



Al-Rowad International Schools

IGCSE

Accounting

Social Sciences Department

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Chapter 1 Introduction to accounting

Bookkeeping:

The detailed recording of all the financial transactions of business is known as bookkeeping.

Accounting:

Accounting makes use of these records to prepare periodic financial statements, which can be used to assess the performance of the business.

Double entry bookkeeping:

Every business is different, so the records maintained will vary because of the different information which is required, but the basis of all the accounting systems is double entry bookkeeping.

Trading and profit and loss account:

The aim of the business is to make a profit. A Trading and Profit and loss Account is prepared which shows the calculation of the profit or loss earned by the business.

Balance sheet:

The owner of a business needs to know the financial position of the business, so a Balance sheet is prepared. This summarizes the position of a business, in monetary terms on a certain date.

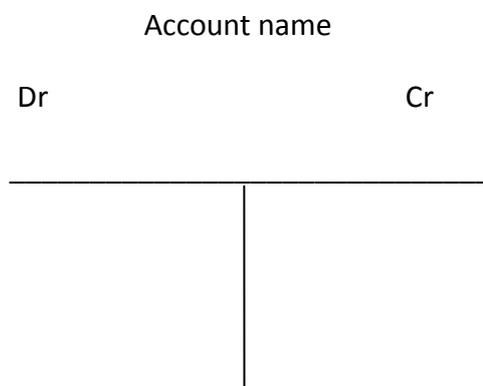
Assets and liabilities:

The balance sheet shows what the business owns, known as **assets**, and what the business owes, known as **liabilities**.

Complete the exercises of your accounting book. (pages 2-5)

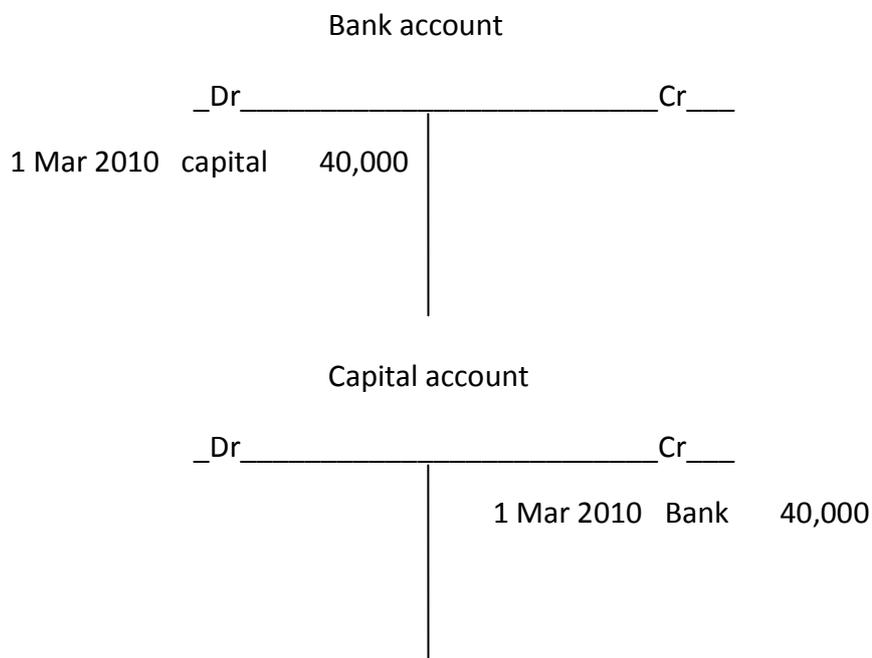
Chapter 2 Double entry bookkeeping part A

- Day-to-day business transactions are recorded using the double entry system.
- This dual aspect of a giving and receiving is recorded in the day-to-day records.
- A simple T account is divided into two sides by the centre line.
- The left-hand side is the **debit** side (abbreviated to **Dr.**) and the right-hand side is the **credit** side (abbreviated to **Cr.**)



- There is a **giving** and **receiving** in every transaction, two entries are made- a debit in one account and a credit in another account.

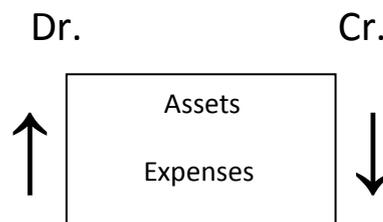
2.1 Example: March 1 2010 Abdul set up a business. He opened a business bank account and paid in \$40000 as capital.



2.2 Debit and credit Rules:

- At first, it is natural for the debit/credit rules to seem confusing. However, the debit/credit rules are logical.
- You are advised to memorize the debit/credit rules.

2.3 Assets, expenses:

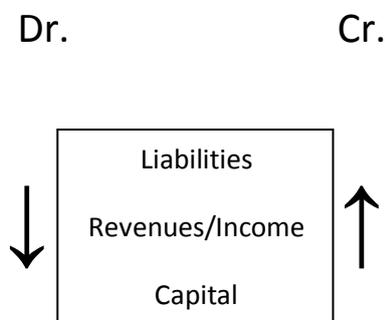


2.4 Example: March 2, 2010. Business bought premises for \$20,000 and paid by cheque.

Bank account			
	Dr		_Cr_
1 Mar 2010	capital	\$ 40,000	2 March 2010 premises \$20,000

Premises account			
	Dr		_Cr_
2 Mar 2010	Bank	\$20,000	

2.5 Liabilities, Revenues and Capital



2.6 Complete exercise on page 8 of your accounting book.

2.7 Sales, purchases and returns

Two accounts are needed to record the purchase of goods in which the business trades, and the later sale of those goods. These must be kept separate as the goods will **come in** at cost price and usually **go out** at a higher price, which enables the business to earn a **profit**. Instead of a **Goods account**, there is a **purchases account** and a **sales account**.

Complete exercises on pages 12-14

Carriage inwards: it occurs when business has to pay for purchased goods to be delivered to its premises.

Carriage outwards: it occurs when a business pays for sold goods to be delivered to its customers' premises.

Drawings: it is the term used when the owner of a business takes any value from the business for his/her own use. This may be in the form of money, goods, or even fixed assets.

To avoid the capital account having a large number of entries, a drawing account is used to record all amounts with drawn by the owner. At the end of the year the total of drawing account is transferred to the capital account, and so reduces the amount invested by the owner.

The Trial Balance

- A trial balance is a list of the balances of accounts contained in the ledger
- The trial balance can assist in locating **errors**.
- It is, however important to remember that it only indicates that **the total debits equal the total credits**.
- It does not prove the complete **accuracy** of the bookkeeping.

It is necessary to know which ledger account has a debit balance and which has a credit balance. Certain types of account always have debit balance and certain types of account always have a credit balance.

Trial Balance as at Feb. 2010

Name of accounts	Dr.	Cr.
Assets (cash, stock, premises, debtor, etc.)	√	
Expenses (rent, insurance, wages, etc)	√	
Drawings	√	
Purchases	√	
Sales returns	√	
Liabilities (loans, creditors, etc)		√
Income (commission received, rent received, etc)		√
Sales		√
Purchase returns		√
Provision for depreciation		√
Provision for doubtful debts		√
	_____	_____
	50,000	50,000
	_____	_____

Complete the exercises of your accounting book on pages (26-27)

Chapter 4 Double entry bookkeeping part B

The two-column cash book

- In two-column cash book the **cash account** and **bank account** appear side by side.

How to record transaction

- Any money **received** is recorded on the **debit side** and entered in the appropriate column, depending on where it was put in the **cash column** or put into the **bank column**.
- Any money paid is recorded on the **credit side**, being shown in the cash column if it was paid in cash, and bank column if it was paid by cheque.
- It is important to remember that there are two accounts side by side, and each account must be **balanced separately**.
- **Contra entries:**
 - (a) **Cash withdrawn from the bank** and placed in the cash
Debit cash account
Credit bank account
 - (b) **Cash deposited/ paid into the bank**
Debit bank account
Credit cash account
- **Dishonored cheques:**
 - (a) A dishonored cheque is a cheque that a business has **received** from a customer and which the **customer's bank refuses to pay**.
 - (b) The cheque is returned to the business that paid it into the bank and it is recorded on the credit side of the cash book.

Look at the example on page 30 in your accounting book.

A petty cash book is used to record low-value **cash payments** such as postages, travelling expenses and window cleaning.

When paying out cash, the petty cashier should obtain a petty cash **voucher**. This voucher is presented by the person **receiving the cash**. It should show details of the expenditure and be signed to indicate that the money has been received from the petty cashier.

What is imprest system of petty cashbook?

The petty cashier starts each period with a certain amount of money. This system is known as imprest system. At the end of the period, when the petty cash book is balanced, the chief cashier will give the petty cashier enough cash to restore the balance remaining to the imprest amount.

How to write up a petty cash book?

- The petty cash book is **debited with amounts received**.
- Any money paid out is **entered on the credit side** under the **total paid column**.
- **Add up** the total paid column
- Total each of the **analysis columns**.
- **Balance** the petty cash book and **carry down the balance**.
- **Debit the petty cash book** with the amount received to **restore the imprest**.

Business documents and books of prime entry

Invoice:

- When goods are sold on credit, the **supplier will issue an invoice**.
- The original copy of the invoice is sent to **the customer**, who uses it to record his **credit purchases**.
- A copy of the invoice is retained by **the seller**, who uses it to record his **credit sales**.
- Sometimes a deduction is shown on an invoice for **Trade Discount**.

Debit Note:

- **The purchaser may send a debit** note to the **supplier** to report any faults, shortages overcharges or damaged goods.

Credit Note:

- When goods are returned, **a supplier may issue a credit note**.
- This reduces the amount owed by the customer.

Statement of Account:

- It is usual for a supplier to issue a monthly statement of account **to the customer**.
- A statement of account acts as **a reminder** to the customer of the amount due.
- The customer can also **check** the statement against **his records** to ensure that no **errors** have been made either by himself or by the supplier.

Books of prime entry:

The books of prime entry are:

- Sales journal
- Purchase journal
- Sales returns journal
- Purchase returns journal
- Cash book
- Petty cash book
- Journal

Complete exercises on pages 58-62

Final Accounts

- At the end of a financial period, usually a year, final accounts are prepared.
- Final accounts are consist of a **Trading account**, a **Profit and Loss Account** and a **Balance Sheet**.
- Final accounts are usually prepared from a trial balance. **Every item** in a trial balance appears **once** in the final accounts.
- The basic formula for gross profit is:

$$\text{Sales} - \text{Cost of goods sold} = \text{Gross profit}$$

- The basic formula to calculate the cost of sales is:

$$\text{Opening stock} + \text{purchases} - \text{purchase returns} - \text{goods for won use} + \text{carriage inwards} = \text{cost of sales}$$

- The basic formula for Net Profit is:

$$\text{Gross profit} + \text{Other income} - \text{Expenses} = \text{Net Profit}$$

- If additional information of expenses are given then we have to **deduct prepaid** amount from the expenses paid and we have to **add the expenses** if they are outstanding.

Layout of trading, profit and loss account

Hasan and Sons' company
Trading and Profit and loss Account
For the year ended 30 Oct. 2010

	\$	\$	\$
Sales		18600	
Less sales returns		<u>180</u>	18420
<u>Less Cost of goods sold</u>			
Opening stock		3200	
Purchases	14300		
Less purchases returns	<u>400</u>		
	13700		
Less goods for own use	<u>200</u>		
	13500		
Add carriage inwards	<u>500</u>	<u>14000</u>	<u>17200</u>
Gross profit			1220
<u>Add other sources of income</u>			
Discount received			<u>350</u>
Total income			1570
<u>Less expense</u>			
Wages		150	
General expenses		400	
Heat and light		<u>200</u>	<u>750</u>
Net profit			<u><u>820</u></u>

Complete exercise on page 75-76

Layout of Balance Sheet

Hasan and Sons' company
Balance Sheet as at 30 Oct 2010

<u>Fixed assets</u>	\$	\$	\$
	Cost	Prov. for depreciation	NBV
Premises	-	-	65000
fixtures and equipment	<u>34000</u>	<u>5000</u>	<u>29000</u>
			94000
 <u>Current assets</u>			
Stock		26000	
Debtors		28000	
Bank		25500	
Cash		50	
Prepaid insurance		<u>50</u>	
		79600	
 <u>Less current liabilities</u>			
Creditors	20000		
Bank overdraft	1500		
Outstanding salary	<u>1500</u>	<u>23000</u>	
Working capital			<u>56600</u>
			150600
 <u>Less long-term liabilities</u>			
Loan- Riyadh bank			<u>25000</u>
			<u>125600</u>
 Financed by:			
Capital		120000	
Add net profit		<u>14000</u>	134000
Less drawings			<u>8400</u>
			<u>125600</u>

Accounts rules

Concepts and conventions:

- **Concepts**
Concepts are basically rules, which set down how the financial activities of a business are recorded.
- **Conventions**
Conventions are regarded as the generally accepted methods by which the rules (concepts) are applied to given situations.

The main accounting rules:

- **Business entity**

The business is treated as completely separate from the owner of that business.

The owner's personal assets, the owner's personal spending etc. do not appear in the accounting records of the business.
- **Going concern:**

Applying this concept, **the fixed assets** of a business appear in the Balance Sheet at **book value** and **stock** appears at the lower of **cost** or **net realizable value**.
- **Duality:**

The term double entry is used to describe how the dual aspect of all transactions is recorded.

- **Money measurement:**

The accounts of a business only record the information which can be **expressed in monetary terms**.

There are many other aspects of a business **which do not appear** in the accounting records because they cannot be **measured in terms of money**. The **value** of a good manager, a **loyal** workforce and high staff **morale** are of great benefit to a business.

- **Consistency**

Once a certain method is chosen it should be applied consistently from year to year.

- **Matching**

Matching concept is applied on **trading profit and loss account**, on **prepaid** and on **accrued**.

- **Prudence**

The concept of prudence is applied to **provision for doubtful debts** and on **stock valuation**

- **Capital and revenue expenditure and receipts**

Capital expenditure is money spent by a business on the purchase of **fixed assets**.

Revenue expenditure is money spent on **running a business on day to day basis**.

A capital receipt occurs when a **fixed asset is sold**.

Revenue receipts are sales of other items of income such as **rent received and discount received**.

- **Stock valuation:**

Applying the concept of prudence, stock must always be valued at **the lower of cost or net realizable value**.

Accruals and prepayments

- The final accounts prepared up to this point have not really **been true to life**.
- In practice, **adjustments** often have to be made to the **accounting records** at the **end of the financial position** of the business.

Accruals Expenses

- An accrual is **an amount due** in an accounting period, which **is unpaid** at the end of that period.

Who to record and adjust such accounts?

Accrued expenses

- Record the amount paid during the year on **debit side** of the expense account.
- Record the amount accrued at the end of year **on debit side** with a sentence of **BALANCE C/D** of the account.
- Less amount accrued at start of year

For example:

Hassan's financial year ends on **31 December** every year.

He rents an office at an annual rent of \$3200, payable in **four quarterly** installments of \$800.

During 2009, Hassan paid rent by cheque on **1 Jan, 1 April and 1 July**. The rent due on **1 Oct remained unpaid** on 31 December 2009.

<u>Rent account</u>			
2009 Jan 1 Bank	800	2009 Dec 31 profit and loss	3200
Apr 1 Bank	800		
July 1 Bank	800		
Dec 31 Balance c/d	<u>800</u>		—
	<u>3200</u>		<u>3200</u>
		2010 Jan 1 Balance b/d	800

Hassan's financial year ends on **31 December** every year.

He rents an office at an annual rent of \$3200, payable in **four quarterly** installments of \$800.

On 1 Jan 2010 Hassan rent account showed a **credit balance of 800** for rent due on 1 Oct 2009. During 2010 Hassan **paid rent** by cheque as follows- **\$ 1600** on 2 Jan, **\$800** on 1 Apr, **\$800** on 1 July and **\$800** on 1 Oct.

Rent account			
	1600	2010 Jan 1 Balance b/d	800
2010 Jan 2 Bank		Dec 31 profit and loss	3200
Apr 1 Bank	800		
July 1 Bank	800		
Oct 1 Bank	<u>800</u>		<u> </u>
	<u>4000</u>		<u>4000</u>

Prepayments:

A prepayment is when a payment is **paid in advance** of the period to which it relates. If an expense is prepaid it means that an amount is paid during an accounting period for a benefit or service to be received **in a future period**.

The **matching concept** must be applied to ensure that **only the expense** for the particular period is entered in the profit and loss account.

Who to record and adjust such accounts?

Prepayments

- Record the amount paid during the year on **debit side** of the expense account.
- Record the amount prepaid at start of year at the end of year **on debit side** of the account.
- Less amount prepaid at the end of year of year.

For example:

Ahmad's financial year ends on **31 December**.

On **1 Oct 2009** he purchased a new motor vehicle and paid one year's motor vehicle insurance of **\$800** by cheque.

Write up the Motor vehicle insurance account in Ahmad ledger for the year ended at **31 Dec, 2009**.

Motor vehicle insurance account			
		2009 Oct 1 Bank <u>800</u>	2009 Dec 31 profit and loss 200
		<u>800</u>	Balance c/d <u>600</u>
			<u>800</u>
2010 Jan 1	Balance b/d	600	

On **1 Jan 2010**, Ahmad Motor vehicle insurance account showed a debit balance of \$ **600**. On 1 oct 2010 he **paid one year's motor vehicle insurance of \$ 840** by cheque.

Motor vehicle insurance account			
		2010 Balance b/d 600	2010 Dec 31 profit and loss 810
		Oct 1 Bank <u>840</u>	Balance c/d <u>630</u>
		<u>1440</u>	<u>1440</u>
1 Jan 2010	Balance b/d	630	

Chapter 10 **Depreciation and disposal of fixed assets**

Depreciation is an estimate of the loss in value of a **fixed asset** over its expected working life. Most fixed assets lose value over time. The accounts of a business should show a **fair view of the financial position** so it is necessary to record this loss in value.

In the profit and loss account **depreciation** of fixed assets will appear with the other **expenses** and the net profit will be reduced.

Methods of calculating depreciation

- Straight line method of depreciation

Cost of asset – residual value	12000-2000
Number of expected years of use	4 years
	=2500

- Reducing balance method

Cost	12000
 Depreciation for the year ended 31 December 2004	
(12000 × 36%)	4320
Book value at 1 Jan. 2005	7680
 Depreciation for the year ended 31 December 2005	
(7680 × 36%)	2765
Book value at 1 Jan 2006	4915
 Depreciation for the year ended at 31 December 2006	
(4915 × 36%)	1769
Book value at 1 Jan 2007	3146
 Depreciation for the year ended at 31 December 2006	
(3146 × 36%)	1133
Book value at 1 Jan 2008	2013

- Revaluation method of depreciation

On 1 Jan 2004 Ahmad purchased a machine for \$12000. He decided to revalue the machine at the end of each financial year. On 31 December 2004 he valued the machine at \$8500.

Cost of machine 1 Jan 2004	12000
Value of machine 31 December 2004	8500
	<hr/>
Depreciation for the year	3500
	<hr/>

Recording depreciation in the ledger

- The asset account will always have a **debit balance**.
- The provision for depreciation account will always have a **credit balance**.

Example:

Javeed's financial year ends at 31 December.

On 1 Jan 2004 he purchased a machine for \$12000. He estimates that he will keep the machine for 4 years and then sell it for \$2000. He decided to use the straight line method of depreciation.

Make the necessary entries in Javeed's ledger for each of the year ending 31 Dec. 2004, 2005, 2006 and 2007.

Provision for Depreciation of Machinery account			
2004 Dec. 31 balance c/d	2500	2004 Dec. 31 P & L	2500
	2500		2500
		2005 Jan 1 Balance b/d	2500
2005 Dec. 31 balance c/d	5000	2005 Dec. 31 P & L	2500
	5000		5000
		2006 Jan 1 Balance b/d	5000
2006 Dec. 31 balance c/d	7500	2006 Dec. 31 P & L	2500
	7500		7500
		2007 Jan 1 Balance b/d	7500
2007 Dec. 31 balance c/d	10000	2007 Dec. 31 P & L	2500
	10000		10000

Disposal of fixed assets

When a fixed asset reaches the **end of its useful life**, or when it is **no longer needed** by the business, it will be sold. When fixed assets are **purchased** this is known as **capital expenditure** and the asset is recorded in a fixed asset account rather than the **purchases account**.

When fixed assets are sold this is known as a **capital receipt**.

How to record the disposal of fixed asset?

1. Record the fixed asset in the account at the **debit side**.
2. Record the provision for depreciation at the **credit side** of the account.
3. Open a disposal account.
 - a. **Credit** the fixed asset account
 - b. **Debit** disposal of fixed asset account
 - c. **Debit** provision for depreciation account
 - d. **Credit** disposal of fixed asset account
 - e. **Credit** P & L account with any loss on sale.
Or **Debit** P & L account with any profit on sale.

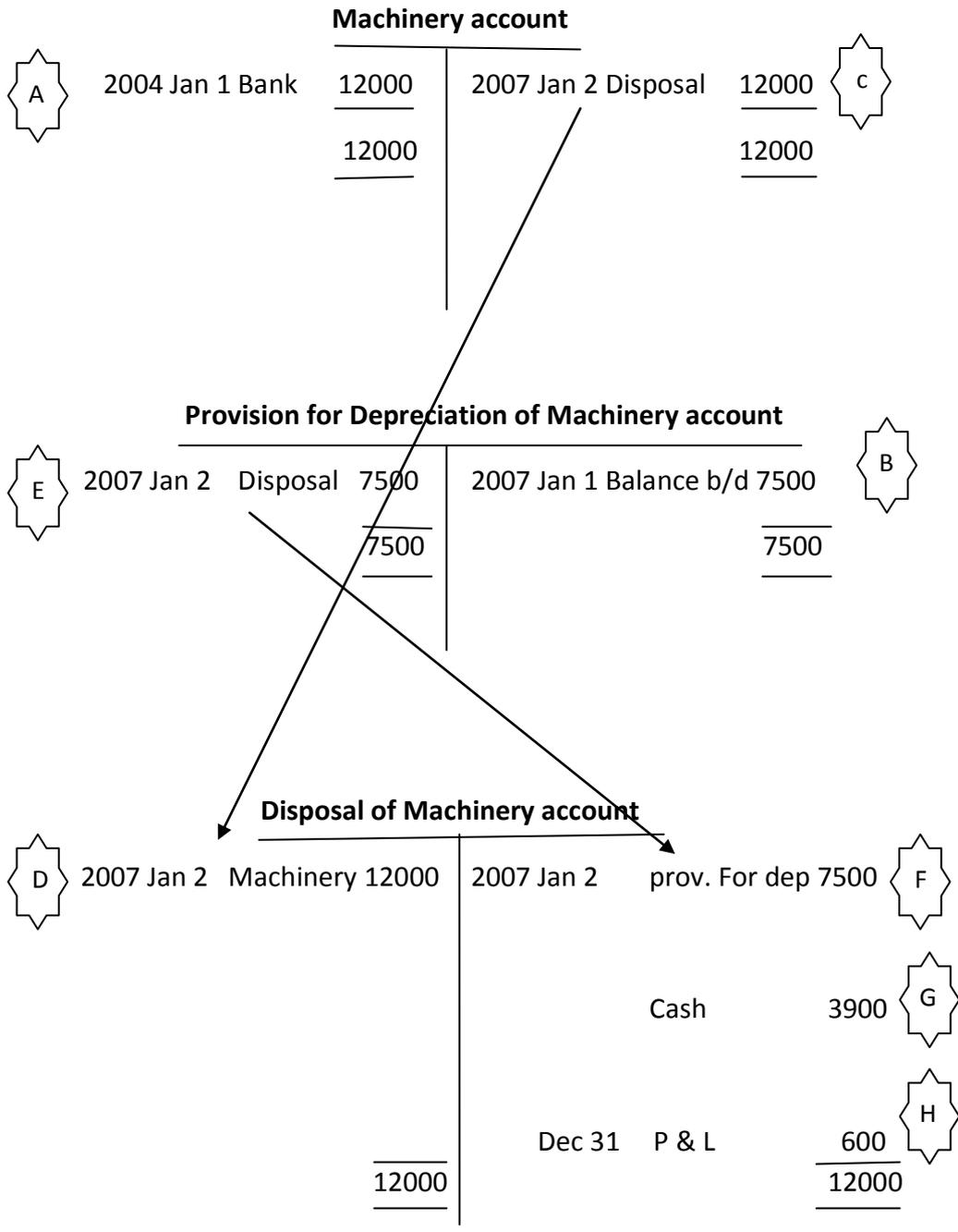
Example:

Ahmad's financial year ends on 31 December.

On 1 Jan 2004 he purchased a **machine for \$12000**. On 1 Jan 2007 the provision for depreciation of machinery account showed a **credit balance of \$7500**. Ahmad sold the machine on 2 Jan 2007 for **\$3900** cash.

Write up the following accounts

- a. Machinery account
- b. Provision for depreciation of machine account
- c. Disposal for machinery account.



Chapter 11 Bad debts and provision for doubtful debts

A bad debt is an amount owing to a business, which will **not be paid by the debtor**.

When it is decided that all possible means to obtain payment from the debtor have **failed**, the debt should be **written off**.

This means that the **debtor's account** in the sales ledger is **closed** and the amount due is **transferred to a bad debts** account in the nominal ledger.

How to write off the account of a customer?

- Record the credit sales at the debit side of the customer account.
- Credit the debtor's account
- Debit the Bad Debts account
- Credit the Bad debts account

Example

On 1 May 2000, Ahmad sold goods **\$240 on credit** to Khalid. On 28 May 2000 Khalid **paid the** account by cheque and **purchased** further goods, **\$200, on credit**.

Ahmad wrote off the account of Khalid on 31 March 2001

On 20 Aug 2001 Khalid sent a cheque to Ahmad for the amount he **owed on 28 May 2000**.

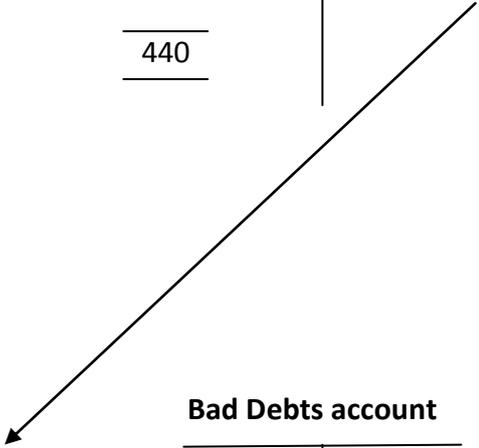
Ahmad wrote off debtors totaling \$542 during the financial year ended 31 March 2002

Write up the following accounts

- Khalid account
- Bad debts account
- Bad debts recovered account

Khalid account

2000 May 1 sales 240 28 sales 200 <hr style="width: 50%; margin-left: 0;"/> 440		2000 May 28 Bank 234 Discount 6 2001 May 31 bad debts 200 <hr style="width: 50%; margin-left: 0;"/> 440	
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Bad Debts account

2001 Mar 31 khalid 200 <hr style="width: 50%; margin-left: 0;"/> 200 <hr style="width: 50%; margin-left: 0;"/> 2002 Mar 31 Debtors 542 <hr style="width: 50%; margin-left: 0;"/> 542		2001 Mar 31 P & L 200 <hr style="width: 50%; margin-left: 0;"/> 200 <hr style="width: 50%; margin-left: 0;"/> 2001 Mar 31 P & L 542 <hr style="width: 50%; margin-left: 0;"/> 542	
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Bad debts Recovered account

2002 Mar 31 P & L 200 <hr style="width: 50%; margin-left: 0;"/> 200 <hr style="width: 50%; margin-left: 0;"/>		2001 Aug 20 Bank (khlaid) 200 <hr style="width: 50%; margin-left: 0;"/> 200 <hr style="width: 50%; margin-left: 0;"/>	
--	--	--	--

Provision for doubtful debts

- A provision for doubtful debts is an **estimate** of the amount that a business **will lose** in a financial year because of **bad debts**.
- This is something **referred** to as a provision **for bad debts**.

Example:

- During the financial year ends on 31 Oct 2003 he decided to create a provision for doubtful debts of **3%, who owed \$17000** at that date.
- During the financial year ends on 31 Oct 2004 he decided to create a provision for doubtful debts of **4%, who owed \$20000** at that date. (increase)
- During the financial year ends on 31 Oct 2005 he decided to create a provision for doubtful debts of **3%, who owed \$19000** at that date. (decrease)

<u>Provision for doubtful debts</u>			
2003		2003	
Oct 31 Balance c/d	<u>510</u>	Oct 31 P & L	<u>510</u>
	<u>510</u>		<u>510</u>
Oct 31 Balance c/d	<u>800</u>	1 Nov Balance b/d	510
	<u>800</u>	2004 31 Oct P&L	<u>290</u>
2005 31 Oct P & L	230		<u>800</u>
Balance c/d	<u>570</u>	1 Nov Balance b/d	800
	<u>800</u>		—
		2005 1 Nov Balance b/d	570
			<u>800</u>

- The purpose of bank reconciliation is to explain any difference between the bank balance appearing in the cash book of a business and the balance appearing on the bank statement provided by the bank.
- The bank statement must be compared with the bank account in the cash book. If the balance differ it is necessary to reconcile them, that is, explain why the differences have arisen.

Reasons for differences between cash book and bank statement

1. Items in the cash book but not in the bank statement

a. Cheques not yet presented

Cheques that have been paid by the business and credited in the cash book, but which do not appear on the bank statement.

b. Amount not yet credited

Cheques and other amounts which have been paid into the bank and debited in the cash book, which do not appear on the bank statement.

- c. It is possible that there are **errors** in the cash book which do not appear on the bank statement.

(The error of the cash book must be corrected in the cash book)

2. Items in the bank statement but not in the cash book

- Standing orders and credit transfers:** Amount received by the bank which has been paid directly into the business's bank account.
- Credit transfers, standing orders and direct debits:** amount paid by the bank to other people.
- Bank charges and bank interest:** which the bank has taken from the businesses account to cover the costs of running the account and for any interest on loan and overdrafts the business may have.
- Dishonored cheques:** These are the cheques paid into the bank but which have been returned as the drawer of the cheque did not have sufficient funds to cover the cheque.
- Bank errors:**

3. Procedure for bank reconciliation:

- **Compare the bank statement with the bank account in the cash book.**
(Remember to compare the debit of the bank account against the credit of the bank statement and place a tick (✓) against those items which appear in both records.)
- **Update the cash book:** by entering any items which appear on the bank statement but which have not yet been entered in the bank account.
- **Correct any errors in the cash book.**
- **Balance the cash book.**

4. Prepare the bank reconciliation statement.

- Start with the balance shown on the bank statement.
- Add on any items that have been debited in the cash book but not yet credited on the bank statement.
- Deduct any items that have been credited in the ca book but nit ye debited on the bank statement.
- Make any necessary adjustments for bank errors.
- The final balance of bank reconciliation statement should be equal to the updated cashbook.

Take the example of your book on page 136-138

Lay out of bank reconciliation:

Balance as per bank statement:		4182
Add amount not yet credited	Ahmed and co	110
	Sales	<u>874</u>
		<u>984</u>
		5166
Less cheques not yet presented:	insurance	95
	G Bierling	<u>416</u>
		<u>511</u>
Balance as per cash book		<u>4655</u>

(If bank balance is not given in the question then we will use updated cash book balance and we will use the following lay out.)

Balance as per cah book:		4655
Less: amount not yet credited	Ahmed and co	110
	Sales	<u>874</u>
		<u>984</u>
		3671
Add: cheques not yet presented:	insurance	95
	G Bierling	<u>416</u>
		<u>511</u>
Balance as per bank statement		<u>4182</u>

(Complete the exercises on pages 141-144)

Chapter 13 Journal Entries and Correction of Errors

The journal is a book of prime entry, but it is not part of the double entry system. It is a journal, noting the entries to be made in the ledger.

Opening journal entries:

These are the entries necessary to open the books when a business is first started, or when an existing business first to keep proper accounting records.

The assets are listed in the debit column, and the liabilities in the credit column, and the difference, the capital is inserted as the balance figure.

Example: Ahmed has been in the business for two years, but has not kept any accounting records. On 1 Feb 2002, he provided the following information:

Assets: machinery \$12000, motor vehicle \$3200, stock \$1900, bank \$2660, debtors \$490

Liabilities: creditors \$750

Prepare an opening journal entry for Ahmad on 1Feb 2002

Show your working below.

Correction of errors: when the errors are discovered, they should be corrected by a journal entry. Look at the book example on pages 148-158

Control accounts

Control accounts are sometimes known as total accounts. A control account acts as a summary of the ledger which it controls.

1 Sales ledger control accounts.

- a. A sales ledger control account is sometimes known as a total debtors account. The control account is balanced at the end of the period.
- b. If the balance on the control account differs from the total of the individual debtor's balances an error must have occurred, either in the sales ledger or within the control account.
- c. It is essential that the information required to prepare a sales ledger control account is obtained from books of prime entry, not the sales ledger account.

Items appearing in a sales ledger control account

		<u>Sales ledger account</u>	
Balance b/d	10230	sales returns	1380
Sales	71500	bank	68800
Dishonour cheques	870	cash	1050
Cash refunded to debtor	30	Discount allowed	1440
		Bad debts	160
		Balance c/d	9800
	82630		82630
Balance b/d	9800		

Purchase ledger control accounts

1 A purchase ledger control account is sometimes known as a total creditors account. At the end of the period the balance on the purchase ledger control account should agree with the total of the balances of all the individual accounts in the purchase ledger.

2 If the balance on the control account differs from the total of the individual creditor's balances there must be an error, either in the purchase ledger or in the control account.

<u>Debit entries</u>	<u>Credit entries</u>
Purchase returns	Balance b/d
Cash and cheques paid	purchases on credit
Discount received	cash refunded by creditors
Balance c/d	
_____	_____
_____	_____
	Balance b/d

Advantages of control accounts

1. Control accounts can help in locating errors by providing the arithmetical accuracy of the ledgers which they control.
2. Fraud is made more difficult by the use of control accounts.
3. control accounts also provide a summary of the transactions affecting the debtors and creditors for the financial period.

Incomplete records

Small businesses do not maintain a full set of double entry record. **As a result trial balances can't be produced and complete set of final accounts can't be prepared without further analysis of the records that do exist.**

- Where the only records available are the **assets and liabilities** at the beginning of the year and at the end of the year.
- It is not possible to prepare a **Trading and Profit** and **Loss Account**.

The information of liabilities and assets are listed in a **Statement of affairs**. This would have been called a **Balance sheet** if it had been drawn up from double entry records.

- The only way the profit for the year can be found is by comparing the capital shown in the opening statement of Affairs with the capital shown in the closing statement of Affairs. The basic formula is –

Closing capital- opening capital drawings- capital introduced = profit

statement of affairs as at 1 January 2001

Fixed assets

Machinery at cost			9500
-------------------	--	--	------

Current asset

Stock	1050		
Debtors	630		
Prepayments	120		
Bank	<u>2700</u>	4500	

Less current liabilities

Creditor	970		
Accruals	<u>30</u>	<u>1000</u>	<u>3500</u>

Less long term liability

Abc bank			<u>5000</u>
----------	--	--	-------------

<u>Financed by</u>			<u>8000</u>
---------------------------	--	--	-------------

Capital			<u>8000</u>
---------	--	--	-------------

Statement of affairs as at 31 December 2001

<u>Fixed assets</u>	\$	\$	\$
Equipment	7000	700	6300
Machinery	2500	250	2250
Motor vehicle	<u>1800</u>	-	<u>1800</u>
			10350
<u>Current assets</u>			
Stock	1290		
Debtors	660		
Prepayments	<u>40</u>	1990	
<u>Less current liabilities</u>			
Creditors	860		
Accruals	20		
Bank OD	<u>120</u>	<u>1000</u>	
Working capital			<u>990</u>
			11340
<u>Less long term liability</u>			
Loan			<u>2000</u>
			<u>9340</u>
<u>Financed by</u>			
Capital			<u>9340</u>

Calculation of profit for the year ended 31 December 2001

Capital at 31 December 2001	9340
Less capital at 1 January 2001	<u>8000</u>
	1340
Add drawings during the year	<u>1040</u>
	2380
Less capital introduced	<u>1800</u>
Net profit	<u>580</u>

A business may be able to provide other information, in addition to **the assets and liabilities at the beginning and end of the year**. Where details of money paid and received are also available, it is possible to calculate the **sales, purchases and expenses and so prepare a Trading and profit and loss account**.

Calculation for credit sales

Receipts from debtors	41100
Less debtors opening balance	<u>3330</u>
	37770
Add debtors ending balance	<u>3660</u>
Credit sales for the year	<u>41430</u>

Calculation for total sales of the year

Credit sales	41430
Cash sales	<u>2570</u>
Total sales	<u>44000</u>

Calculation for credit purchase

Payments to creditors	32320
Less creditors opening balance	<u>2900</u>
	29420
Add creditors ending balance	<u>3080</u>
Credit purchase for the year	<u>32500</u>

Calculation for total sales for the year

Credit purchase		32500
Cash purchase		<u>11100</u>
Total purchase		<u>33600</u>

Calculation for total debtors account

Opening balance of debtors		3330
Add credit sales		<u>42440</u>
		45770
Less bank	41100	
Discount allowed	<u>1010</u>	<u>42110</u>
Total debtors account		<u>33360</u>

Calculation for total creditors account

Opening balance of creditors		2900
Add credit purchase		<u>34660</u>
		37560
Less bank	32320	
Discount received	<u>2160</u>	<u>34480</u>
Total creditors account		<u>3080</u>

Mark up, margin, and stock turnover

It is sometimes necessary to use percentages to calculate missing information in incomplete records.

We use mark up and margin to calculate Gross Profit.

- If total sales are given we apply margin on sales to calculate gross profit.
- If total cost of sales is given we apply mark up to calculate gross profit

How to change margin into mark up, and mark up into margin?

<u>Margin</u>		<u>Mark up</u>
1/2	1/1+2	1/3
<u>Mark up</u>		<u>Margin</u>
1/3	1/1-3	1/2

Rate of stock turnover

This is the number of times a business replaces its stock in a given period.

The formula is:

$$\frac{\text{Cost of sales}}{\text{Average stock}} = \frac{32000}{6800+6000 \div 2} = 5 \text{ times}$$

Accounts of clubs and societies

Introduction:

- The main aim of a non-trading organization is to provide facilities and services for its members.
- A non-trading organization only maintains a cash book.
- At the end of financial year, the accountant prepares a summary of cash book; known as **Receipts and Payments Account**.
- If there is some form of regular trading, such as a snack bar, sports shop, etc, a Trading Account may be prepared.
- A non-trading organization prepares an **Income and Expenditure Account** instead of a profit and loss account.
- A non-trading organization prepares a **Balance sheet** in the same way as a trading business, but **capital** is replaced by **Accumulated Fund**.

1. **Receipts and payments account**

Any money received during the period is debited and any money paid during the period is credited. The account is then balanced in the usual way. The balance is carried down and becomes the opening balance for the next financial period.

<u>Receipts and payments account</u>			
Dr.			Cr.
Balance b/d	\$\$\$	Purchase	\$\$\$
Subscriptions	\$\$\$	Equipment	\$\$\$
Receipts from café	\$\$\$	Wages	\$\$\$
Ticket sales for play	\$\$\$	Balance C/D	\$\$\$
	_____		_____
	_____		_____
Balance b/d	\$\$\$		

2. Trading account

Sales		\$\$\$
<u>Less cost of sales</u>		
Opening stock	\$\$\$	
Purchases	<u>\$\$\$</u>	
	\$\$\$	
Less closing stock	<u>\$\$\$</u>	
	\$\$\$	
Wages of assistant	<u>\$\$\$</u>	\$\$\$
Profit on café		<u>\$\$\$</u>

3. Income and expenditure account

- This is similar to the profit and loss account prepared for a business. It lists all the expenses of the organization and all the gains.
- Where the expenses are lower than the gain, the difference is referred to as **Surplus**, where the expenses are more than the gain; the difference is referred to as **Deficit**.

(If opening balance of insurance is given then it must be added and ending must be subtracted)

(If opening balance of outstanding or accrual is given then it must be subtracted and ending must be added)

Income and expenditure account

Income:

Subscriptions (receipt + unpaid or owed- paid in advance)			\$\$\$\$
Profit on café			\$\$\$\$
Annual play	tickets	\$\$\$\$	
	Less expenses	<u>\$\$\$\$</u>	<u>\$\$\$\$</u>
			\$\$\$\$

Expenditure:

Wages	(wages+ wages unpaid or accrual)	\$\$\$\$	
Insurance	(insurance – prepaid)	\$\$\$\$	
Administration expenses		\$\$\$\$	
Depreciation		<u>\$\$\$\$</u>	<u>\$\$\$\$</u>
Surplus / deficit for the year			<u>\$\$\$\$</u>

Club and societies

Balance sheet

<u>Fixed assets</u>	cost	pro. Depreciation	NBV
Premises	\$\$\$\$	-	\$\$\$\$
Equipment	\$\$\$\$	\$\$\$\$	<u>\$\$\$\$</u>
			\$\$\$\$
<u>Current assets</u>			
Stock in café		\$\$\$\$	
Subscription owing or unpaid or accrual		\$\$\$\$	
Prepayments		\$\$\$\$	
Bank		<u>\$\$\$\$</u>	
(Ending balance of receipt and payment account)		\$\$\$\$	
<u>Less current liabilities</u>			
Creditors	\$\$\$\$		
Subscription paid in advance	\$\$\$\$		
Accrual expense	<u>\$\$\$\$</u>	<u>\$\$\$\$</u>	<u>\$\$\$\$</u>
(wages, electricity, rent, etc.)			\$\$\$\$
<u>Less long term liability</u>			
Loan			<u>\$\$\$\$</u>
			<u>5000</u>
Financed by:			
Accumulated fund			\$\$\$\$
Add surplus for the year			<u>\$\$\$\$</u>
			<u>5000</u>

If the club makes a loss then it must be subtracted from accumulated fund.

For subscription account look at the example on page 193 of your book

Partnership accounts

A partnership is a business in which two or more people work together as owners with a view to make profits. Normally there cannot be more than twenty partners.

Partnership agreement:

It is usual for an agreement to be drawn up when a partnership is formed to eliminate any confusion and misunderstanding which may arise if no written agreement is prepared.

Following are the contents of a partnership agreement:

- the amount of capital to be invested by each partner
- how the profits and losses to be shared between the partners
- interest on partners' capital
- salaries are to be paid to the partners
- interest on partners' drawings
- interest on partners' loan

Profit and loss appropriation account:

A partnership business draws up an appropriation account to show how the net profit is shared out between partners.

Steps to make appropriation account

- take the net profit
- add the interest charged on drawings
- subtract: interest on capital, salaries and share of profit and loss according to the agreement

Profit and loss appropriation account

Net profit			9220
Add interest on drawings			
	Ann	160	
	Joe	<u>120</u>	<u>280</u>
			9500
Less interest on capital			
	Ann	800	
	Joe	<u>1200</u>	<u>2000</u>
			7500
Partner's salary	Ann		<u>5000</u>
			2500
Shares of profit	Ann	1000	
	Joe	<u>1500</u>	<u>2500</u>

Partners' ledger accounts

	<u>Ann Current account</u>		
DR			Cr
Drawings	4000		Balance b/d
Interest on drawings	160		interest on capital
Balance c/d	3140		salary
			Profit share
	<u>7300</u>		<u>1000</u>
			<u>7300</u>
			Balance b/d
			3140

How to show current accounts of partners in Balance sheet?

- Credit balance of partner's current account is added to capital in the balance sheet.
- Debit balance of partner's current account is subtracted from the capital in the balance sheet
- For example: Ann current account shows a Dr. balance of 3140 and Joe current account shows Cr. Balance of 220.

Extraction of balance sheet

Financed by:

	Ann	Joe	total
Capital	8000	12000	
Current account	<u>3140</u>	<u>(220)</u>	
	<u>11140</u>	<u>11780</u>	22920

How to write off the goodwill account? And how to record goodwill in the capital accounts:

- Write the goodwill on the debit side of the account using old ratio.
- And write the goodwill on the credit side of account using new ratio.

Goodwill account

Ann	2400	Ann	2000
Joe	3600	Joe	3000
		Ken	1000
	<u>6000</u>		<u>6000</u>

Capital account

	<u>Ann</u>	<u>Joe</u>	<u>Ken</u>		<u>Ann</u>	<u>Joe</u>	<u>Ken</u>
Goodwill	2000	3000	1000	balance b/d	8000	1200	-
Balance c/d	8400	12600	9000	bank	-	-	10000
		<u>10400</u>	<u>15600</u>	Goodwill	2400	3600	-
					<u>10400</u>	<u>15600</u>	<u>10000</u>
				Balance b/d	8400	12600	9000

Accounts of Manufacturing

Manufacturing account shows how much manufacturing cost the business to make the goods produced in the financial year. There are four main elements of cost which make up the cost of manufacturing

1. Direct cost
2. Direct labor
3. Direct expenses
4. Factory overheads (indirect expenses)

Manufacturing account for the year ended 31 December 2009

<u>Cost of material consumed</u>	\$	\$
Opening stock of raw material	4500	
Purchases of raw material	52000	
Carriage on purchases	<u>1050</u>	
	57550	
Less closing stock of raw material	<u>4950</u>	57600
Direct wages		<u>49800</u>
Prime cost		102400
<u>Factory overheads</u>		
Indirect wages	32600	
Light and power	2750	
General expenses	4100	
Machinery repairs	1950	
Depreciation of machinery	<u>5000</u>	<u>46400</u>
		148800
Add opening stock of raw material in progress		<u>2100</u>
		150900
Less closing stock of work in progress		<u>1900</u>
Production cost of goods completed		<u>149000</u>

Trading accounts of manufacturing businesses

	\$	\$
Sales		181000
<u>Less cost goods sold</u>		
Opening stock of finished goods	5700	
Production cost of goods completed	149000	
Purchases of finished goods	<u>2500</u>	
	157200	
Less closing stock of finished goods	<u>6200</u>	<u>151000</u>
Gross profit		30000
<u>Less expenses</u>		
Office expense	2000	
Office equipment depreciation	<u>1000</u>	<u>3000</u>
Net profit		<u>27000</u>

Balance sheet of manufacturing businesses

Extraction of balance sheet

Current assets

Stock of raw material	4950	
Stock of work in progress	1900	
Stock of finished goods	<u>6200</u>	13050

Limited Company Accounts

A minimum of two members is necessary to form a limited company, but there is no maximum. The capital of a company is divided into units known as shares which can be any monetary amount.

The members (shareholders) of the company are only liable for the debts of the company up to the amount they agree to pay for their shares.

There are two types of limited company- Public limited company and private limited company.

Public limited company offers its shares to the public and a private limited company usually a smaller company and is not allowed to offer its shares to the public.

Share capital:

- When a limited company is first formed the amount of its share capital must be stated. **This is known as the authorized share capital**
- Authorized share capital is the maximum amount of share capital the company is allowed to issue.
- The total amount a company has requested from the shareholders is known as the **called up capital**.
- The term **paid up capital** refers to that part of called up capital for which a company has actually received cash from its shareholders.

Types of shares:

- The authorized share capital is divided into different types of shares. The most common ones are preference shares and ordinary shares.
- **Preference shares:**
 - a. They received a fixed rate of dividend which is payable before any dividend is payable to the ordinary shareholders.
 - b. The dividend is same every year.
 - c. If a company is wound up any money left after paying outside liabilities is used to pay back the preference shareholders before anything is returned to the ordinary shareholders.
 - d. Preference shareholders are not entitled to vote at shareholders meetings.
- **Ordinary shareholders:**
 - a. The dividend is not a fixed amount, but varies according to the profits of the business.
 - b. If the trading results are poor the ordinary shareholders may received no dividend at all.
 - c. Ordinary shareholders are entitled to vote at shareholders meetings on the basis of one vote per share.

- **Debentures:**
 - a. A company may also obtain funds from debentures, which are long term loans.
 - b. Debentures carry a fixed rate of interest, which is payable whether or not the company makes a profit.
 - c. Debenture holders are not the member of the company.

Profit and loss appropriation account

Example:

- Anand Ltd was formed on 1 July 2003 with an authorized capital of \$700,000 divided into 400,000 5% preference shares of \$1 each and 600,000 ordinary shares of \$0.50 each.
- On 30 June 2006 half of the preference shares and all of the ordinary shares had been issued and were fully paid.
- The net profit for the year ended 30 June 2006 was \$58000. On that date the balance brought forward on the profit and loss appropriation account amounted to \$21000.
- Half of the preference share dividend was paid on 31 December 2005. On 30 June 2006 the directors recommended the transfer of \$8000 to general reserve, the payment of the remaining preference dividend, and the payment of an ordinary share dividend of 8%.

Prepare the profit and loss appropriation account for the year ended 30 June 2006

	\$	\$	\$
Net profit for the year			58000
Less Transfer to general reserve			<u>8000</u>
			50,000
Dividends- preference paid		5000	
Proposed - preference shares		5000	
Ordinary shares		<u>24000</u>	<u>34000</u>
Retained profit for the year			16000
Retained profit b/d			<u>21000</u>
Retained profit carried forward			<u>37000</u>

Prepare an extract from the balance sheet of Anand Ltd at 30 June 2006 showing the shareholders' funds.

Share capital	Authorized	Issued
5% preference share of \$1 each	400,000	200,000
Ordinary shares of \$0.50	<u>300,000</u>	<u>300,000</u>
	<u>700,000</u>	500,000
Reserves		
General reserve	34000	
Profit and loss account	<u>37000</u>	<u>71000</u>
Share holders' funds		<u>571000</u>

Profitability ratios

Return on capital employed (ROCE)

- It shows the profit earned for every \$100 of capital employed.

$$\frac{\text{Net profit}}{\text{Capital employed}} \times 100$$

Gross profit as a percentage of sales

- This measures the gross profit for every \$100 of sales. It indicates how profitable the sales were.
- Any significant reduction in gross profit possibly caused by:
 - a. Selling goods at cut prices
 - b. Holding seasonal sales
 - c. Offering trade discounts to customers in bulk
 - d. Not passing on increased costs to customers.
- The gross profit percentage could be increased by:
 - a. Looking for cheaper supplies
 - b. Increasing selling prices
 - c. Increasing advertising and sales promotions
 - d. Changing the proportions of the different types of goods sold

Profitability ratios:

Gross profit percentage: $\text{Gross profit} \div \text{sales} \times 100$

Net profit percentage: $\text{net profit} \div \text{sales} \times 100$

Liquidity ratios:

Formula: Current assets: current liabilities

- This is a measure of the business's ability to meet existing current liabilities as the fall due.
- Anything between 1.5:1 and 2:1 is generally be regarded as satisfactory.
- A ratio of over 2:1 may imply poor management of current assets.

Consequences of not having enough working capital include:

- a. Problems in meeting debts as they fall due
- b. Inability to take advantage of cash discounts
- c. Difficulties in obtaining further supplies
- d. Inability to take advantage of business opportunities as they arise

Ways of improving the working capital include:

- a. Introduction of further capital
- b. Obtaining long term loans
- c. Reducing owner's drawings
- d. Selling surplus fixed assets

Quick ratio:

Current assets – stock: current liabilities

- a. **A ratio of 1:1 is usually regarded as satisfactory. This indicates that liquid assets match the current liabilities.**
- b. **With a ratio of 1:1 the current liabilities can be paid without the need to sell stock immediately and without selling fixed assets.**
- c. **A ratio more than 1:1 may indicate poor management of liquid assets.**

Collection period for debtors

Formula: $\text{debtors} \div \text{credit sales} \times 365 \text{ days}$ (for answer in days)

$\text{Debtors} \div \text{credit sales} \times 52 \text{ weeks}$ (for answer in weeks)

How to improve collection period for debtors?

- a. Offer cash discount for early settlement of debts
- b. Charge interest on overdue debts
- c. Refuse further supplies until the outstanding balance is paid

Payment period for creditors:

Formula: $\text{Creditors} \div \text{credit purchase} \times 365 \text{ days}$ (for answer in days)

$\text{Creditors} \div \text{credit purchase} \times 365 \text{ days}$ (for answer in weeks)

- a. Taking extended credit benefits the liquidity position as the business is able to use the money for other purposes for a longer period.
- b. The drawbacks to delays in paying creditors are the loss of any cash discounts which may be available, and the damage to the relationship with the suppliers.