omitted from books by mistake

Since the purchase of office equipments was not entered in either office equipments account or cash account, we need to pass a simple double entry that can record debit and credit aspects of this transaction.

The rectifying entry should be:

DESCRIPTION	DEBIT	CREDIT
Office equipments	**$5000**	
Cash		**$5000**

Having passed this rectification entry, cash can be posted in cash book and cash account and office equipments can be entered to office equipment ledger account which means error has now been corrected

Rectifying entry for errors of commission

Error: A purchase of goods amounting to $500 from Mr. Z was entered in Mr. B account due to a mistake

In this case, we have purchased goods from Mr. Z but by mistake we have credited Mr. B account or entered the transaction in Mr. B account. To correct this mistake, we have to cancel Mr. B's account and have to credit the Mr. Z account with amount of goods purchased

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Purchases	**$500**	
Mr. B		**$500**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Purchases	**$500**	
Mr. Z		**$500**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Mr. B	**$500**	
Mr. Z		**$500**

We have debited Mr. B's account to cancel the effect of error and credited Mr. Z's account to complete the original entry. Remember that we don't have to debit the purchase account because it has already been posted correctly

Look at the effect of rectifying entry on Mr. B and Mr. Z accounts

Mr. B Account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31	Mr. Z (Error rectificaiton)	$500	Mar. 31	Purchases	$500

Mr. Z Account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
			Mar. 31	Purchases (which was entered in Mr. B's account by mistake)	$500

Rectifying entry for errors of principle

Error: A sale of building for $50,000 was entered in sales account

Building is a fixed asset that should be entered in building account and it can't be credited to sales account. Therefore, we would cancel sales account by debiting it and we would enter sale of building to building account by crediting building account.

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	**$50,000**	
Sales		**$50,000**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Cash	**$50,000**	
Machinery		**$50,000**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Sales	**$50,000**	
Machinery		**$50,000**

By debiting sales we have cancelled the effect of error and by crediting machinery we have entered the transaction in a place where it should be. No need to adjust cash since it is already in its right place i.e debit side of the cash account

Rectifying entry for errors of compensation

Error: Rent income is overstated by $100 and salary expense is overstated by $100 as well.

Since rent income usually has credit balance and salary expense has debit balance, the overstatement of rent income balance will offset the overstatement of salary account balance. Therefore, trial balance will remain balance

The rectifying entry should be:

DESCRIPTION	DEBIT	CREDIT
Rent income	**$100**	
Salary expenses		**$100**

Credit balance of rent income account and debit balance of salary expense account has been overstated by $100. To correct the error we just have to reverse the balances i. e we would debit the credit balance of rent income account and credit the debit balance of salary expense account

Rectifying entry for errors of original entry

Error: A cash sales of goods amounting to $50 was taken as $30 in the books of accounts

The original value of sales was $50 but we have entered $30 in sales and cash account. We, therefore, add another $20 in the accounts to rectify this error. This can be done by debiting cash with $20 and crediting sales account with $20 as well.

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	**$30**	
Sales		**$30**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Cash	**$50**	
Sales		**$50**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Cash	**$20**	
Sales		**$20**

Because we debited $30 in the cash account and credited $30 in sales account instead of entering $50 in each of these accounts. We have now added $20 more to cash account and sales account respectively to correct the error

Rectifying entry for errors of transition

Error: A cash sales of goods amounting to $85was taken as $58 in the books of accounts

The error and its treatment is same as "error of original entry" the only difference is error of transposition occurs because of interchanging the digits in the amount or figure. In this case, we have interchanged the position of digit 8 with the position 5 and came up with the figure of 58 which resulted in the deficiency of $27 in sales and cash account balance. We, therefore, need to correct this error by adding $27 additional to these accounts.

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	**$58**	
Sales		**$58**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Cash	**$85**	
Sales		**$85**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Cash	**$27**	
Sales		**$27**

Because there was a deficiency of $27 in cash and sales account balance, we have debited cash account by $27 and credited sales account by $27 to rectify the error

Rectifying entry for error of complete reversal of entries

Error: A cash purchases of goods for $300 was incorrectly posted in the debit side of cash account and was credited to purchase account.
This might be hard to understand. Since we have debited the credit item and credited the debit item, we first have to cancel the effect of wrong entry with original amount ($300) and then we would make the actual entry in the books of accounts which means the rectifying entry would be made with double the amount of original entry (with $600 or 2x$300)

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	**$300**	
Purchases		**$300**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Purchases	**$300**	
Cash		**$300**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Purchases	**$600**	
Cash		**$600**

We have credited $600 to purchases account which is double the original amount ($300) because $300 is needed to correct the error and another $300 is required to pass the original entry in the purchase account. This will give you the net effect of $300 Debit in the purchases account. Same goes for the cash account.

The effect of wrong entry on ledger accounts

Purchases Account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
			Mar. 31	Cash	$300

Cash Account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31	Purchases	$300			

We have passed a reverse entry with original amount ($300)

Purchases Account

DEBIT **CREDIT**

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31	Cash (Rectifying entry with original amount, error corrected but actual entry can't be entered because the account balance is ZERO)	$300	Mar. 31	Cash	$300

Cash Account

DEBIT

CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31	Purchases	$300	Mar. 31	Purchases (Rectifying entry with original amount, error corrected but actual entry can't be entered because the account balance is ZERO)	$300

Entry has successfully corrected the error but still there is no actual "purchase of good" entry in the accounts because debit $300 and credit $300 equal to Zero balances of cash and purchase accounts. Therefore, we need make a rectifying entry with double the original amount of entry ($600)

So, we would pass a reverse or rectifying entry with double the original amount (double amount=$600) which gives the balance of $300 of purchase account and $300 of cash account ($600-$300=$300 Balance)

Purchases Account

DEBIT CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31	Cash (Rectifying entry with double amount, error corrected as well as actual entry entered)	$600	Mar. 31	Cash	$300

Cash Account

DEBIT CREDIT

DATE	DESCRIPTION	AMOUNT	DATE	DESCRIPTION	AMOUNT
Mar. 31	Purchases	$300	Mar. 31	Purchases (Rectifying entry with double amount, error corrected as well as actual entry entered)	$600

Example

1) Sale of building for $30,000 was recorded in sales account

2) Goods amounting to $500 returned by Mr. A were entered in Mr.B's account mistakenly

3) Purchase of goods for $1000 was never entered in the books of accounts

4) A cash recipt of $1000 from Mr.Z was recorded as $500 in the books

5) A payment of $1000 made to Mr. Z was recorded on the debit side of the cash book and credited to Mr. Z A/C

6) The Repair of Machinery worth $200 was charged to Machinery account.

7) G Man was credited with the check received from Mr. Z. (Hint: G man and Mr. Z are Debtors)

Required: Pass some rectifying double entries to correct the errors

Solution:

1) Sale of building for $30,000 was recorded in sales account

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	**$30,000**	
Sales		**$30,000**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Cash	**$30,000**	
Building		**$30,000**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Sales	**$30,000**	
Building		**$30,000**

2) Goods amounting to $500 returned by Mr. A were entered in Mr.B's account mistakenly

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Sales return	**$500**	
Mr. B		**$500**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Sales return	**$500**	

Mr. A		$500

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Mr. B	$500	
Mr. A		$500

3) Purchase of goods for $1000 was never entered in the books of accounts

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Purchases	$1000	
Cash		$1000

4) A cash recipt of $1000 from Mr. Z was recorded as $500 in the books

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	$500	
Mr. Z		$500

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Cash	$1000	
Mr. Z		$1000

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Cash	$500	
Mr. Z		$500

5) A payment of $1000 made to Mr. Z was recorded on the debit side of the cash book and has Credited to Mr. Z account

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Cash	$1000	
Mr. Z		$1000

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Mr. Z	**$1000**	
Cash		**$1000**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Mr. Z	**$2000**	
Cash		**$2000**

6) The Repair of Machinery worth $200 was charged to Machinery account.

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Machinery	**$200**	
Cash		**$200**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Repair expenses	**$200**	
Cash		**$200**

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
Repair expenses	**$200**	
Machinery		**$200**

7) G Man was credited with the $500 check received from Mr. Z. (Hint: G man and Mr. Z are Debtors)

The wrong entry that we have made by mistake

DESCRIPTION	DEBIT	CREDIT
Bank	**$500**	
G man		**$500**

The right entry that we should have passed

DESCRIPTION	DEBIT	CREDIT
Bank	**$500**	

Mr. Z		$500

The rectifying entry that will correct the error

DESCRIPTION	DEBIT	CREDIT
G man	$500	
Mr. Z		$500

Capital and Revenue Expenditures

In this topic, we would try to distinguish capital expenditure from revenue expenditures and try to elucidate some other related terms. Differentiation between capital and revenue is necessary to come up with the true and fair financial view of an entity since capital expenditures are shown in balance sheet while revenue expenditures are presented in income statement

Capital expenditures

Amount of money spent on either buying fixed assets or improving the earning capacity of these assets

Therefore, all expenditures are capital expenditures if they are incurred in connection with:

• Purchasing a new fixed asset. **Or**

• Improving the earning capacity of existing fixed assets / Adding value to existing fixed assets

The cost of purchasing a new fixed asset includes not only the purchase price of fixed asset but also all costs necessary to bring a new fixed asset into business location and workable condition

Examples of a new fixed asset costs include:

- Purchase price of fixed asset itself
- Legal costs in the case of property, land etc.
- Cost related to delivery of fixed asset to business location
- Installation costs of fixed asset at business place
- Demolition costs necessary to remove unwanted things before the installation of a fixed asset
- Inspection and testing fees before a new fixed asset can be used
- Demurrage charges
- All non-refundable tax charges related to the new fixed asset

In addition to the cost of a new fixed asset, capital expenditure could include business money spending on adding value to existing fixed assets which would benefit business for a longer period of time such as more than a year.

Examples of costs incurred on adding value to existing fixed assets:

- Installing an additional motor in machinery to help increase its capacity
- Adding a new fuel tank to existing plant and machinery
- Putting a new engine into an existing vehicle
- Replacing interior wall of the business building

Revenue expenditures

All expenditures other than capital expenditures are referred to as revenue expenditures and they are also known as expenses

Revenue expenditures are day to day expenses of a running business that don't provide benefits for a long period of time, for example they benefit business financially for less than a year.

Revenue expenditures are incurred either on the following:

• Ordinary course of business for example selling expenses, administrative expenses, financial charges etc. **Or**

• Maintaining existing value or earning capacity of fixed assets for example repair and maintenance cost of machinery, painting the existing factory building, repair expenses of vehicle etc.

A more comprehensive Example:

Description of Expenditure	Kind of Expenditure
Purchase of Plant and machinery	**Capital Expenditure**
Repair of plant and machinery (It is done every year)	**Revenue Expenditure**
Fuel cost of plant and machinery (incurred frequently during the year)	**Revenue Expenditure**
Installing a new motor in machinery (that will be used for more than a year)	**Capital Expenditure**
Painting the walls of factory building (That is done every year)	**Revenue Expenditure**
Buying vehicles and equipment	**Capital Expenditure**
Electricity cost of plant and machinery	**Revenue Expenditure**
Site preparation for the new plant	**Capital Expenditure**
Interest on loan	**Revenue Expenditure**
Software price (Software will be used for more than a year)	**Capital Expenditure**
Software customization cost (Customized software will be used for many years)	**Capital Expenditure**
Cost of printer paper (incurred frequently during the year)	**Revenue Expenditure**
Cost of adding air conditioner	**Capital Expenditure**
Cost of acquiring copy right, patents, goodwill (Intangible assets will be used for many years)	**Capital Expenditure**

Depreciation expenses of fixed assets	**Revenue Expenditure**
Amortization expenses	**Revenue Expenditure**
Cultivation of land (Cultivated land will be used for more than a year)	**Capital Expenditure**
Expenses incurred to make the newly purchase fixed operational	**Capital Expenditure**
Initial delivery and handing cost of equipments	**Capital Expenditure**
Professional or expert fee for testing the new fixed asset	**Capital Expenditure**
Adding new headlights on delivery truck (will be used for more than a year)	**Capital Expenditure**
All non-refundable tax charges related to the new fixed asset	**Capital Expenditure**

Expenditures and financial statements

All revenue expenditures are charged to income statement while capital expenditures are shown in balance sheet

Errors regarding the classification of expenditures

We can commit the following mistakes

- We can consider revenue expenditure as capital expenditure
- We can consider capital expenditure as revenue expenditure

In either of the case, our income statement and balance sheet won't reflect the true and fair view of business entity and they would be regarded as misleading on business profitability and financial position.

Capital income and revenue income

Capital income are the proceeds from the sale of fixed assets. For example business purchased a building for $30,000 five years ago which is now being sold for $10,000. The receipt of $10,000 should be considered as capital income and it would be credited to building account.

Revenue income is referred to as ordinary sales of merchandise and the revenue which is shown in income statement. For example sale of goods, commission income, rent receivable etc.

Depreciation- Its Nature, Calculation and methods

ABC Company purchased a machine for $5000. The machine will be used for 5 years and after that it will be useless/scrape for the ABC Company with nil/zero market value. Since the machine will be used for more than one accounting period (or one year), ABC Company can't show the full $5000 as an expense in its income statement for current accounting period (or current year). Otherwise, its income statement will not present the true and fair amount of net income/loss for the accounting period and it could be considered as misleading. **Keep in mind that by definition an expense is the amount of cost which is consumed or expired during an accounting period.** The cost of machine in this example is $5000 which will be consumed

gradually in 5 years time period and at the end of 5th year the cost will be zero or fully consumed. It implies that the all ABC Company has do is to determine the amount of cost consumed during this accounting period (or this year) and the issue will get resolved, since it can show the cost of machine consumed during this year in its income statement. Let's assume the company estimate that approximate $1000 of total cost is consumed every year (or every accounting period) which means $1000 will be presented in income statement as an expense in the first year, $1000 will be in the 2nd year, $1000 in the 3rd year and so on. So, what's depreciation? The answer is $1000 which is being presented as an expense in income statement for each accounting period or year. Therefore, depreciation expense for the first year = $1000, second year = $1000, third year = $1000, fourth year=$1000 and fifth year which is the last year of vehicle's useful life =$1000

Definition of Depreciation

Depreciation expense is a portion of a fixed asset's cost (which was vehicle in the above mentioned example) which is expired/consumed/used up during an accounting period.

Why should we bother calculating the depreciation expenses?

A fixed asset has a long life and it provides business with benefits for more than one accounting period. Considering the full cost of a fixed asset as an expense for an accounting period makes a business's financial statements unreliable and misleading because incomes and expenses arising from that fixed asset should match each other (it is the matching concept of accounting). Therefore, if you ignore depreciation, net income will overstate and considering full cost of a fixed asset as an expense for just one accounting period will understate the net income. Moreover, you need to show the true value of fixed assets in the balance sheet which would not be possible without providing for depreciation. In short, depreciation expense helps financial statements of a business in reflecting true and fair view of the business's financial position and performance.

Reasons of Depreciation

Depreciation is a portion of the cost of a fixed asset which is expired or consumed during an accounting period. There are several factors which are directly or indirectly responsible for the consumption of fixed asset cost or in plain language factors that cause depreciation

Physical deterioration
With the passage of time fixed assets such as building, plant and machinery physically deteriorate and tear. Resultantly, value of fixed assets declines or their cost continually expires/consumes

Time
Sometimes, companies buy intangible assets (like copy rights, patents) for a specific period of time. Since these intangible assets have limited useful life for the business, cost of these fixed assets gradually used up or consumed with the passage of time. The cost consumed during an accounting period is reported as depreciation expense in the financial statements

Obsolescence
Obsolescence is the process of being "out of date". Some fixed asset could become out of date or old fashioned as a result of new inventions and technological advancements. Since some of the fixed assets continually obsolete and consequently, become useless for the business, their cost gradually uses up/expires/consumes which is known as depreciation

Please note that being out of date or useless for a business doesn't imply that the fixed asset can't be used. It has become useless for the business, but some people can still buy and use these fixed assets

Depletion
Natural resources such as mines, minerals and petroleum resources diminish and deplete when companies extract them. There is a point in time when these fixed assets will reduce to nothing. Therefore, their cost is constantly being consumed by the company that owns these resources

In addition to these factors, there are many more factors that are responsible for the depreciation of fixed assets such as natural calamities, inadequacy, accidents, government restrictions etc.

Important Terms

Depreciation
Depreciation is a portion of a fixed asset's cost which is expired or consumed during an accounting period.

EXAMPLE
A company purchased a building for $10,000 and it will last for 20 years. Since it will be useful for a limited time period (i.e. 20 years), its cost is being consumed/expired/used up gradually with the passage of time and after 20 years, it will reduce to nothing. Now assume that company considers 1 year as its accounting period, the specific part or portion of building's cost consumed during this accounting period must be the depreciation expense. Let's say $500 out of total building cost gets consumed every year. Therefore, depreciation for one year or one accounting period is $500

Useful life
An estimated period of time (usually more then one year) during which a fixed asset is used and depreciated by an entity or a business.

EXAMPLE
XYZ business purchased a car for $2000 which will be used by the business for 4 years. Therefore, the car's useful life is 4 years
Residual value or scrape value
The estimated amount that can be realized at the end of a fixed asset's useful life or in other words the estimated amount that can be recovered from a fixed asset at the time when it will be put out of use by the business

EXAMPLE
XYZ Company purchased furniture for $6000. Furniture will be used or last for 10 years. After 10 years, it could be sold for $500 as scrape. Therefore, $500 is the scrape or residual value of the furniture

Accumulated Depreciation
The total depreciation expenses of a fixed assets at a specific point in time. In other words, the sum of depreciation expense of an asset for the current accounting period and depreciation expenses of the same asset for the previous accounting periods are the accumulated (total) depreciation expense of that asset

EXAMPLE

XYZ Company purchased an air conditioner for $2000 on January 2011. XYZ Company charges $500 as an annual depreciation expense. Therefore, accumulated depreciation expense of the air conditioner at 31 December 2012 should be calculated as follow:

Depreciation expense for 2011 = $500
Depreciation expense for 2012 =$500

Accumulated depreciation = Depreciation for 2011 + Depreciation for 2012
Accumulated depreciation = $500 + $500
Accumulated depreciation = $1000

$1000 is the accumulated depreciation of the air conditioner at 31 December 2012

Provision for depreciation
Provision for depreciation is an alternative term for accumulated depreciation. See the accumulated depreciation for its explanation

Methods of Depreciation
As we explained before Depreciation is a portion of a fixed asset's cost which is expired or consumed during an accounting period, but how to determine what amount/portion of fixed asset's cost is consumed during an accounting period? The answer is there are a variety of methods to determine what portion of cost should be considered as depreciation. These methods are commonly known as "method of depreciation". We will discuss these methods in full detail

Book value of a fixed asset
Cost of a fixed asset minus its accumulated depreciation is the book value of that fixed asset.

Book value of a fixed asset = its cost – its accumulated depreciation

Fixed assets are presented in balance sheet at their book value

Method of depreciation

There are several methods or techniques to find out how much cost of a fixed asset is consumed during an accounting period. These methods are known as method of depreciation.

Different methods of depreciation are listed below

1. Straight line method
2. Reducing/diminishing balance method
3. Declining balance method
4. Sum of the years digit method
5. Revaluation method
6. Annuity method
7. Sinking fund method
8. Insurance policy method
9. Repair fund method
10. Units of output method
11. Machine hour rate method
12. Depreciation fund method

As you can see, there are many methods of depreciation but in practice, companies generally

use just 3 or 4 methods. The most widely used method is straight line while the least used is Insurance policy method

Why there are so many different methods of depreciation?

Not all fixed assets are same, some fixed asset are more productive in initial years but will be less productive in the later years, some fixed assets remain equal productive throughout their useful life and some other fixed assets diminish when companies use them regardless of passage of time. Therefore, using same method of depreciation for different categories of fixed assets will make our financial statement misleading and deceptive. After all, depreciation is nothing but an effort to mach expenses with revenues (This is the matching concept)

Depreciation is an expense that is presented in income statement. It implies that increase or decrease in a depreciation expense can directly affect the net income of a company. Since depreciation expenses affect net income, companies choose a specific method of depreciation to make net income increase or decrease in order to affect the income tax charges. And finally, there are many other reasons as to why different methods of depreciation are being used

Straight line method of depreciation

Straight line method is the simplest and the most popular method of depreciation. As the name of this method suggests, the depreciation expense of a fixed asset will remain same for every accounting period until the useful life of the fixed asset come to an end. In plain and simple language, if you have calculated $500 as the depreciation expense of a fixed asset for the current accounting period, $500 will be considered as a depreciation expense in the each subsequent accounting period. There will be no change in the amount of depreciation expenses

Under straight line method of depreciation, depreciation expense for an accounting period is calculated by deducting the residual value from the cost of a fixed asset and the resultant net figure is divided by the useful life of that fixed asset which is pretty much simple

Consider the following formula for the straight line method

$$Depreciation = \frac{Cost - Residual\ Value}{Useful\ Life}$$

Lets say cost of a car is = $12000 Residual value = $2000 and its useful life is 10 years.

Here is how depreciation expense of the car is calculated:

Depreciation expense = (Cost – Residual value) / Useful life

By putting values in the formula

Depreciation expense = ($12000 – $2000) / 10 years
Depreciation expense = (10,000) / 10
Depreciation expense = 10,000/ 10
Depreciation expense = 1000 or 1000 dollars

Therefore,

Depreciation expense for the 1st year or accounting period = $1000

Depreciation expense for the 2nd year or accounting period = $1000

Depreciation expense for the 3rd year or accounting period = $1000

Depreciation expense for the 4th year or accounting period = $1000

Depreciation expense for the 5th year or accounting period = $1000

Depreciation expense for the 6th year or accounting period = $1000

Depreciation expense for the 7th year or accounting period = $1000

Depreciation expense for the 8th year or accounting period = $1000

Depreciation expense for the 9th year or accounting period = $1000

Depreciation expense for the 10th year or accounting period = $1000

Did you notice that depreciation expense i.e. $1000 remained same throughout the car's useful life?

Example No. 1

XYZ Company purchased a machine on January 2012 at the total cost of $6000. The machine was estimated to have a useful life of 5 years and it will have a residual value of approximately $1000.

In straight line method, annual depreciation expense can be calculated by deducting residual value ($1000) from the total machine cost ($6000) and dividing the resultant figure by the useful life (5 years) of the car

Annual Depreciation expense = (Cost – Residual value) / Useful life
Annual depreciation expense = ($6000 – $1000) / 5 years
Annual depreciation expense = $5000 / 5 years
Annual depreciation expense = $1000

Therefore, depreciation expense for one year or annual depreciation expense is $1000

Following table demonstrates the depreciation expenses over entire useful of the machine

Years	Calculation of Depreciation	Depreciation Expenses	Accumulated Depreciation*	Book value of the Asset*
Purchase				$6000
1st year	($6000 – $1000) / 5	$1000	$1000	$5000

	years=$1000			
2nd year	($6000 – $1000) / 5 years=$1000	$1000	$2000	$4000
3rd year	($6000 – $1000) / 5 years=$1000	$1000	$3000	$3000
4th year	($6000 – $1000) / 5 years=$1000	$1000	$4000	$2000
5th year	($6000 – $1000) / 5 years=$1000	$1000	$5000	$1000

*Accumulated depreciation = The total or accumulated amount of depreciation expenses at a point in time
*Book value = Cost the asset - Accumulated depreciation expenses
*Depreciable amount = Cost the asset - Residual value the asset

Example No.2

ABC Company purchased a building costing $12,000 on January 2012. The building useful life was estimated to be 10 years with residual value of $2000.

Required: Calculated amount of building depreciation expense using straight line method of depreciation for the year ended on 31 December, 2012?

Solution:

Formula of straight line method for calculating depreciation for an accounting period

Depreciation expense = (Cost – Residual value) / Useful life

Values that will be used in the calculation of depreciation

Building cost = $12000
Building Useful life = 10 years
Building residual value = $2000

By substituting values in the formula of straight line method

Depreciation expense = (12000 – 2000) / 10
Depreciation expense = 10,000 / 10
Depreciation expense = 1000

Hence, **$1000** is the **depreciation expense** for the year ended on 31 December, 2012
Reducing/diminishing balance method

The second most popular method of depreciation. This method is generally applied on certain

fixed assets that are more productive or useful initially and with the passage of time or with constant use their usefulness decrease

The calculating of depreciation expenses in this method is not that difficult. Under this method, a certain percentage of a fixed asset's book value is considered as depreciation expense for an accounting period. For example if a car has a book value = $5000 and depreciation is to be charged at 20%, the depreciation expenses should be 5000 X 20% = 1000. Therefore, depreciation expenses is $1000 for the current accounting period

Consider the following formula for Reducing/diminishing balance method

$$R = \sqrt[n]{\frac{S}{C}}$$

For example cost of a car is = $12000, Residual value = $4901 and its useful life is 5 years

Here is the calculating of depreciation

First of all, we have to calculated the rate of depreciation or percentage of the car's book value that should be considered as depreciation expense

Formula

$$R = \sqrt[n]{\frac{S}{C}}$$

Values

n = Number of years = 5 years

S = Scrape value/Salvage value/Residual value = $4901

C= Cos the fixed asset/car = $12000

R = Rate of depreciation expense = ?

By putting values in the formula

r = 1- (4901/12000)^1/5
r = 1- (0.41)^1/5
r = 1- 0.836

r = 0.164 or we can say 16.4%

Therefore, **rate of depreciation is 16.4%** or 16.4% of the car's book value should be regarded as depreciation expense in every accounting period

Following table shows the depreciation expenses over entire useful of the car

Years	Calculation of Depreciation	Depreciation Expenses	Accumulated Depreciation	Book value of the Asset
Purchase				$12000
1st year	$12000 X 16.4%=$1968	$1968	$1968	$10032
2nd year	$10032 X 16.4%=$1645	$1645	$3613	$8387
3rd year	$8387 X 16.4%=$1375	$1375	$4988	$7012
4th year	$7012 X 16.4%= $1150	$1150	$6138	$5862
5th year	$5862 X 16.4%=$961	$961	$7099	$4901

*Accumulated depreciation = The total or accumulated amount of depreciation expenses at a point in time
*Book value = Cost the asset - Accumulated depreciation expenses
*Depreciable amount = Cost the asset - Residual value the asset

EXAMPLE

XYZ Company purchased a truck costing $5000 on January 2012. The truck's useful life was estimated to be 5 years with residual value of $1000.

Required: Calculated the amount of truck's depreciation expense using reducing balance method of depreciation for the first 3 years

Solution

First of all, we need the rate of depreciation for the computation of depreciation expense.

Formula for depreciation rate:

$$R = \sqrt[n]{\frac{S}{C}}$$

Where,

n = Useful life = 5 years
S = residual value = $1000
C = Cost = $5000
r = Rate of depreciation =?

By putting these values in the formula

r = 1- (1000/5000)^1/5
r = 1- 0.2^1/5
r = 1- 0.725
r = 0.275 or 27.5% approximately

Depreciation for the first year

Book value = Cost – Accumulated depreciation

By putting values

Book value = $5000 – 0
Book value = $5000

Depreciation expense = Book value X Rate of depreciation

By putting values

Depreciation expense = $5000 X 27.5%

Depreciation expense = 1375

Depreciation for the 2nd year

Book value = Cost – Accumulated depreciation

By putting values

Book value = $5000 – 1375
Book value = $3625

Depreciation expense = Book value X Rate of depreciation

By putting values

Depreciation expense = $3625 X 27.5%

Depreciation expense = $997

Depreciation for the 3rd year

Book value = Cost – Accumulated depreciation

By putting values

Book value = $5000 – 2372

Book value = $2628

Depreciation expense = Book value X Rate of depreciation

By putting values

Depreciation expense = $2628 X 27.5%
Depreciation expense = 723

Declining balance method

Declining balance method of depreciation is similar to reducing balance method but there is a slight difference between these two methods of depreciation. In declining balance method, we use a fixed predetermined rate which is not directly applied on the book value of a fixed asset rather than it's first applied on straight line rate of depreciation and the resultant rate of depreciation is used to calculate depreciation expense

There are two versions of decline balance method

150% declining balance method of depreciation which is commonly known as Declining balance method
200% declining balance method of depreciation which is called double declining balance method

Consider the example of double declining blance method to help grasp the concept. XYZ Company purchased a machine for $9000. Machine's useful life = 5 years and residual value = $1000

To calculate depreciation expense under double declining balance method, follow these steps

Step one
Calculate the straight line rate of depreciation which in this case is "20%" (1/5=0.2 or 20%)

Step two
Double the straight line rate of depreciation or make it 200%. Therefore, the rate should be "40%" (20% X 2=40%)

Step Three
Apply the doubled straight line rate of depreciation (40%) on the book value of the fixed asset and you should be done, you would get the depreciation expense for an accounting period.

Book value of the machine in the first year is $9000. Therefore, its depreciation should be: "3600" (9000 X 40% =3600)

Following table shows the depreciation expense for each year

Years	Calculation of Depreciation	Depreciation Expenses	Accumulated Depreciation	Book value of the Asset
Purchase				$9000
1st year	$9000 X 40%=3600	$3600	$3600	$5400
2nd year	$5400 X 40%=2160	2160	5760	$3240
3rd year	$3240 X 40%=1296	$1296	$7056	$1944
4th year	$1944 X40%=778	$778	$7834	$1166
5th year	$1166 X 40%=~~466~~ ****166**	$166	$8000	$1000

*Accumulated depreciation = The total or accumulated amount of depreciation expenses at a point in time
*Book value = Cost the asset - Accumulated depreciation expenses
*Depreciable amount = Cost the asset - Residual value the asset

**Note that the estimated residual value of the machine was $1000 and the depreciaton expense for the last year in accordance with the declining balance method should be $466 which gives 1000-466=534 residual value (less than the estimated residual value). Therefore, we are not counting 466 and 1166-1000=166 should be regarded as the depreciation expense for the last year of machine useful life in order to justify the estimated residual value ($1000)

Sum of the years digit method of depreciation

Also known as SYD, another method of depreciation which gives higher depreciation expense in the early life of an asset and lower depreciation afterward. In this method, depreciation rate is shown as a fraction. The fraction gets smaller each accounting period and this is the reason why depreciation expense constantly decreases with the passage of time. To calculated depreciation expense for a given accounting period, you just need to apply this fraction on depreciable amount (Depreciable amount = Cost – Residual value) of the fixed asset

Example:

XYZ Company purchased a vehicle for $6000. The vehicle will be used for 5 years and $1000 was estimated as its residual value

To calculate depreciation expenses follow these steps:

Step one
Calculate the depreciable amount of the fixed asset

Depreciable amount = Cost – Residual value

In the current example,
Cost = $6000
Residual value = $100

By putting values in the formula

Depreciable amount = 6000 – 1000
Depreciable amount = 5000

Hence, the depreciable amount is equal to $5000. This is the amount that will be depreciated over the useful life of that vehicle

Step Two
Calculate the “sum of the digits fraction” (which is a kind of depreciation rate)

At the time of purchase, the vehicle’s useful life is = 5 years
At the beginning of 2nd year, the vehicle’s useful life is = 4 years
At the beginning of 3rd year, the vehicle’s useful life is = 3 years
At the beginning of 4th year, the vehicle’s useful life is = 2 years
At the beginning of 5th year, the vehicle’s useful life is = 1 years

Now sum these digits 5 years+4 years+3 years+2 years+1 year = 15 years (or 15)

Finally, the "sum of the digits fractions" for each year

Sum of the digits fraction for the 1st year = 5/15
Sum of the digits fraction for the 2nd year = 4/15
Sum of the digits fraction for the 3rd year = 3/15
Sum of the digits fraction for the 4th year = 2/15
Sum of the digits fraction for the 5th year = 1/15

These fractions are applied on the depreciable amount to calculated the depreciation expense for each year or accounting period as the following table shows

Years	Calculation of Depreciation	Depreciation Expenses	Accumulated Depreciation	Book value of the Asset
Purchase				$6000
1st year	$5000 X 5/15	$1667	$1667	$4333
2nd year	$5000 X 4/15	$1334	$3001	$2999
3rd year	$5000 X 3/15	$1000	$4001	$1999
4th year	$5000 X 2/15	$667	$4668	$1332
5th year	$5000 X 1/15	$334	Approx. $5000	Approx. $1000

*Accumulated depreciation = The total or accumulated amount of depreciation expenses at a point in time
*Book value = Cost the asset - Accumulated depreciation expenses
*Depreciable amount = Cost the asset - Residual value the asset

Units of output method

Units of output method is used on specific types of fixed assets or companies consider at times that units of output method is more appropriate for calculating depreciation expenses of the fixed assets

The method is fairly simple. In this method of depreciation, depreciation expense for an accounting period is calculated on the basis of number of units/products a machine (or a fixed asset) produces in an accounting period

Formula

$$\text{Depreciation} = \frac{\text{Cost} - \text{Residual Value}}{\text{Total Expected Units}} \times \text{Current Accounting period Units}$$

Example

The cost of a machine purchased by ABC Company was $6000. It was estimated that the machine will have a $1000 residual value and it will last for 5 years. The machine total expected production was estimated at 500 units during its useful life time. However, during the first year of operation, it produced 100 units of output. Calculate the depreciation expense for the first year

Cost of the machine = $5000
Residual value = $100
Useful life = 5 years
Total expected units = 500 units
Current years or accounting period units=100 units

Formula

$$\text{Depreciation} = \frac{\text{Cost} - \text{Residual Value}}{\text{Total Expected Units}} \times \text{Current Accounting period Units}$$

By putting values in the formula

Depreciation = ($6000-$1000)/500 units X 100 units

Depreciation = 5000/500 X 100

Depreciation = 10 X 100

Depreciation = $1000

Hence, $1000 is the depreciation expense of the machine for the first year

Now, let's assume in the 2nd year, the machine produced 150 units. We are now required to calculate the depreciation expense for the 2nd year

Following are the values that we need to calculate depreciation expense. You might have noticed that all values are same except the one which is the **current year or accounting units**

Cost of the machine = $5000
Residual value = $100
Useful life = 5 years
Total expected units = 500 units
Current years or accounting period units=150 units

Formula

$$Depreciation = \frac{Cost - Residual\ Value}{Total\ Expected\ Units} \times Current\ Accounting\ period\ Units$$

By putting values in the formula

Depreciation = ($6000-$1000)/500 units X 150 units

Depreciation = 5000/500 X 150

Depreciation = 10 X 150

Depreciation = $1500

Hence, $1500 is the depreciation expense of the machine for the 2nd year

Land and Depreciation

By now, you should be well aware of depreciation and its calculating. As we mentioned in the begging of this topic that depreciation is the part of fixed asset's cost that is decreased/consumed/expired during an accounting period. Now assume that a fixed asset has an unlimited or endless life. Since that fixed asset has an unlimited life, its cost/value does not expire/consume rather its cost remain same even after 10 or 20 years. Moreover, in some cases we can sell that fixed asset at any time in future and most probable it will be sold for a price higher than the price we had paid at the time of buying it. So, what does this mean? It implies that the fixed asset value is still the same as it was before (or in some cases its values could be higher). If a fixed asset value remains same or even increase because it has an unlimited useful life, then how can we charge depreciation on it? Land is that type of fixed asset, it has an unlimited useful life and hence its value doesn't decrease. Therefore, it is inappropriate to charge depreciation expense on land (freehold land)

On the other hand, if the useful life of land is limited or determinable, then land needs to be depreciated. In theses circumstances, a portion of land's cost should be recognized as depreciation expense each year or accounting period since the land will be put out of use and its cost will expire or use up to its residual value

To sum up, if the useful life of land is limited or determinable, Depreciation expense of land should be calculated. As opposed to this, if the useful life of land is infinite/unlimited/indeterminable, depreciation should not be provided for land

Generally land is not depreciable. However, land can be depreciated under the following conditions

- Land at the sea-shore will be occupied by sea because of increasing water level in the sea
- Land will be taken by government (nationalization) in future
- Land will be destroyed because of river changing its direction
- There is a legal restriction on its future use
- Land sliding when land is located at a mountains area
Accounts of Non-Profit Organizations

Non-profit organization

Also known as NPO, not-for-profit organization, non-commercial organization, nonprofit etc.

Non-profit organizations are those organizations that are not meant for making profit or their main purpose is not to make profit, but they exist for the welfare of their members and/or general public

It is inappropriate to prepare income statement for a non-profit organization since non-profit organizations don't exist to make profit. Therefore, non-profit organizations prepare income and expenditure account as a substitute of income statement

The amount of total Revenues greater than the amount the total expenses of a non-profit organization is referred to as surplus (not net profit). Surplus is not distributed among the members of non-profit organization rather than it is kept for growth and expansion of the organization, for example non-profit organizations use surplus to buy fixed assets such as building for the club, land, equipments etc.

Examples of non-profit organizations

Charitable organizations such as Human rights groups, animal right organizations, Hospitals, health care clinics, Emergency relief services such as Red Cross, charitable schools / colleges etc.

Professional Associations and Trade Associations such as chamber of commerce, Association on American Indian Affairs, American Lung Association, Association for Firefighters and Paramedics, Teacher's Retirement fund Associations etc.

Religious organizations for example churches, mosques, Islamic International Foundation of Cooperation (IslamIFC)

Welfare organizations and clubs such as Calgary women's emergency shelter, Institute of Field Research Expeditions, sports club, social clubs etc.

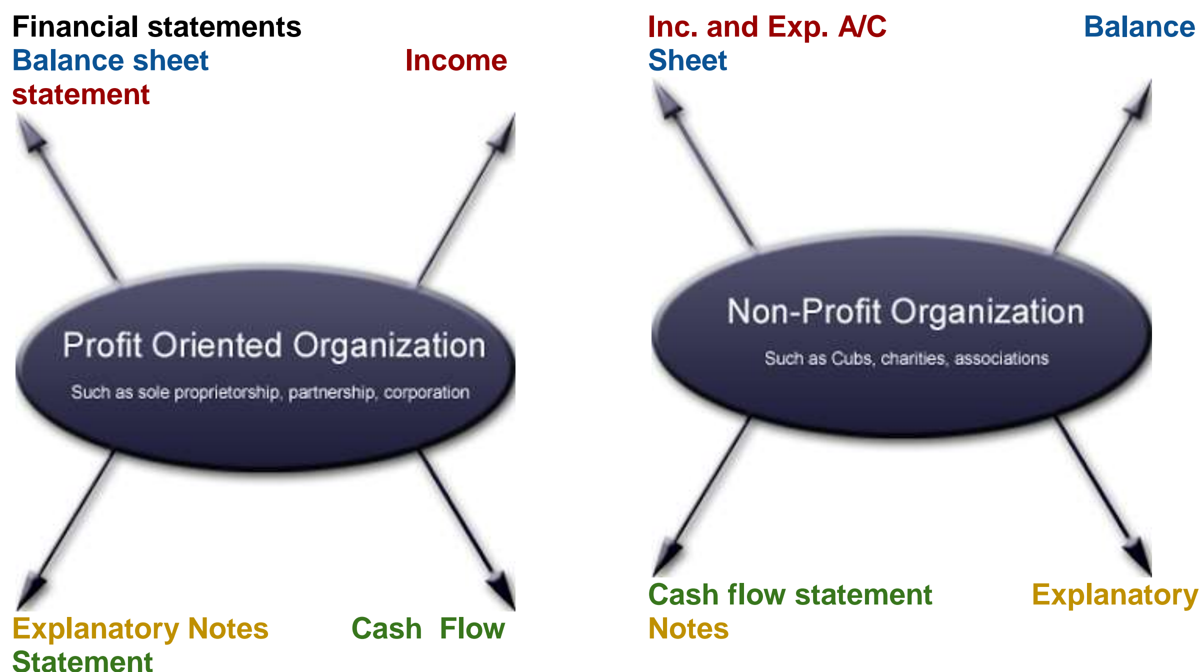
Scientific groups such as general research groups, cancer research groups, chemistry research groups etc.

Difference between non-profit organizations and profit oriented organizations

Characteristics Profit-Oriented Organizations	Non-Profit Organizations
Main purpose is to make profit	Main purpose is Not to make profit
Sole proprietorship: Owned by a single owner Partnership: Owned by partners Company: Owned by the shareholders	No one owns a non-profit organization
Profit is distributed to shareholders or owner(s)	Not distributed but kept for growth and expansion of the organization
Main revenue source = Rendering services or selling goods	Main revenue source = Membership subscription
Tax is generally charged on net income	Tax Exemption in many countries

Terminology Profit-Oriented Organizations	Non-Profit Organizations
Income Statement or Profit and Loss Account	Income and Expenditure Account
Net profit or Net income	Surplus
Net Loss	Deficit
Capital, Owner's Equity or Shareholders'	Accumulated Fund

Equity	
Capital + Liabilities = Assets	Accumulated Fund + Liabilities = Assets



X.Y.Z Golf Club
Receipts and payments Account
For the year ended on 31 Dec, 2012

RECEIPTS	AMOUNT	PAYMENTS	AMOUNT
Balance b/d (or Balance at 1.1.2012) Donations received Loan from bank Profit on investment Subscription received Rent received Legacies Entrance fee	$15000 $2000 $1000 $10,000 $1000 $4000 $2000 $2000	Salaries paid Rent and rates expenses Stationery and postage expenses Legal expenses Groundsman wages Interest on bank loan Utility expenses paid Secretary Honorarium Sports material purchased Balance c/d (Balance at 31.12.2012)	$3000 $1000 $1000 $1000 $2000 $1000 $1000 $3000 $2000 $17000
TOTAL	$37000	**TOTAL**	$37000

Receipt and payments account

Receipts and payments account is maintained by small charities and clubs in order to keep the record of cash paid and received during an accounting period. Cash receipts are recorded on

the debit side and cash paid recorded on credit side of a receipts and payments account.

As long as the cash is received or paid during an accounting period it appears in cash receipts and payments account despite the fact that receipts and payments of cash are related to previous, current or subsequent accounting period.

Receipts and payment account is different from a cash book mainly because it records cash payments and cash receipts at the end of an accounting period with less details, whereas a cashbook record cash related transactions as soon as they occur with more details

Balance of receipt and payment account is not used to produce a balance sheet

Things you should know about a receipts and payment account

1. Receipts and payments account is used to record all cash related transactions of a non-profit organization
2. Receipt and payments account is prepared at the end of an accounting period
3. Receipts and payments account is a summary of cashbook
4. Receipts and payments account is NOT a book of original entries (such as cash book)
5. Receipt and payments account is generally prepared by non-profit organizations NOT by all types of organizations
6. It is not compulsory for a non-profit organization to produce a receipts and payments account

Difference between a receipts and payments account and a cashbook

A receipts and payments account looks like a cash book but there is a slight difference between a cash book and receipts & payments account. A receipts and payments account shows cash receipts and payments during an accounting period. A receipts and payments account is the summary of cash book, that means it doesn't show the bank account and cash related transactions separately nor does it contain discount column. Moreover, receipts and payments account is not used to prepared a balance sheet

A Few major points of difference

Accounting timing
A receipts and payments account is prepared at the end of an accounting period. Whereas transactions are entered in a cash book frequently during the accounting period

Nature of entities
A receipts and payments account is prepared by a non-profit organization only. However, cash book is prepared by all types of organizations

Nature of Books
Cash book is the book of original entries while receipts and payment account is not a book of original entries and it’s not compulsory for an entity to prepare a receipts and payment account

Revenue sources for non-profit organizations

There are several sources of revenue for a non-profit organization such as donations, annual subscription, member entrance fee, profit on sale of old fixed asset at scrape value etc.

Although non-profit organizations don't exist to make profit, they incur expenses on the provision of services or goods to their members or general public. Therefore, in order to cover these expenses, non-profit organizations need some sources of revenue

Sources of revenue vary from one non-profit organization to another. However, the most common sources of revenue are listed below:

Donations

Some people would like to donate money or goods to non-profit organizations (such as a charitable school) to help continue their operations

There are two types of donations: General donations and specific donations

1. Specific donations
Specific donations are donations for a specific purpose

For example, Mr. X donated $50,000 to a charitable school in order to help school in buying new furniture. In this case, helping school to buy new furniture is the specific purpose of donation

2. General donations
Donations without a specific purpose are general donations. Such donations can be used by non-profit organizations for any purpose

Both specific and general Donations received during an accounting period are generally considered as income/revenue for that accounting period and they are shown in an income and expenditure account

Entry fees

When a new member gets admission in a non-profit organization, the non-profit organization may require him/her to pay a certain amount of fee in order to be a member of non-profit organization

Fee received in an accounting period is generally considered as revenue/income for that accounting period. Therefore, it is reported in an income and expenditure account

Profit on sale or disposal of old fixed assets

Profit on the sale of a fixed asset is considered as revenue of a non-profit organization and thereby, it is shown in an income and expenditure account for the accounting period in which fixed asset disposal was carried out

Profit on sale of fixed asset = Market value of a fixed asset – Book value of a fixed asset

For example, A vehicle has a book value of $1000 was sold for $500, therefore, profit on sale of vehicle should be $1000-$500=$500 or $500 is the profit on disposal of vehicle

Membership annual subscription

To be a non-profit organization's member, you need to pay a specific fee to the non-profit organization. The fee is known as membership subscription and it is generally payable annually. Because the membership subscription is received for one year, it is treated as the revenue of a non-profit organization

For example, Mr. X needs to pay $500 per year in order to remain a member of a sports club (a non-profit organization). Being a member of a sports club, Mr. X can use sports ground and sports equipments

Income and expenditure account is based on accrual concept of accounting. Therefore, subscription that is not related to current accounting period won't get counted. In other words only earned subscription is recorded in an income and expenditure account

Let's assume the current accounting period is 2015. Cash received as subscription during this accounting period totaling $3000. The amount $1500 out of $3000 received during 2015 was actually the subscription of previous year 2014 and $500 received in advance as the subscription of upcoming year 2016. Thereby, the remaining $1000 should be the subscription of current year or 2015.

Interest received on investments

A non-profit organization might have invested its surplus cash in different companies bonds, debentures, treasury bonds etc. Therefore, non-profit organization receives a certain amount of interest at a regular interval. The amount of interest is generally considered as the revenue of a non-profit organization and interest is shown in the income and expenditure account for the year in which it is received

Profit from bar trading

Some clubs and other non-profit organizations have a bar and/or a cafeteria. Bar and cafeteria sells its drinks, snacks or food to the members of club. The profit on these sales or trading activities is generally considered as the revenue of non-profit organization and therefore profit or loss on bar trading is shown in income and expenditure account for the year (or accounting period) during which bar tradings take place

Some non-profit organizations prepare a separate account for a bar known as bar trading account. A bar trading account includes the following:

- Bar sales or takings
- Opening stock, purchases and closing stock
- Gross profit
- Operating expenses and other expenses
- And finally the net profit or loss

As you can see a bar trading accounting is nothing but an income statement or profit and loss account of a bar. The net income or net profit shown on a bar trading account is a revenue while the net loss is an expense of a non-profit organization

Life membership subscription

Some non-profit organizations may offer their members the facility to pay a single amount of subscription for their full life membership. Therefore, the member that has paid the life membership subscription will never have to pay annual subscription

Such subscriptions are inappropriate to be considered as revenue completely but a portion of the life membership subscription can be shown in the income and expenditure account as a revenue for an accounting period

Since life membership can't be considered as revenue for just one accounting period, it is recorded in an account known as life membership account. The double entry to record life membership at the time of its receipt is:

DESCRIPTION	DEBIT	CREDIT
Cash	**XXXX**	
Life membership fund		**XXXX**

Narration: life membership subscription received

Life membership account is shown in the balance sheet immediately after the accumulated fund

From the life membership fund account a fair amount is taken out as the revenue for an accounting period and shown in the income and expenditure account

Legacy

Legacy is the property or money received by the non-profit organization as stated by the will of a deceased person. For example, Mr. Z declared in his will to donate his house and car to a non-profit organization.

Common expenditures of non-profit organizations

- Rent expenses
- wages and salaries expenses
- Printing and stationery expenses
- Depreciation on fixed assets
- Traveling expenses
- Interest on bank loan
- Canteen miscellaneous expenses
- Heat and light expenses
- Telephone expenses
- Meeting expenses
- Honorarium etc.

Honorarium

Honorarium is a payment to a person for his/her services that are generally supposed to be performed voluntarily. In other words, an honorarium is a payment to a person for his/her services which are customarily not required any fee or money to be paid. For example, a person (an outsider) got paid $500 (honorarium) for giving a good lecture to the students of a non-profit college

Income and expenditure account

It is an income statement of a non-profit organization. All revenues (or incomes) and expenditure (or expenses) of a non-profit organization are shown in the income and expenditure account.

Income and expenditure account is based on the accrual concept of accounting which means only earned incomes and incurred expenses will be recorded in the income and expenditure account not all incomes and expenses. For example, a non-profit organization receives $500 as subscription from a member but that $500 includes $300 subscription for the next year. Since the member has not yet received the services for $300 or in other words the non-profit organization has not earned this $300, the non-profit organization can't show full $500 as revenue in the income and expenditure account for the current accounting period or year. The same goes for expenses, if a non-profit organization pays telephone charges in advance but hasn't used the telephone service until the end of accounting period, the non-profit organization can't show telephone expenses in income and expenditure account for the current accounting period (e.g. a year)

ABC Sports Club
Income and Expenditure Account
For the year ended on 31 Dec, 2012

EXPENDITURES	AMOUNT	INCOMES	AMOUNT
Building rent expense	$5000	Subscription	$25,000
Groundsman wage	$3000	Entrance fee	$7000
Printing and stationery expenses	$1000	Donations	$5000
Depreciation on building	$2000	Net income from canteen trading	$6000
Depreciation on equipment	$1000	Tournament fees and charges	$5000
Salaries	$5000	Interest income on deposits	$2000
Traveling expenses	$1000	Profit on investments	$1000
Tournament general expenses	$1000	Sundry income	$2000
Tournament prizes	$7000	Profit on sale of fixed assets	$7000
Brochure expenses	$1000	Rent income	$3000
Depreciation on furniture	$2000	Profit Sale of instruction manuals	$1000
Interest on bank loan	$1000	Green fees	$3000
Canteen miscellaneous expenses	$1000		
Heat and light expenses	$2000		
Telephone expenses	$1000		
Upkeep of play ground	$3000		
Meeting expenses	$1000		
Honorarium	$2000		
Surplus	**27,000**		
TOTAL	$67,000	**TOTAL**	$67,000

Balance sheet of non-profit organizations and accumulated fund

Balance sheet is a statement that lists down the detail of Assets, liabilities and capital. Balance

sheet represents the financial position of an entity at a point in time

Balance sheet of non-profit organizations is slightly different, yet it is pretty much similar to other organizations such as companies, partnerships and other profit oriented entities.

Balance sheet is based on accounting equation that is **Capital + liabilities = Assets**. As you can see there are two parts of this equation the first one is **capital + liabilities** and second one is **Assets**. Therefore, there are two sides or parts of a balance sheet one is **capital+ liabilities side** and other is **assets side**, both sides need to be equal

Accounting equation of a profit oriented organization or a business is:

Capital + Liabilities = Assets

While accounting equation of a non-profit organization is:

Accumulated fund + liabilities = Assets

Note that accounting equation of a non-profit organization is almost same as accounting equation of profit oriented organizations or businesses except THE ACCUMULATED FUND PART. Accumulated fund is the capital of non-profit organizations. Non-profit organizations use the term accumulated fund in spite of capital because it is more appropriate to use the term accumulated fund than capital, since these organizations exist not to make profit and no one owns them

XYZ Friends Club
Balance sheet
As on 31 Dec, 2012

ASSETS	AMOUNT		ACC. FUND + LIABILITIES	AMOUNT	
Current Assets			**Accumulated fund**		
Cash in hand		$10,000	Opening accumulated fund	$50,000	
Cash at bank		$15,000	Add: Surplus for the year	$20,000	
Subscriptions receivable		$25000	Closing accumulated fund		$70,000
Bar Stock		$2000	**Short term liabilities**		
Prepaid rent expenses		$1000	Subscriptions in advance		$10,000
Intangible Assets			Creditors		$5000
Goodwill	$10,000		Interest expenses payable		$2000
Less: Acc. Amortization	$5000	$5000	Building rend payable		$5000
Fixed Assets			**Long term liabilities**		
Land		$20,000	Bank loan		$7000
Building	$15,000		Mortgage loan		$10,000
Less: Acc. depreciation	$10,000	$5000			
Cars and other vehicles	$20,000				
Less: Acc. depreciation	$10,000	$10,000			
Sports equipment	$5000				
Less: Acc. depreciation	$2000	$3000			
Long term investments					
Investment in mutual fund		$5000			
investment in Govt.		$8000			

securities					
TOTAL	$109,000		**TOTAL**	$109,000	

Example 1. A simple Income and Expenditure account

Following is a receipts and payments account of XYZ Golf club for the year ended on 31 December, 2012

X.Y.Z Golf Club
Receipts and payments Account
For the year ended on 31 Dec, 2012

RECEIPTS	AMOUNT	PAYMENTS	AMOUNT
Balance b/d (or Balance at 1.1.2012)	$5	Salaries paid	$2
Donations received	$2	Grounds man wage	$2
Profit on investment	$2	Rent and rates expenses	$2
Subscription received	$5	Stationery and postage expenses	$3
Entrance fee	$3	Utility expenses paid	$1
		Balance c/d (Balance at 31.12.2012)	$7
TOTAL	$17	**TOTAL**	$17

Assumption: Incomes received and expenses paid during the year 2012 were earned and incurred in that accounting period

Required: Prepare an income and expenses account for the year ended on 31 December, 2012

Solution:

X.Y.Z Golf Club
Income and Expenditure Account
For the year ended on 31 Dec, 2012

EXPENDITURES	AMOUNT	INCOMES	AMOUNT
Salaries expenses	$2	Donations	$2
Grounds man wage	$2	Profit on investment	$2
Rent and rates expenses	$2	Subscriptions	$5
Stationery and postage expenses	$3	Entrance fee	$3
Utility expenses paid	$1		

Surplus (Note 1)	$2		
TOTAL	$12	**TOTAL**	$12

Note 1

Surplus = Total incomes - Total expenditures

Surplus = (Donations + Profit on investment + Subscriptions+ Entrance fee) **-** (Salaries expenses + Groundsman wage + Rent and rates expenses + Stationery and postage expenses + Utility expenses paid)

Surplus = ($2 + $2+ $5 + $3) **-** ($2+$2+$2+$3+$1)

Surplus = ($12) **-** ($10)

Surplus = $12 **-** $10

Surplus = $2

Example 2. Income and Expenditure account with Adjustments

Following is a receipts and payments account of X.Y.Z Golf club for the year ended on 31 December, 2012

X.Y.Z Golf Club

Receipts and payments Account

For the year ended on 31 Dec, 2012

RECEIPTS	AMOUNT	PAYMENTS	AMOUNT
Balance b/d (or Balance at 1.1.2012)	$5	Salaries paid	$2
Donations received	$2	Groundsman wage	$2
Profit on investment	$2	Rent and rates expenses	$2
Subscription received	$7	Stationery and postage expenses	$3
Entrance fee	$3	Utility expenses paid	$1
		Balance c/d (Balance at 31.12.2012)	$9
TOTAL	$19	**TOTAL**	$19

Additional information: Total Subscription received was $7, out of which 1$ related to the previous year and $2 were received in advance for the next year or 2013

Required: Prepare an income and expenses account for the year ended on 31 December, 2012

Solution:

X.Y.Z Golf Club
Income and Expenditure Account
For the year ended on 31 Dec, 2012

EXPENDITURES	AMOUNT	INCOMES	AMOUNT
Salaries expenses	$2	Donations	$2
Groundsman wage	$2	Profit on investment	$2
Rent and rates expenses	$2	Subscriptions (Note 1)	$4
Stationery and postage expenses	$3	Entrance fee	$3
Utility expenses paid	$1		
Surplus (Note 1)	$1		
TOTAL	$11	**TOTAL**	$11

Note 1
Only the portion of total subscriptions that is earned during the current year or 2012 will be recorded in the Income and Expenditure Account

Total subscription received during the current year = $7

Subscription related to the previous year = $1
Subscription related to the next year = $2

Therefore, subscription amounting to $4 is related to the current year or 2012

Example 3. Income and expenditure account and Balance sheet

Following is a receipts and payments account of X.Y.Z Golf club for the year ended on 31 December, 2012

X.Y.Z Golf Club
Receipts and payments Account
For the year ended on 31 Dec, 2012

RECEIPTS	AMOUNT	PAYMENTS	AMOUNT
Balance b/d (or Balance at 1.1.2012)	$5	Salaries paid	$2
Donations received	$2	Groundsman wage	$2
Profit on investment	$2	Rent and rates expenses	$2
Subscription received	$7	Stationery and postage expenses	$3
Entrance fee	$3	Utility expenses paid	$1
Bank loan	$10	Payments to creditors	$3
		Balance c/d (Balance at 31.12.2012)	$16
TOTAL	$29	**TOTAL**	$29

Additional information: Total Subscription received was $7, out of which 1$ related to the previous year and $2 were received in advance for the next year or 2013

Assets, liabilities and accumulated fund of X.Y.Z Golf club at 1st January, 2012 were as follows:

- Building (at cost) = $10
- Land = $2
- Investment = $3
- Cash at Bank = $5
- Creditors = $9
- Subscription receivable = $1
- Accumulation fund = $10

Depreciation on building is chargeable at the rate of **10% per year**. Note that accumulated depreciation on building was $1 at 1st January, 2012

Required: Prepare an income and expenses account and a balance sheet as on 31 December, 2012

Solution:

X.Y.Z Golf Club

Income and Expenditure Account
For the year ended on 31 Dec, 2012

EXPENDITURES	AMOUNT	INCOMES	AMOUNT
Salaries expenses	$2	Donations	$2
Groundsman wage	$2	Profit on investment	$2
Rent and rates expenses	$2	Subscriptions	$4
Stationery and postage expenses	$3	Entrance fee	$3
Utility expenses paid	$1		
Surplus (1)	$1		
TOTAL	$11	**TOTAL**	$11

XYZ Friends Club
Balance sheet
As on 31 Dec, 2012

ASSETS	AMOUNT		ACC. FUND + LIABILITIES	AMOUNT	
Current Assets			**Accumulated fund**		
Cash at bank-**N6**		$16	Opening accumulated fund	$10	
Fixed Assets			Add: Surplus for the year -**N1**	$1	
Land		$2	Closing accumulated fund-**N2**		$11
Building-**N7**	$10		**Short term liabilities**		
Less: Acc. depreciation	$2	$8	Subscriptions in advance-**N3**		$2
Long term investments			Creditors-**N4**		$6
Investments		$3	**Long term liabilities**		
			Bank loan- **N5**		$10
TOTAL	$29		**TOTAL**	$29	

N1 (Note 1)
Only the part of total subscriptions that is earned during the current year or 2012 will be recorded in the Income and Expenditure Account

Total subscription received during the current year = $7

Subscription related to the previous year = $1
Subscription related to the next year = $2

Therefore, only $4 subscription is related to the current year or 2012

N2

Opening accumulated fund Plus Surplus (as shown in the income and expenditure account) = Closing Accumulated fund

$10+$1=$11

N3

Total subscription received was $7 (as per receipts and payments account), $2 out of $7 were received as an advance subscription for the next year or 2013. Since $2 subscription was received but not yet earned, it is considered a liability of X.Y.Z Golf Club

N4

Creditors at January 1st, 2012 = $9 (as per additional information provided in the example)

$3 were paid to creditors (as per receipts and payments account). It means creditors amounting to $6 remain to be paid ($9-$3=$6). Therefore, $6 is the closing balance of creditors that should be reported in the balance sheet

N5

Looking at the receipts and payments account, you can clearly see that X.Y.Z Golf club has obtained $10 in terms of bank loan

N6

The Balance c/d or balance at 31 December, 2012 or closing balance of receipts and payments account

N7

As mentioned in "Additional information" the Cost of building is $10, accumulated depreciation on January 1st, 2012 was $1 and rate of depreciation is 10% per year

Step 1, calculation of current year depreciation:

Depreciation expenses on building = Building cost X Rate of depreciation
Depreciation expenses on building = $10 X 10%
Depreciation expenses on building = $1

Hence, depreciation on building for the current year is = $1

Step 2, calculation of Accumulated depreciation at 31 December

Accumulated depreciation at 31 December, 2012 should be:

Accumulated depreciation at 31 December, 2012 = Current year depreciation + Accumulated depreciation at January 1st, 2012

Accumulated depreciation at 31 December, 2012 = $1 + $1

Accumulated depreciation at 31 December, 2012 = $2