Basic Definitions

Capital:
Initial and subsequent investment with which the business is started and expanded respectively
Example:
Mr. A started a business with $50,000 and after two years a further amount of $80,000 was injected into the business for expansion. So $50,000 is the initial investment and $80,000 subsequent investment, both are capital so capital for Mr. A would be $130,000.

Separate Entity Concept:
Its states that the affairs of the business are to be treated as being quite separate from the non business activities of the owner. In short owner starts the business, works for the business but still cannot use business money/goods for his/her personal purposes, if he/she does it, these are said to be drawings. The benefit of the owner is the profit that he/she earns from the business and the amount of salary that he/she takes for working for the business.

Drawings:
Amounts or goods taken by the owner/proprietor for his/her personal use

Assets:
Things owned by a business are known as assets
There are two types of assets

1. Non Current Assets / Fixed Assets
2. Current Assets

Non Current Assets / Fixed Assets:
Non Current Assets have a life of more than one year.
Examples

- Premises
- Land & Building
- Motor Vehicles
- Fixtures & Fittings
- Office Equipment
- Plant & Machinery etc etc,

Current Assets
Current Assets have a life of less than a year
Examples:

- Stock / Inventories (Unsold Goods are known as Inventories)
- Trade Receivables (Who owe money to the business)
- Other Receivables / Prepaid Expenses
- Cash at Bank
- Cash in hand

Liabilities
Amounts payable by the business
There are two types of liabilities

1. Current Liabilities
2. Long term Liabilities / Non Current Liabilities

Current Liabilities
Amounts to be paid / settled within or less than a year
Examples

- Trade Payables / Trade Creditors (who owe money from the business)
- Other Payables / Accrued Expenses
- Bank Overdraft (when more amount is withdrawn than the business has in its bank account)

Long term Liabilities / Non Current Liabilities
Amounts to be paid / settled after a period of one year
Examples

- Bank Loans
- Debentures (Long term loans raised by a company from the public other than the shares) etc etc

Sales / Revenue
Goods sold are known as sales
There are two types of sales

1. Cash Sales (goods sold for cash)
2. Credit Sales(goods sold on credit and the persons to whom the goods are sold on credit are called Debtors / Trade Receivables)

Purchases / Raw Materials:
Goods bought for resale are called Purchases / Raw Materials
There are two types of sales

1. Cash Purchases (goods bought for cash)
2. Credit Purchases (goods bought on credit and the persons from whom the goods are bought on credit are called Creditors / Trade payables).

Operating Expenses:
Are expenses incurred for operating the business e.g., rent, rates, insurance, wages & Salaries etc

Selling & Distribution Expenses:
Expenses that are incurred for selling a product e.g., Advertisements, bad debts, discount allowed, carriage outwards, sales staff salaries & Commission and Depreciation of delivery vehicle

Financial Charges
Expenses that are actually cost of raising capital e.g., Bank Charges and Interest on Overdraft or loan etc

Stock / Inventories
Unsold goods are known as stock
There are two types of stock

1. Opening Stock (Stock at the start of a period)
2. Closing Stock (Stock at the end of a period)

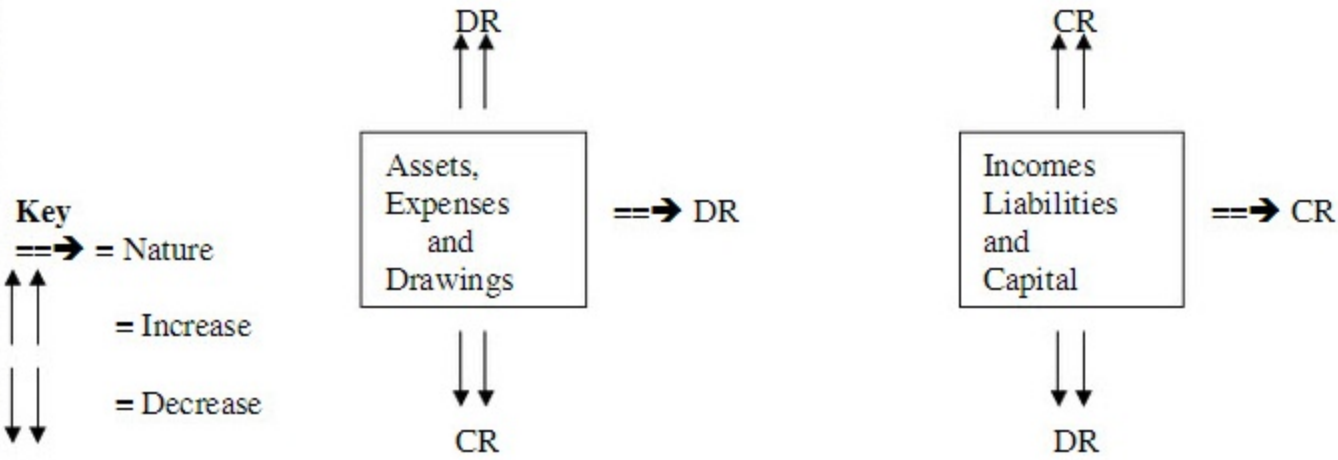
Accounting

Definition

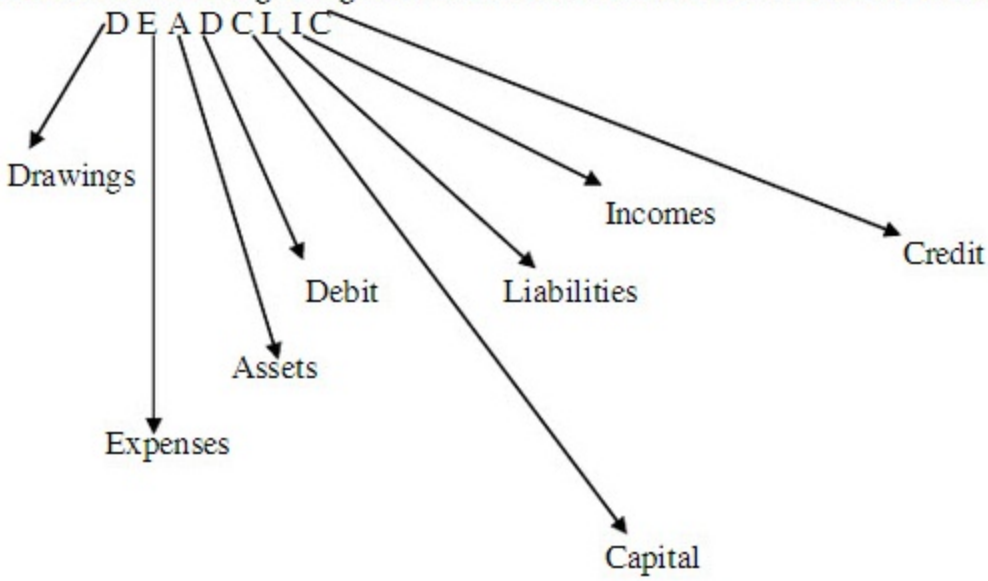
It is an art of recording, classifying, summarizing and interpreting the financial statements in a manner understandable for all

The first step of the definition is **recording,** which means to record the transactions in appropriate books. While recording keep in mind the following steps:

1. How to Record ====➔ Using a system called "Double Entry System of Recording"
2. What is this System of double entry ====➔ It says for every Debit (DR), there is an equal and opposite Credit (CR)
3. What are Debit (DR) and Credit (CR) ====➔ These are tools to Record
4. How to use these tools ====➔ Using a logic which is narrated below



There is a short cut rule regarding use of Debit & Credit Known as "DEAD CLIC"



Next step in Accounting Definition is **Classifying**
Which means to classify the transactions according to their titles. Which is done by posting the transactions into T Accounts.

How to post the transactions in the T Accounts

Since every T Account has two sides. DR side and CR side
Left side of every T Account is DR side and the right side of every T Account is CR side
While posting the first question which arises is

On Which side to Write
If the Title of Account (for which a T Account is being made) is being debited in the transaction, we will write on the debit side of the T Account

In the same way, If the Title of Account (for which a T Account is being made) is being Credited in the transaction, we will write on the Credit side of the T Account

What to write

Cross Reference (title of account on the opposite side)
For a DR Title of Account, title of account on the CR (opposite side) is Cross reference and
For a CR Title of Account, title of account on the DR (opposite side) is Cross reference

Take the example of a transaction

- Started business with $10,000 in the bank

The accounting entry for this transaction is

DR---------- Bank 10,000

CR---------- Capital 10,000

Now if we make the T Account for "BANK"

DR Side	Bank Account		CR Side
	$		$
Capital	10,000		

The transaction will be placed on the DR side of the bank account because bank is being debited so we will write on the DR side of the bank account and Capital would be written as Cross reference because it is the title of account on the credit side (opposite side)

DR Side	Capital Account		CR Side
	$		$
		Bank	10,000

The transaction will be placed on the CR side of the Capital account because Capital is being credited so we will write on the CR side of the Capital account and Bank would be written as Cross reference because it is the title of account on the debit side (opposite side)

Now after the T accounts have been prepared, next step is to balance the T Account at the end of a given period Which is known as Closing balance and written as Balance c/d
The closing balance of a period would be the opening balance of the very next period known as opening balance and is written as balance b/d.

Balancing of T Accounts

- Take the total of both DR and CR sides
- Write the total of the bigger side on the bigger side and on the shorter side both
- Subtract the shorter side from the bigger side the balance would be known as Closing balance and is written as balance c/d
- Remember balance c/d would always be on the shorter side and is above the "totals"
- Balance b/d would always be on the opposite side of balance c/d and is below the "totals"

After balancing the T accounts next step is to extract a trial balance

Trial Balance

It is a list of balance b/d`s extracted from the T Accounts. It has two sides, DR side and the CR side and these two sides totals are always equal to each other, if these two sides totals are not equal to each other, it means there is an error while recording or posting the transactions in the T Accounts

Example

- Mr. X started a business with $10,000 in the bank
- He bought furniture and fixtures worth $2,000 paying by cheque
- He bought goods paying by cheque worth $3,000
- Sold goods paying by cheque $4,000

DR Side	Bank Account		CR Side
	$		$
Capital	10,000	Furniture & Fixtures	2,000
Revenue	4,000	Purchases	3,000
		Balance c/d	9,000
	14,000		14,000
Balance b/d	9,000		

Now if we write the bank figure in a trial balance it would appear on the debit side of the trial balance because balance b/d is on the debit side

Trial Balance As at 31 December 20X8

	DR ($)	CR ($)
Bank	9,000	

After a trial balance has been extracted next step is to make an Income Statement for the year ended 31 December, 20X8. An Income Statement is made to calculate profit on trading i.e., Gross Profit and then the overall profit of the business i.e., Net Profit.

Gross Profit = Revenue – Cost of Sales

Cost of Sales = Opening Inventory + Raw Materials (Purchases) – Closing Inventory

Net Profit = Gross Profit – Operating Expenses

Now if we plot these formulas in a format, it would be

Income Statement
For the year ended 31 December, 20X8 (this date / year is assumed, in questions it will be the date / year given)

	$	$	$
Revenue		XXXX	
Less Return Inwards		(XXX)	XXXX
Less Cost of Sales			
Opening Inventory	XXXX		
Add Raw Materials / Purchases	XXXX	XXXX	
Less Closing Inventory		(XXX)	(XXX)
Gross Profit			**XXXX**
Less Operating Expenses:			
Rent		XXXX	
Insurance		XXXX	
Utility Bills		XXXX	
Wages & Salaries		XXXX	
Motor Expenses		XXXX	
Repair & Maintenance etc etc.		XXXX	(XXX)
Net Profit / Net Loss			**XXXX**
			=====

Note:
Net Loss Would be a Negative Figure i.e, if we subtract Operating Expenses from Gross Profit, and the answer is a negative figure, it would be Net Loss

Next format is of **Balance Sheet**

A balance sheet is a financial statement that tells the business`s financial position at a certain date.

Working Capital = Current Assets – Current Liabilities

Net Assets = Fixed Assets + Working Capital

Format of a Balance Sheet

Balance Sheet , As At 31 December 20X8 (this date / year is assumed, in questions it will be the date / year given)

	$	$	$
Non Current Assets:			
Premises		XXXX	
Land & Building		XXXX	
Motor Vehicles		XXXX	
Fixtures & Fittings		XXXX	
Office Equipment		XXXX	
Plant & Machinery etc etc		XXXX	XXXX
Current Assets			
Inventory (Closing)	XXXX		
Accounts Receivables	XXXX		
Bank	XXXX		
Cash	XXXX	XXXX	
Less Current Liabilities			
Accounts Payables	XXXX		
Bank Overdraft	XXXX	(XXXX)	
Working Capital (CA – CL)			XXXX
Net Assets (NCA + W/C)			XXXX
			=====
Financed By:			
Capital (Opening)		XXXX	
Add Net Profit **OR**		XXXX	
Less Net Loss		(XXX)	XXXX
Less Drawings (Cash Drawing + Drawings in goods)			(XXX)
Add Long Term Loan			XXXX
Closing Capital			XXXX
			=====

Books of Original / Prime Entries

There are six books of prime / original entries which have to be maintained by the businesses if they wish to keep their accounting records up to date and informative.

These books are:

1. Sales Day Book / Sales Journal
2. Purchases Day Book / Purchases day book
3. Return Inwards Day Book / Sales Returns day book / Return Inwards Journal
4. Return Outwards Day Book / Purchases Returns Day book / Return Outwards Journal
5. Cash Book
6. General Journal / The Journal

What Transactions are recorded in these books individually

Sales Day Book :

Only Credit Sales transactions are included in Sales Day Book

Purchases Day Book :

Only Credit Purchases transactions are included in Purchases Day Book

Sales Returns Day Book :

Only Credit Sales returns transactions are included in Sales Return Day Book

Purchases Returns Day Book :

Only Credit Purchases returns transactions are included in Purchases Returns Day Book

Cash Book (Three Column)

Cash Sales, Cash Purchases, Expenses Paid in Cash or by Cheque, Incomes received in Cash or by cheque in short All Receipts and all Payments both in Cash or by Cheque

General Journal / The Journal

Non Current Assets bought on credit, Non Current Assets Sold on Credit, Entries for recording Bad Debts, Provision for Bad Debts, Depreciation, Provision for Depreciation, All Rectifying Entries and All Opening & Closing Entries are recorded in General Journal

Formats

Sales Day Book / Sales Journal

Date	Details / Description	Amount ($)
	Debtor (Accounts Receivables) A	
	Debtor (Accounts Receivables) B	
	Debtor (Accounts Receivables) C	
	Total	

Note: Only names of the debtors are written in Sales Day Book

Purchases Day Book / Purchases Journal

Date	Details / Description	Amount ($)
	Creditor (Accounts Payables) A Creditor (Accounts Payables) B Creditor (Accounts Payables) C	
	Total	

Note: Only names of the Creditors (Accounts Payables) are written in Sales Day Book

Return Inwards Day Book / Return Inwards Journal

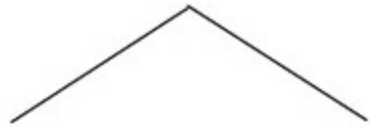
Date	Details / Description	Amount ($)
	Debtor (Accounts Receivables) A Debtor (Accounts Receivables) B Debtor (Accounts Receivables) C	
	Total	

Return Outwards Day Book / Purchases Returns Journal

Date	Details / Description	Amount ($)
	Creditor (Accounts Payables) A Creditor (Accounts Payables) B Creditor (Accounts Payables) C	
	Total	

Discounts

There are two types of discounts

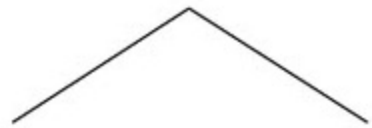


1. Trade Discount

- it is at the time of transaction
- is a result of bulk buying and bargaining
- is not recorded in the books at all

2. Cash Discount

after a credit transaction
is offered to encourage settlement of payment
is recorded in the books and is of two types



Discount Allowed **Discount Received**

Example:
Mr. A sold goods to Mr. B. The list price of the goods were $34,000. However Mr. B was able to negotiate a price of $30,000 with Mr. A. Credit terms were 3 months. However only after one month Mr. A approaches Mr. B, and asks for payment against a discount of 2%. Mr. B takes advantage of the additional discount.
Record the transactions in the books of Mr. A and Mr. B

Books of Mr. A

DR---------- Mr. B	30,000	
CR----------Sales		30,000
DR---------- Bank	29,400	
DR----------Discount Allowed	600	
CR----------Mr. B		30,000

Books of Mr. B

DR---------- Purchases	30,000	
CR---------- Mr. A		30,000
DR---------- Mr. A	30,000	
CR----------Bank		29,400
CR---------- Discount RCVD		600

Three Column Cash Book

Date	Details	Discount ($)	Cash ($)	Bank ($)	Date	Details	Discount ($)	Cash ($)	Bank ($)
	Balance c/d					Balance c/d			

Notes:

1. All receipts and discount allowed are placed on the debit side of the cash book
2. All payments and discount received are placed on the credit side of the cash book
3. Discount columns (Discount allowed and received) are not balanced, rather the total of both discounts are written in the respective Debit & Credit Columns
4. Bank column balance c/d is taken, if the balance c/d is on the credit side, it means it is a debit balance and would be written in the balance sheet as "Current Asset". If balance c/d is on the debit side, it means it is a credit balance and would be written in the balance sheet as "Current Liability"
5. Cash column balance c/d is taken, if the balance c/d is on the credit side, it means it is a debit balance and would be written in the balance sheet as "Current Asset". Cash Column can never have a balance c/d on the debit side
6. **Set Off / Contra** means either Cash has been paid into the bank OR
   Cash has been withdrawn out of the bank
7. A Contra entry is written on both sides of the cash book

   for example

   "Cash has been paid into the bank"
   On the **Debit side** we will write **Cash** in the **details** Column and write the amount in the **Bank** Column then On the **Credit side** we will write **Bank** in the **details** Column and write the amount in the **Cash** Column

   and

   "Cash has been withdrawn out of the bank"
   On the **Credit side** we will write **Cash** in the **details** Column and write the amount in the **Bank** Column **then** On the **Debit side** we will write **Bank** in the **details** Column and write the amount in the **Cash** Column

General Journal / The Journal

Date	Details / Particulars	Debit ($)	Credit ($)
	Total		

Every transaction has a Debit and a Credit in it

For Example

Non Current Assets bought on Credit
DR----------Fixed Assets
CR----------Accounts Payables

Non Current Assets would be written in the Details Column and the amount in the Debit Column **then** Accounts Payables would be written in the Details Column and the amount in the Credit Column etc etc

Common transactions and their Journal Entries

Transactions	**Debit**	**Credit**
1. Fixed Assets sold on credit	Accounts Receivables	Non Current Assets
2. Bad Debts	Bad Debts	Accounts Receivables
3. Provision for bad debts	Profit & Loss	Prov. For bad debts
4. Returns of Non Current Assets bought	Accounts Payables	Non Current Assets

Ledgers There are three types of ledgers

1. Sales Ledger (in this book only Accounts Receivable T Accounts are made)
2. Purchases Ledger (in this book only Accounts Payable T Accounts are made)
3. General Ledger (Rest of all the T Accounts are made in General Ledger)

Table for Transactions in which book of prime entry to write and T Accounts relating the transaction would be made in which books

Transaction	Book of Original Entry	Ledgers
1. Goods sold on credit	Sales day book	A/R T account in Sales Ledger (DR side) Sales T Account in General Ledger (CR side)
2. Goods Bought on credit	Purchases day book	A/P T accounts in Purchases Ledger (CR side) Purchases T Account in General Ledger (DR side)
3. Return Inwards	R/I day book	A/R T account in Sales Ledger (CR side) R/I T account in general ledger (DR side)
4. Return Outwards	R/O day book	A/P T account in Purchases Ledger (DR side) R/O T account in general Ledger (CR side)
5. Cash Sales	Cash Book	Sales T account in General Ledger (CR side)
6. Cash Purchases	Cash Book	Purchases T Account in General Ledger (DR side)
7. Amount received from Account Receivables and allowed them discount	Cash Book	A/R T account in Sales Ledger (CR side) Discount Allowed T account in General Ledger (DR side)
8. Amount paid to accounts payables and received from them discount	Cash Book	A/P T account in Sales Ledger (CR side) Discount Received T account in General Ledger (CR side)
9. Other income received For example Commission received	Cash Book	Commission Received T Account in G.L. (CR side)
10. Expenses paid for ex. Rent , Insurance paid	Cash Book	Expenses T Account in General Ledger (DR side)
11. Non Current Assets bought on credit	General Journal	Non Current assets T account in G.L. (DR side) A/P for fixed Assets T account in G.L. (CR side)
12. Bad Debts	General Journal	Bad Debts T account in G.L. (DR side) A/R T account in Sales Ledger (CR side)
13. Provision for bad debts	General Journal	Provision for bad debts T account in G.L (CR side) Profit & Loss T account in G.L. (DR side)

14. Depreciation General Journal Depreciation T account in General Ledger (DR side)

Non Current Assets T account in G.L. (CR side)

Capital & Revenue Expenditures:

Capital Expenditures

1. Purchase of Non Current Assets (expenses whose benefit can be taken for more than one year)
2. Extension of Non Current Assets
3. Expenses incurred until and unless asset comes into working condition e.g., machinery bought for $50,000, paid transportation charges to bring the machinery to factory $1,000 and then paid erection charges of the machinery $500. Purchase of machinery is a Capital Expenditure and the rest two are also capital because these expenses are before the machinery has come into working condition
4. Expenses that result in increase in efficiency or earning capacity of the business e.g., $60,000 was spent to increase the seating capacity of a cinema hall from 1,000 seat to 1,200 seats. This would be capital expenditure because this has led to increase in earning capacity of the business due to increased seating arrangement.
5. Expenses of non recurring nature.

Treatment of Capital Expenditures in the accounts

Capital expenditures are added in the cost of the non current assets

Revenue Expenditures

1. Operating expenses of the business e.g., rent, rates, insurance, wages & Salaries etc.
2. Repair & Maintenance expenditures
3. Expenses of Recurring nature etc.

Treatment of Revenue Expenditures in the accounts

Revenue expenditures are included in Profit & Loss account under the heading "Expenses"

Bad Debts and Provision for bad debts or provision for doubtful debts

Bad debts

When accounts receivables don`t pay the business, it is known as bad debts. OR
Amounts irrecoverable from Accounts Receivables are known as bad debts

Accounting entry for bad debts

DR----------Bad Debts
CR------------------------------Debtors

Bad debts are an loss / expense so these are being debited and bad debts result in decrease in accounts receivables and when accounts receivables decrease, they are being credited.

In bad debts T account, accounts receivables are placed on the DR side AND
In Accounts receivables T account, bad debts are placed on the CR side

Provision for bad or doubtful debts

Matching Concept

Expenses are matched against revenues. Expenses against an income (e.g., bad debts are an expense against sales income) should be recorded in the same accounting year, in which that income is earned and recorded.

Prudence Concept / Principle of Conservatism

Anticipated (future) losses should be recorded in the financial statements and Anticipated gains should not be recorded in the financial statements **OR** Incomes and assets shouldn't be overstated

Provision for bad debts is based on these two principles. To understand the concept lets take an example

Mr. A sold goods on credit on 28th December 20X8. Credit terms were 3 months i.e., amount for these credit sales from accounts receivables would be received by Mr. A in the next year i.e., 28th March 20X9.
Mr. A recorded these goods sold as "Sales" in the income statement for the year ended 31 December, 20X8. now following the matching and prudence concept, any bad debts arising against these sales should be recorded in the income statement for the year ended 31st December, 20X8. but the amount of any bad debts against this sales would be known on the date of receipt of amount from accounts receivables but by that time income statement would have been drafted.
So we take an estimation of bad debts against accounts receivables and name it as provision for bad debts and record it in the income statement of the same year in which sales have been recorded.

Following Prudence concept, if provision is not created, it would decrease expenses and so increase assets, moreover, provision for bad debts is subtracted from Accounts Receivables and if not created, wouldn't be subtracted resulting in increase in Assets (Accounts receivables)

Accounting entry for Provision for bad debts

DR---------- Profit & Loss
CR----------Provision for bad debts

Note:

Increase in Provision for bad debts is recorded as an expense in income statement
Decrease in Provision for bad debts is added in Gross Profit in income statement

Practice Question 1

Years	Bad Debts written off ($)	Accounts receivables ($)	% of provision for bad debts
20X1	500	80,000	5%
20X2	600	90,000	6%
20X3	800	100,000	7%
20X4	400	70,000	10%
20X5	700	60,000	5%
20X6	600	50,000	8%
20X7	900	80,000	9%
20X8	800	90,000	8%
20X9	700	120,000	5%
20X0	600	80,000	8%

Required:

(a) Bad Debts account
(b) Provision for bad debts account
(c) Extracts from the income statement
(d) Extracts from the balance sheet

Practice Question 2

Years	Bad Debts not written off ($)	Accounts receivables ($)	% of provision for bad debts
20X1	800	80,800	4%
20X2	600	90,600	6%
20X3	800	100,800	7%
20X4	400	70,400	6%
20X5	700	60,700	7%
20X6	600	50,600	8%
20X7	900	80,900	9%
20X8	800	90,800	7%
20X9	700	70,700	9%
20X0	600	80,600	8%

Required:

(a) Bad Debts account
(b) Provision for bad debts account
(c) Extracts from the income statement
(d) Extracts from the balance sheet

Depreciation

Wear and tear in the value of an asset due to its usage OR
Gradual decrease in the value of an asset due to its usage

Depreciation is a non cash expense, and is always debited.
Depreciation results in decrease in the value of fixed asset so fixed assets are credited.

Accounting entry for depreciation

Debit ---------- Profit & Loss A/C
Credit ---------- Provision for depreciation A/c

Depreciation is recorded following matching principle, which states that expenses are matched against revenues. Because asset has been used to generate revenue so this decrease in value (due to wear and tear) while generating revenue is recorded as an expense against sales.

Cost : it means cost of purchase **plus** all capital expenditures
Net Book Value (NBV): Cost – Accumulated Depreciation (Collective depreciation)
Useful Life: No. of years asset is used to generate revenue is known as its useful life
Scrap Value / Residual Value: Estimated Selling Value of an asset at the end of its useful life

Methods to calculate depreciation

1. **Straight Line method / Original Cost method / Fixed Installment method**
   (when Depreciation % is not given, a formula is used)

$$\text{Depreciation (p.a.)} = \frac{\text{Cost} - \text{Scrap Value}}{\text{Life}}$$

For Example
An asset has been bought for $20,000. it has a useful life of 5 years and could be sold for $2,000 at the end of its useful life (Scrap Value). What is the annual depreciation charge of the asset (using straight Line method) for each of the five years, stating clearly the value remaining at the end of each year.

$$\text{Depreciation (p.a.)} = \frac{20{,}000 - 2{,}000}{5} = \$3{,}600 \text{ p.a.}$$

	$
Cost of the Asset	20,000
Less first year end depreciation	(3,600)
NBV at the end of year 1	16,400
Less second year end depreciation	(3,600)
NBV at the end of year 2	12,800
Less third year end depreciation	(3,600)
NBV at the end of year 3	9,200
Less fourth year end depreciation	(3,600)
NBV at the end of year 4	5,600
Less fifth year end depreciation	(3,600)
NBV at the end of year 5 / Scrap Value	2,000

When Depreciation % is given

Depreciation (p.a.) = (Cost – Scrap Value) × dep. %

For Example
An asset has been bought for $20,000. it has a useful life of 4 years and could be sold for $2,000 at the end of its useful life (Scrap Value). Depreciation rate is 25%. What is the annual depreciation charge of the asset (using straight line method) for each of the four years, stating clearly the value remaining at the end of each year.

	$
Cost of the Asset	20,000
Less first year end depreciation (20,000 – 2,000) × 25%	(4,500)
NBV at the end of year 1	15,500
Less second year end depreciation (20,000 – 2,000) × 25%	(4,500)
NBV at the end of year 2	11,000
Less third year end depreciation (20,000 – 2,000) × 25%	(4,500)
NBV at the end of year 3	6,500
Less fourth year end depreciation (20,000 – 2,000) × 25%	(4,500)
NBV at the end of year 4 / Scrap Value	2,000

2. Diminishing Balance method / Reducing balance method / Reducing Installment method
Depreciation each year is calculated on the Net Book Value (NBV) of the assets every year
And
NBV = Cost – Accumulated Depreciation

Note:
Scrap Value is ignored even if its given in the question in this method

For Example

An asset has been bought for $20,000. it has a useful life of 4 years and could be sold for $2,000 at the end of its useful life (Scrap Value). Depreciation rate is 25%. What is the annual depreciation charge of the asset (using straight line method) for each of the four years, stating clearly the value remaining at the end of each year.

	$
Cost of the Asset	20,000
Less first year end depreciation (20,000 × 25%)	(5,000)
NBV at the end of year 1	15,000
Less second year end depreciation (15,000 × 25%)	(3,750)
NBV at the end of year 2	11,250
Less third year end depreciation (11,250 × 25%)	(2,813)
NBV at the end of year 3	8,437
Less fourth year end depreciation (8,437 × 25%)	(2,109)
NBV at the end of year 4	6,328

A formula can also be used for calculating depreciation for reducing balance method

$$R = 1 - \sqrt[n]{\frac{s}{c}}$$

where R = rate of depreciation
n = no. of years
s = residual value / scrap value
c = cost of the asset

if we take an example

n = 4 years
s = $4,000
c = $40,000

$$R = 1 - \sqrt[4]{\frac{4,000}{40,000}} \quad \Longrightarrow \quad 1 - {}^{1/4}[0.1] = 1 - 0.6 = 0.4 \times 100 = 40\%$$

3. revaluation method

this method applies to those fixed assets which value is subject to large fluctuations e.g., take the example of loose tools. Loose tools are such assets whose value is subject to large fluctuations so a specific method of depreciation is not applicable on them. That`s why this method is used

Depreciation (p.a.) = **Value of Fixed Asset at the year start + Additions - Value at the year end**

Example: Mr. X business has loose tools of $60,000 at the start of the year. It bought further loose tools of $ 30,000 during the year. Value of loose tools at the end of the year was $50,000. so
Depreciation = 60,000 + 30,000 – 50,000 = 40,000
Every year the same formula would be used to calculate depreciation.

Choice of the methods

The purpose of depreciation is to spread the total cost of a fixed asset over the period in which it is to be used. The method chosen should be that which allocates cost to each period in accordance with the proportion of the overall economic benefits from using the fixed asset that was expanded during the year.
If therefore, the main value is to be obtained from the asset in its earlier years, it may be appropriate to use the reducing balance method, which charges more in the early years, if on the other hand, the benefits are to be gained evenly over the years, then the straight line method would be more appropriate.

4. Output Method / Production / Usage method

$$\text{Depreciation} = \frac{\text{Current year production}}{\text{Total Production}} \times (\text{Cost} - \text{Scrap Value})$$

Example:

A business bought a machine for $ 50,000. it is estimated to be used for 4 years and has an estimated scrap value of $5,000. The production for the 4 years is as follows

Years	**Units**
Year 1	10,000
Year 2	8,000
Year 3	6,000
Year 4	6,000
Total Production	30,000

$$\text{Depreciation for year 1} = \frac{10,000}{30,000} \times (50,000 - 5,000) = \$15,000$$

$$\text{Depreciation for year 2} = \frac{8,000}{30,000} \times (50,000 - 5,000) = \$12,000$$

$$\text{Depreciation for year 3} = \frac{6,000}{30,000} \times (50,000 - 5,000) = \$9,000$$

$$\text{Depreciation for year 4} = \frac{6,000}{30,000} \times (50,000 - 5,000) = \$9,000$$

5. Sum of digits method

Example

A business bought a machine for $ 50,000. it is estimated to be used for 4 years and has an estimated scrap value of $5,000.

Life = 4 years

If we add up these four years it would be = 4 + 3 + 2 + 1 = 10

So

$$\text{Depreciation for year 1} = \frac{4}{10} \times (50,000 - 5,000) = \$18,000$$

$$\text{Depreciation for year 2} = \frac{3}{10} \times (50,000 - 5,000) = \$13,500$$

Depreciation for year 3 = $\frac{2}{10}$ x (50,000 – 5,000) = $9,000

Depreciation for year 4 = $\frac{1}{10}$ x (50,000 – 5,000) = $4,500

Basis for charging depreciation

1. **Monthly basis**

Depreciation is calculated for each month of ownership.

For example, as asset costing $20,000 was bought by a business on 30 September 20X2. it has a scrap value of $2,000 and a useful life of 4 years. Depreciation rate is 25% using straight line method. In the year 20X5 on 30th June 20X5, this asset was sold. The business year end is 31st December every year.

Depreciation for year ended 31st December 20X2 = (20,000 – 2,000) x 25% x 3/12 = $1,125
Depreciation for year ended 31st December 20X3 = (20,000 – 2,000) x 25% = $4,500
Depreciation for year ended 31st December 20X4 = (20,000 – 2,000) x 25% = $4,500
Depreciation for year ended 31st December 20X5 = (20,000 – 2,000) x 25% x 6/12 = $2,250

2. **Yearly basis**

A full years depreciation is calculated on the asset in the year of purchase, irrespective of the date of purchase and no depreciation is calculated on the asset in the year of sale.

For example, as asset costing $20,000 was bought by a business on 30 September 20X2. it has a scrap value of $2,000 and a useful life of 4 years. Depreciation rate is 25% using straight line method. In the year 20X5 on 30th June 20X5, this asset was sold. The business year end is 31st December every year.

Depreciation for year ended 31st December 20X2 = (20,000 – 2,000) x 25% = $4,500
Depreciation for year ended 31st December 20X3 = (20,000 – 2,000) x 25% = $4,500
Depreciation for year ended 31st December 20X4 = (20,000 – 2,000) x 25% = $4,500
No depreciation would be calculated for the year ended 31st December 20X5 because we are using yearly basis and according to this, no depreciation is taken on the assets in the year of disposal

Disposal of Fixed Assets

When a fixed asset is disposed off, its NBV (net book value) is compared against its proceeds i.e., the amount received by selling fixed assets, to calculate the gain or loss on the fixed asset.

NBV = Cost – Accumulated depreciation

Accumulated depreciation = Total depreciation on the asset from all the previous years till now
Accumulated depreciation is also known as provision for depreciation. But IAS 37 prohibits the use of Provision for depreciation rather the word Accumulated depreciation should be used.

Entry for Accumulated depreciation / Provision for depreciation

DR ---------- Profit & Loss
CR ---------- Accumulated depreciation / provision for depreciation

Accounting Entry for Disposal of fixed asset

1. Transfer the original cost of the asset sold to asset disposal account

   DR ---------- Asset Disposal Account
   CR ----------Asset Account
   (with the original cost of the asset sold)

2. Transfer total accumulated depreciation on the sold asset from the date of purchase till the date of sale to "Asset Disposal Account"

   DR ---------- Provision for Depreciation Account
   CR ----------Asset Disposal Account
   (with the total accumulated depreciation on the asset sold calculated from the date of purchase till the date of sale)

3. Transfer sale proceeds of the asset sold to asset disposal account

   DR ---------- Cash / Bank Account
   CR ----------Asset Disposal Account
   (with the sale proceeds received by selling that asset)

If we make the T Accounts:

DR Side — Asset (at cost) Account — CR Side

	$		$
Balance b/d		Asset Disposal (at cost)	
Cash / Bank (Additions)			
		Balance c/d	
	---		---
	=====		=====

DR Side — Accumulated Depreciation Account — CR Side

	$		$
		Balance b/d	
Asset Disposal (total dep. on sold asset)		Profit & Loss (dep. for the year)	
Balance c/d			
	---		---
	=====		=====

DR Side Asset Disposal Account CR Side

	$		$
		Acc. Dep.	
Cost of asset sold		(total dep. on sold asset)	
		Cash / Bank (sale proceeds)	
Profit & Loss (bal. fig.) (Gain on disposal)		Profit & Loss (bal. fig.) (Loss on disposal)	
	---		---
	=====		=====

Types of Expenses (From payment point of View)

1. Accrued / Outstanding / Owing / due / unpaid / payable / provided for Expenses

"Def."

Services have been taken but the amount has not yet been paid.

Accrued Expenses (Closing Balance) Treatment (Method 1)

- Profit & Loss Account — Added in the relevant expense
- Balance Sheet — Shown as a Current Liability

Accrued Expenses (Opening Balance) Treatment (Method 1)

- Profit & Loss Account — Subtracted from the relevant expense
- Balance Sheet — Shown as a Current Liability

2. Prepaid / Paid in Advance Expenses

"Def."

Services have not yet been taken but the amount has been paid in advance.

Prepaid Expenses (Closing Balance) Treatment (Method 1)

- Profit & Loss Account — Subtracted from the relevant expense
- Balance Sheet — Shown as a Current Asset

Prepaid Expenses (Opening Balance) Treatment (Method 1)

- Profit & Loss Account — Added in the relevant expense
- Balance Sheet — Shown as a Current Asset

Method 2 (by making a T Account)

Accrued Expenses are a Current Liability and Current liability opening balance is always placed on the Credit side of the T Account and Closing balance is placed on the Debit side of the T Account

Prepaid Expenses are Current Assets and Current Assets opening balance is always placed on the Debit side of the T Account and Closing balance is placed on the Credit side of the T Account

DR Side	Expenses Account		CR Side
	$		$
Prepaid b/d		Accrued b/d	
Cash / Bank (exp. paid)		Profit & Loss (bal. fig.)	
Accrued c/d		Prepaid c/d	
	========		========

Notes relating to Final Accounts (T, P&L a/c and Balance Sheet):

- **Drawings in goods**

  DR---------- Drawings (add in drawings)
  CR----------Purchases / Stock (subtract from purchases)

- **Accumulated Depreciation / Provision for depreciation (dep. of all previous years)**

  It is shown in Trial Balance and is subtracted from the fixed assets in the balance sheet together with the current year depreciation. In Profit & Loss a/c, only current year dep. is shown.

- **Bank charges and Bank interest**

  It is given in notes or additional information that bank has debited bank charges or interest which has not been included in the cash book so these bank charges and interest would be taken as an expense in Profit & Loss a/c and the amount of these charges would also be subtracted from the bank balance figure. If the bank balance is overdraft, these charges would increase the amount of overdraft.

  If interest has been credited in the bank statement and has not been included in the cash book then this would be treated as an income and would be added to gross profit and on the other hand bank balance would increase. If the bank balance is an overdraft, such incomes would decrease the overdraft

Format of an income statement with adjustments

Income Statement

For the year ended 31 December, 20X8 (this date / year is assumed, in questions it will be the date / year given)

	$	$	$
Revenue		XXXX	
Less Return Inwards		(XXX)	XXXX
Less Cost of Sales			
Opening Inventory	XXXX		
Add Raw Materials / Purchases	XXXX	XXXX	
Less Closing Inventory		(XXX)	(XXX)
Gross Profit			**XXXX**
Add Other Incomes:			
Discount received		XXXX	
Commission received		XXXX	
Decrease in provision for bad debts		XXXX	
Profit / gain on the sales of fixed assets		XXXX	XXXX
			XXXX
Less Operating Expenses:			
Rent		XXXX	
Insurance		XXXX	
Utility Bills		XXXX	
Wages & Salaries		XXXX	
Motor Expenses		XXXX	
Discount Allowed		XXXX	
Repair & Maintenance etc etc.		XXXX	(XXX)
Net Profit / Net Loss			**XXXX**
			=====

Format of a Balance Sheet with adjustments

Balance Sheet , As At 31 December 20X8 (this date / year is assumed, in questions it will be the date / year given)

	$	$	$
Non Current Assets:			
Premises		XXXX	
Land & Building		XXXX	
Motor Vehicles		XXXX	
Fixtures & Fittings		XXXX	
Office Equipment		XXXX	
Plant & Machinery etc etc		XXXX	XXXX
Current Assets			
Inventory (Closing)	XXXX		
Accounts Receivables	XXXX		
Prepaid Expenses	XXXX		
Bank	XXXX		
Cash	XXXX	XXXX	
Less Current Liabilities			
Accounts Payables	XXXX		
Accrued Expenses	XXXX		
Bank Overdraft	XXXX	(XXXX)	
Working Capital (CA – CL)			XXXX
Net Assets (NCA + W/C)			XXXX
			=====
Financed By:			
Capital (Opening)		XXXX	
Add Net Profit **OR**		XXXX	
Less Net Loss		(XXX)	XXXX
Less Drawings (Cash Drawing + Drawings in goods)			(XXX)
Add Long Term Loan			XXXX
Closing Capital			XXXX
			=====

Bank Reconciliation Statement (a subsidiary book)

It is a statement made by the business to match the bank balance according to the bank statement with the balance of Bank as per cash book (Bank Column). It is only made when the bank balances according to bank statement and cash book don't agree.

Bank statement:

It is a statement made by the bank which shows the amounts deposited and amount withdrawn by the business. A bank statement has a DR column, a CR column and a Balance Column.

The amount that the business deposits in the bank is an asset for the business and is written on the DR side of the cash book (bank column) but at the same time that amount deposited in the bank by the business is a liability for bank and bank would be this deposited amount of the CR side of the bank statement as bank`s liability would increase.

Any amounts withdrawn by the business out of the bank account would be written on the CR side of the cash book as business asset would decrease, and the same amounts would be written on the DR side of the bank statement as bank`s liability would decrease.

Format of a Bank statement

Date	Details	DR ($)	CR ($)	Balance ($)
		Withdrawals by The business	Deposits by the business	

Reasons why Bank Statement balance differs from that of balance of bank in Cash book (bank Column)

1. **Un presented Cheques**

Cheques issued to creditors, entered on the CR side of the cash book (bank column) but don't appear on the DR side of the bank statement because the creditors, to whom cheques have been issued didn't present the cheques at the counter of the bank. So Cash balance would decrease and bank statement balance would not decrease resulting in a difference. These cheques are always **DEBITED**

2. **Un Credited Cheques**

Cheques received from debtors, entered on the DR side of the cash book (bank column) but don't appear on the CR side of the bank statement because funds haven't been collected by our bank from the debtors bank. So Cash balance would increase and bank statement balance would not increase resulting in a difference. These cheques are always **CREDITED**

3. **Direct Debit**

Bank deducts directly amounts from the business account e.g., Bank charges and business is not informed so bank statement balance is decreased by the amount of charges and cash book (bank column) bank balance remains unchanged resulting in a difference

4. **Standing Order**

In writing instructions have been given to the bank to pay on business behalf by taking amount directly. So when bank pays on business behalf, bank statement shows a decreased balance and because this amount has not been subtracted from the cash book, cash book (bank column) remains the same, resulting in a difference

5. Direct Credit / Credit transfer

A customer deposits directly in business`s bank account or a refund is received directly by a creditor due to overpayment, so bank statement shows an increased balance and cash book balance remains the same resulting in a difference

Note:

- Un presented Cheques and Un Credited Cheques are treated in Bank Reconciliation Statement
- Direct Debit, Standing Order and Direct Credit are treated in Adjusted / Updated Cash Book.

While solving a question on Bank Reconciliation Statement, first and adjusted cash book is made and then a bank reconciliation statement is made.

Format of an adjusted Cash book

DR Side	Adjusted Cash Book	CR Side
	$	$
Balance b/d (balance as per old cash book)	Standing Order	
Direct Credit	Direct Debit	
	Balance c/d	
---		---
=====		=====

Format of a Bank Reconciliation Statement

As on

		$
Balance as per adjusted cash book	(DR) if c/d is on the CR side of adj. c / b	----
Un Presented Cheques	(DR) / +	----

Un Credited Cheques	(CR) / –	----
Balance as per Bank statement (Opposite to the balance according to cash book)		----
		========

Note:

If the resultant balance (answer) of BRS is DR, it would be written as a CR in front of balance as per bank statement and vice versa.

Format of a Bank Reconciliation Statement

As on

		$
Balance as per adjusted cash book	(CR) if c/d is on the DR side of adj. c / b	----
Un Presented Cheques	(DR) / –	----

Un Credited Cheques	(CR) / +	----
Balance as per Bank statement (Opposite to the balance according to cash book)		----
		========

Note: If the resultant balance (answer) of BRS is CR, it would be written as a DR in front of balance as per bank statement and vice versa.

Control Accounts

Need for Control Accounts / why control accounts are kept

When all the accounts are kept in one ledger a trial balance could be drawn up as a test of the arithmetical accuracy of the accounts. If the trial balance totals disagree, the books of a small business could easily and quickly be checked so as to find the errors. Of course, as you know, even when the totals do agree, certain types of errors may still have occurred, the nature of which makes it impossible for them to be detected in this way. Nevertheless, using a trial balance at least ensures that all the double entries appear and have been recorded correctly.

A larger business has the accounting work so divided up that there are several ledgers, any errors could be very difficult to find if a trial balance was the only device used to try to detect errors. Every item in every ledger may need to be checked just to balance each ledger, and this requirement is met by the control accounts.

A control account is a summary account that enables you to see at a glance whether the General Ledger balance (Control account balance) for the ledger (sales ledger or purchases ledger) to which that control account belongs agrees with the totals of all the individual account held within that ledger. (sales ledger or purchases ledger)

Advantages of keeping control accounts

- Locating errors
- Detection of fraud
- Set off / contra becomes possible
- Sales and Purchases figures are known
- Debtors and Creditors figures are known

Both "Sales Ledger Control Account" and "Purchases Ledger Control Account" are made in General Ledger.

Format of Sales Ledger Control Account

DR Side **Sales Ledger Control Account** CR Side
OR Total Debtors Account

	$		$
Balance b/d (debit balance)		Balance b/d (credit balance)	
Sales (Only Credit)		Sales Returns	
Dishonored Cheques		Discount Allowed	
Interest on Overdue Debtors		Bad Debts	
Cash refund to debtors		Cash & Bank	
		Set Off / Contra	
Balance c/d (credit balance) (Current Liability)		Balance c/d (Debit balance) (Current Asset)	
	======		======

Notes:

- Debtors may have a Credit balance, when debtors pay more than they owe the business.
- Dishonored Cheques increase the debtors so are written on the debit side of control account
- Interest on Overdue debtors means if a debtor doesn't pay within the allowed time period, interest would be charged from him for the period of delay and after the interest has been added, the debtor now owes more than he owed before so are written on the debit side of the control account
- Debtors pay the business more than they owed so debtors are credited with more amount and when the extra money received is refunded back to debtors, debtors are debited to cancel off the effect.

Format of Purchases Ledger Control Account

DR Side **Purchases ales Ledger Control Account** CR Side
OR Creditors Control Account

	$		$
Balance b/d (debit balance)		Balance b/d (credit balance)	
Purchases Returns		Purchases (Only Credit)	
Discount received		Dishonored Cheques	
Cash & Bank		Interest on Overdue Creditors	
Set Off / Contra		Cash refund from Creditors	
Balance c/d (credit balance) (Current Liability)		Balance c/d (Debit balance) (Current Asset)	
	======		======

Notes:

- Creditors may have a Debit balance, when we pay the creditors more than we owe them.
- Dishonored Cheques increase the Creditors so are written on the Credit side of control account
- Interest on Overdue Creditors means if we don't pay a creditor within the allowed time period, interest would be charged by him for the period of delay and after the interest has been added, we now owe more than we owed before so are written on the Credit side of the control account
- Creditor are paid more than they owe from the business so Creditors are Debited with more amount and when the extra money paid is refunded back from them, Creditors are Credited to cancel off the effect.

Errors not affecting Trial Balance Agreement

There are certain errors, the happening of which doesn't effect the trial balance agreement i.e., trial balance still balances

1. **Error of Omission**

   An accounting transaction is not recorded at all in the books.
   e.g., Sales to Mr. A worth $20,000 are not recorded, so Debtors would understate (DR side of the trial balance would understate) and sales would also understate i.e., (CR side of the trial balance would also understate) so both sides of the trial balance understate with $20,000 and the totals of the trial balance still agree

2. **Error of Commission**

   An accounting entry is recorded but in the wrong title of account e.g., Sales to Mr. A worth $20,000 were credited to sales but debited to Mr. B with the said amount
   So trial balance totals would agree but the balance in the personal accounts i.e., Mr. A and Mr. B (Debtors) would be wrong

3. **Error of Principle**

   Capital expenditures have been treated as revenue expenditures and vice versa
   e.g., wages paid to bring the machinery to factory were debited to wages account (treated as revenue expenditure) instead of debiting the Machinery (as it is a capital expenditure)
   so Wages have been debited instead of machinery, both amounts are written on the debit side of the trial balance and bank would be credited in both the cases. Which will keep the trial balance totals unchanged but the wages and machinery figures would be incorrect

4. **Error of Original Entry / Transposition Errors**

   Sales to Mr. A worth $213,546 were recorded as $243,516 to both Mr. A`s and Sales Account. So the figures for debtors and sales would be incorrect but the trial balance would still match.

5. **Compensating Errors**

   This is a two error model. Two errors occur in such a way that they cancel out each other`s effect. E.g., Rent was understated by $300 and Commission received was also understated by $300. so Debit side and Credit side of the trial balance are both understated by $300.

6. **Complete Reversal of Entries**

   An accounting entry is completely reversed e.g., Sales to Mr. A worth $30,000 were recorded as Purchases from Mr. A. So Purchases have been written on the debit side instead of bank and Bank has been credited instead of sales leaving the trial balance totals unchanged.

Suspense Accounts

Sometimes due to an inexperienced bookkeeper, trial balance totals don't agree. The bookkeeper being inexperienced can`t trace the error so the amount with which the trial balance doesn't agree is entered in a "suspense account" on the shorter side. These errors are later located and checked by the financial experts and an amended trial balance is drafter which doesn't include in any suspense account as both sides agree and there is no further error.

e.g.,

Trial Balance, as at 31 Dec. 20X0

	DR ($)	CR ($)
Totals	100,000	99,000

In this case the CR side is short by $1,000 so a suspense account is opened with the difference i.e., $1,000 on the credit side as CR side is short. And in this way trial balance both side agree with each other.
Please See Below
So

Trial Balance, as at 31 Dec. 20X0

	DR ($)	CR ($)
Suspense		1,000
Totals	100,000	100,000

Now the errors located would be rectified by the experts and then an amended trial balance is made which is free of all errors and doesn't include in any SUSPENSE figure
After the correction of the errors, SUSPENSE account is drafted which both sides must tally with each other. Is the both sides of the SUSPENSE account don't tally, it means all errors have not been rectified.

Format to Correct the Errors with Examples

- **Sales to Mr. A worth $4,000 were wrongly debited to Mr. B**

Wrong	Correct	Rectify
DR---- Mr. B 4,000 CR---------- Sales 4,000	Mr. A 4,000 Sales 4,000	Mr. A 4,000 Mr. B 4,000

- **Sales were understated by $200**

		Suspense 200 Sales 200

Now after all the errors have been rectified, a suspense account is drafter which both sides automatically tally with each other.

Sometimes in the question it is asked to prepare a statement of corrected net profit
In this case we have to start from the incorrect net profit
e.g.,

Statement of Corrected Net Profit, For the year ended

	$
Incorrect Net Profit	XXXX
Add Purchases Overstated	XXXX
(Purchases overstated result in increase in COGS and so Profit decreases)	
Less rent understated	
(Rent understated would decrease expenses and profit would increase)	
Etc etc.,	

Incomplete Records

When records given are incomplete, we have to complete the records first and then to make the required statements or set of final accounts.

There are two methods to solve incomplete records questions

1. using Single entry system

In this method the requirement is a "Statement of Profit & Loss"

2. using Double Entry System

in this method the requirement is "Set of Final Accounts" (T, P & L a/c and B/S)

Single Entry System

Statement of Profit & Loss, For the year ended

	$
Closing Capital	XXXX
Add Drawings	XXXX
Less Opening Capital	(XXXX)
Less Extra Capital Introduced	(XXXX)
Net Profit / Net Loss	XXXX

The figures of Opening and Closing Capitals wouldn't be given and should be calculated.
In order to find out the figure of Opening Capital an "Opening Statement of Affairs" is drafted
And in order to find out the figure of Closing Capital a "Closing Statement of Affairs" is drafted

Statement of Affairs

It is just like a balance sheet except for the "Financed by" portion. In it "capital" is taken as a balancing figure.
If the Statement of Affairs is made using Opening Assets and Opening liabilities, Capital (balancing figure) would be the Opening Capital, and
If the Statement of Affairs is made using Closing Assets and Closing liabilities, Capital (balancing figure) would be the Closing Capital.

Note:
Long term Loan is also adjusted while calculating the capital figure

Double Entry System

As the requirement is to make a set of Final Accounts i.e., Trading Profit & Loss Account and Balance Sheet So while making Income Statement "Sales" and "Purchases" figures wouldn't be given which have to be calculated.

For Sales figure, Debtors Control Account is drafted

DR Side **Sales Ledger Control Account** CR Side

	$		$
Balance b/d (debit balance)		Balance b/d (credit balance)	
Sales (balancing figure)		Sales Returns	
		Discount Allowed	
		Bad Debts	
		Cash & Bank	
Balance c/d (credit balance)		Balance c/d (Debit balance)	

Total Sales = Credit Sales (from Debtors Control Account) + Cash Sales

And in order to find out the figure of Purchases, "Purchases Ledger Control Account" is drafted.

DR Side **Purchases ales Ledger Control Account** CR Side

	$		$
Balance b/d (debit balance)		Balance b/d (credit balance)	
Purchases Returns		**Purchases (balancing figure)**	
Discount received			
Cash & Bank			
Balance c/d (credit balance)		Balance c/d (Debit balance)	

Total Purchases = Credit Purchases (from Creditors Control Account) + Cash Purchases

Opening Capital is calculated by making an **"Opening Statement Of Affairs"**

Non Profit Organizations

These are such business organizations whose primary motive if not to earn profit rather the welfare of the members and public at large. Profit becomes the secondary motive. E.g., Lahore gymkhana in Pakistan, Services hospital Lahore in Pakistan etc etc.,
Since profit earning is not the primary motive so a Trading Profit & Loss account is not required rather an "**Income & Expenditure account**" is made.
As capital is collected by selling the memberships so it is known as "Accumulated Fund" and is calculated by making an opening statement of Affairs
Cash book is known as "Receipts & Payments account"
"Subscriptions" is the regular contribution by the members towards the NPO for using its services. So a Subscription is an expense by the members but an income for the Organization.

Just like Expenses, **Incomes are of two types (from Receipt point of view)**

1. Accrued / Receivable / due / owing Income
"Definition"
Services have been rendered but the amount has not yet been received.

Accrued Incomes are taken as **Current Assets**

2. Pre-received / received in advance income
"Definition"
Services have not yet been rendered but the amount has been received in advance

Pre-received incomes are taken as **Current Liabilities**

So if we make a Model T account of Subscriptions, it would be

DR Side **Subscription Account** CR Side

	$		$
Accrued b/d (Opening balance)		Pre-received b/d (Opening balance)	
		Cash & Bank (Subscription received)	
Income & Expenditure account (balancing figure)			
Pre-received c/d (Closing balance)		Accrued c/d (Closing balance)	
	======		======

NPO`s also have a bar in it which sell refreshments and drinks to its members at a profit so a "Bar Trading a/c" is made to calculate bar profit

Format of **Bar Income Statement, for the year ended**

	$	**$**	**$**
Sales (Bar)			XXXX
Less Cost of Sales / Cost of goods sold:			
Opening Stock (Bar)	XXXX		
Add Purchases	XXXX	XXXX	
Less Closing Stock		(XXXX)	(XXXX)
Gross Profit			XXXX
Less Bar Expenses			(XXXX)
Bar Profit			**XXXX**

Format of an **Income & Expenditure Account, For the year ended**

	$	$
Incomes:		
Subscriptions		
Bar Profit		
Other incomes		
Less Expenditures:		
All Club expenses		
Surplus (excess of incomes over expenditures)		
Or		
Deficit (excess of expenditures over incomes)		

Balance Sheet is made following the normal format

Departmental Accounts

Departmental accounts refer to making Income Statements of various departments of an organizations (business) to know the net profit or net loss of the departments and the business thereof.

The only problem we face while making the T, P & L a/c of various departments is to apportion the expenses between various departments.
The following basis are used for apportioning expenses (if the question is silent about the basis of apportionment) between various departments:

Expenses	Basis of Apportionment
Rent, Rates, Utility Bills etc.	Floor / Space Area of the respective deptt.`s
Sales Expenses e.g., Advertisements Bad debts, Carriage Outwards, Discount Allowed, Sales Staff Salaries and Commission Depreciation of delivery vehicle etc etc.	On Sales of the respective departments

Format of a Departmental (3 departments) Income Statement, For the year ended

	Deptt. 1		Deptt. 2		Deptt. 3	
	$	$	$	$	$	$
Sales		XXXX		XXXX		XXXX
Less Cost of goods sold:						
Opening Stock	XXXX		XXXX		XXXX	
Add Purchases	XXXX		XXXX		XXXX	
Less Closing Stock	(XXXX)	(XXXX)	(XXXX)	(XXXX)	(XXXX)	(XXXX)
Gross Profit		XXXX		XXXX		XXXX
Less Expenses:						
		(XXXX)		(XXXX)		(XXXX)
Net Profit		XXXX		XXXX		XXXX
		======		=======		======

In Balance Sheet, total accumulated net profit of each deptt. is added to the capital.

Manufacturing Accounts

There are two types of businesses

1. Manufacturing Businesses
For manufacturing businesses, a manufacturing account and then a Income Statement is drafted

2. Trading Businesses
for Trading businesses, only a Trading, Profit & Loss account is made

Format of a **Manufacturing account, For the year ended**

	$	$
Raw Materials / Direct Materials:		
Opening Stock	XXXX	
Add materials purchased during the year	XXXX	
Material available for use	XXXX	
Less Closing Stock	(XXXX)	
Material used / consumed / put into process		XXXX
Add Direct Labor / Factory wages / manufacturing wages		XXXX
Add direct expenses (Royalties, License Fees)		XXXX
Prime Cost (Material used + D L + D exp)		XXXX
Add Factory Overheads:		
Indirect Material	XXXX	
Indirect Labor	XXXX	
All Factory Expenses e.g.,		
Factory rent	XXXX	
Factory rates	XXXX	
Plant & Machinery depreciation etc.	XXXX	(XXXX)
Total Factory Cost (Prime cost + Factory overheads)		XXXX
Add work in progress opening stock / inventory		XXXX
Less work in progress closing stock / inventory		(XXXX)
Production cost of goods completed (trnsfrd to trading a/c)		**XXXX**

Income Statement for the year ended

	$	$	$
Sales		XXXX	
Less return inwards / sales returns		(XXXX)	XXXX
Less Cost of goods sold / Cost of sales:			
Opening Stock (Finished goods)	XXXX		
Add Production cost of goods completed (trnsfrd from mfg a/c)	XXXX	XXXX	
Less Closing stock (Finished goods)		(XXXX)	(XXXX)
Gross Profit			XXXX
Add Other incomes:			XXXX
			XXXX
Less Operating Expenses			(XXXX)
Net Profit OR			**XXXX**
Net Loss			**(XXXX)**

The Balance Sheet will be made normally with only one exception i.e., Current Assets would contain in Stocks of all three Raw materials Stock, Work in progress stock and Finished goods stock

Current Assets:

Stocks:

Raw materials

Work in progress

Finished goods

Partnership Accounts

"Definition" Partnership is an agreement between two or more persons willing to work for the mutual benefit of each others, sharing the responsibilities and profits and losses.

Partnership Agreement / Partnership Deed

There should be an agreement between the partners, known as partnership deed which contains in the following:

- Partners Names & Addresses
- Amount of Capital Contribution
- Ratio of P&L share
- Extent of Drawings
- Interest on Capital %age
- Interest on Drawings %age
- Interest on partners Loan
- Rights, duties and liabilities of partners
- Salaries of partners etc etc.,

In case when there is no partnership agreement, partnership act 1892 automatically holds applicable which states:

- No partners Salaries
- No interest on Capital
- No interest on Drawings
- P&L to be shared equally
- Interest on partner`s loan @ 5%.

While making partnership accounts, first a simple Income Statement is drafted
Then a Profit & Loss appropriation account is made to show the allocation of profit among the partners

Format of **Profit & Loss Appropriation account, For the year ended**

	$	$
Net Profit (after interest on partner`s loan)		XXXX
Add interest on drawings:		
Partner A	XXXX	
Partner B	XXXX	XXXX
		XXXX
Less interest on Capital		
Partner A	XXXX	
Partner B	XXXX	(XXXX)
		XXXX
Less partners Salaries		
Partner A	XXXX	
Partner B	XXXX	(XXXX)
Profit to be distributed among partners on the basis of P& L sharing ratio		XXXX
		====
Partner A	XXXX	
Partner B	XXXX	XXXX
		====

Note:
Interest on partner`s loan is an item of Profit & Loss Account and is not recorded in Profit & Loss Appropriation account

Items	Partnership	Partners
• Interest on Capital	Expense	Income
• Interest on Drawings	Income	Expense
• Partners Salaries	Expense	Income
• Interest on partners loan	Expense	Income

All these items are paid and received via partners capital account i.e., interest on capital is credited to partners capital account as it is an income for the partner and income increases the capital. Similarly partners salaries and interest on partners loan is also credited to the partners capital account.
Interest on drawings is placed on the debit side of the partners capital account as it is an expense for the partners and it decreases capital.

There are two methods to maintain the Capital Accounts

1. Fixed Capital Account
In this method opening balance of Capital is equal to closing balance
so all the adjustments of interest on capital, interest on drawings, partners salaries and interest on partners loan now can`t be made in capital account so an alternative to capital "Current account" is opened which has the Same nature as of "Capital"

2. Fluctuating Capital Account
in this method, opening balance of capital is not equal to the closing balance
so all the adjustments of interest on capital, interest on drawings, partners salaries and interest on partners loan now can be made in capital account so there is no need to open a "Current account"

Format of a Current Account

DR Side **Current Account** CR Side

	$		$
Balance b/d (Opening balance)		balance b/d (Opening balance)	
Drawings		Interest on Capital	
Interest on Drawing		Partners Salaries	
P & L app. Share of loss	OR	Profit & Loss appropriation share of profit	
		Interest on partners loan	
Balance c/d (Closing balance)		balance c/d (Closing balance)	
(Added to "Capital")		(Subtracted from "Capital")	

Note:
A current account may have a debit balance because of more drawings or due to profit & Loss appropriation share of loss etc etc.

Balance Sheet of Partnership, as at

	$	$	$
Fixed Assets:			
Current Assets:			
Less Current Liabilities:			
Working Capital (CA – CL)			
Net Assets (FA + W/C)			
Financed by:			
Capitals:			
Partner A	XXXX		
Partner B	XXXX	XXXX	
Current Accounts:			
Partner A (Credit balance)	XXXX		
Partner B (Debit balance)	(XXXX)	XXXX	
			XXXX
			======

Goodwill

Goodwill is the reputation price, and is arises due to the following reasons:

- Central location
- Expert and trained employees
- Regular customers
- Regular suppliers

There are two ways goodwill is treated in the books

1. **Goodwill account opened / retained in the books**

   DR---------- Goodwill
   CR---------- Old Partners Capital account
   (Old ratio of P&L)

2. **Goodwill account not opened / not retained in the books / Goodwill account opened and written off**

   DR---------- Goodwill
   CR---------- Old Partners Capital account
   (Old ratio of P&L)

   DR---------- All Partners Capital account (partners according to new agreement)
   CR---------- Goodwill
   (New ratio of P&L)

Goodwill will be cancelled in this way and the account accounts are adjusted accordingly

Note:
Normally goodwill account is opened in the books when a new partner bring in the goodwill and is written off when a partner dies or retires.

Purchase of Business

Purchase of business refers to purchase of a sole-tradership by another sole-tradership or a partnership buys a sole-tradership or a partnership buys a partnership

When a business buys another business, the assets and liabilities of the business to be sold would now be the assets and liabilities of the buying business. So the assets and liabilities of the business to be sold would be added in the assets and liabilities of the buying business respectively.

Goodwill is created on the purchase of business. It could be either the "+ ive" or "– ive".

If the net book value of the assets and liabilities is given and the fair value (market value / agreed value) is also given so we will take in to account the fair value for the purpose of calculating goodwill and the assets and liabilities would be recorded in the books of the purchasing business at their fair values.

Purchase Consideration
The agreed value of the business by the purchasing business.

If the fair value of the assets is lesser than the purchase consideration, it will lead to the creation of "+ive" goodwill. Positive goodwill is recorded in the balance sheet under the heading **"Intangible Fixed Assets"**

If the fair value of the assets is more than the purchase consideration, it will lead to the creation of " –ive " goodwill. Negative goodwill is recorded in the balance sheet under the heading **"Intangible Fixed Assets"** and is subtracted from the total of the fixed assets **OR**
Negative goodwill is recorded in the balance sheet under the heading "Capital and Reserves" and is added in the Share Capital and Reserves

Accounts of Limited Liability Companies (Company Accounts)

Company
It is an artificial person, having a separate legal entity, Limited Liability, a common seal and a perpetual succession.

Separate legal entity The company has its own entity apart from the owners unlike soletradership and partnerships.

Limited Liability it means in case of Loss to the business, the personal property of the owners would not be sold to pay off the business debts

Perpetual Succession In case of death of a shareholder or selling of shares by shareholder to someone else, the business continuity would not suffer unlike partnership where when a partner dies or retires, old partnership agreement comes to an end and a new agreement needs to be drafted.

Types of Limited Liability Companies

There are two types of Limited Liability Companies

1. **Private Limited Companies**
   - Shares are distributed among friends, relatives and family members.
   - No shareholder can sell his / her shares without the consent of the rest of the shareholders.
   - Shares of a private limited company cannot be traded on stock exchange.
   - Private limited company doesn't have to show its accounts to the public at large.
   - In UK an company with a Share Capital of less than £50,000 can make a Private Ltd. Co.,

2. **Public Limited Companies**
   - Shares are sold to the public at large. Any one can buy shares.
   - Shareholders can sell his / her shares without the consent of the rest of the shareholders.
   - Shares of a public limited company are traded on stock exchange.
   - Public limited company have to show its accounts to the public at large.
   - In UK an company with a Share Capital of more than £50,000 can make a PLC.

Types of Capital

In Company Capital is collected by issuing shares so Capital is known as "Share Capital"

1. **Authorized Capital**
   It is the capital with which the company is registered. Company can`t issue share for more than its Authorized Capital.
2. **Issued and Paid up Capital**
   It is the amount received by issuing shares. It indicates that from the authorized share capital, this much amount of shares have been issued. And paid up means that the shareholders to whom the shares have been issued, have paid the monies due to the company

Dividends

Dividend is the amount of profit that is paid to the shareholders by the company. Dividend is only paid when the company earns profit. Unlike interest which has to be paid at any cost whether the company earns profits or suffers loss.

Difference between interest and dividend

Dividends	interest
• Is paid only when the company earns profit	has to be paid whether the company earns profits or suffers loss
• Dividends is a variable amount paid to Ordinary shareholders	Interest is a fixed amount.
• Dividends don't reduce taxable income therefore It is recorded in P&L appropriation account	Interest reduces taxable income therefore it is recorded in Profit & Loss Account

Types of Dividends

There are two types of dividends

1. **Interim Dividend**
   Dividend which is paid during the year owing to good performance of the business

2. **Final Dividend**
   In AGM(annual general meeting) the directors of the company declare or propose the dividend, which is known as final dividend. Once dividend has been declared or proposed, it becomes a current liability of the company and should be shown in the balance sheet. Proposed dividend of one year is paid in the next year.

Note:

If dividend on preference share is both interim and final. The final dividend will be after subtracting the interim dividend from the total dividend amount because dividend on the preference shares is fixed.

For Example:

50,000 $1 10% Preference shares have been issued.
It is decided to pay interim dividend of $1,000 and the final dividend should be paid.
Now total dividend on the Preference shares is 50,000 × $1 × 10% = $5,000
From this amount $1,000 has been paid as interim dividend.
The final dividend will be $5,000 - $ 1,000 = $4,000 now this $4,000 would be written in the Profit & Loss Appropriation account under the heading final dividend.

This rule doesn't apply to the Ordinary Shareholders. Because the %age of dividend is variable so interim is taken as separate amount and the final is also taken as separate amount.

Types of Shares

There are two types of shares

1. **Ordinary Shares**
   - They have a variable %age of dividend.
   - Ordinary shareholders are the owners of the company
   - Ordinary shareholders have the voting rights
   - In case of liquidation (dissolution) of the company, Ordinary shareholders have the last right to receive their share of investment in the company

2. **Preference Shares**
   - They have a Fixed %age of dividend.
   - Preference shareholders are the creditors of the company
   - Preference shareholders don't have the voting rights
   - In case of liquidation (dissolution) of the company, Preference shareholders have the second last right to receive their share of investment in the company

Types of Preference Shares

1. **Cumulative Preference Shares**
   If in any year, due to non availability of profits, company cannot pay the dividend, the amount of dividend would be paid along with the dividend of next years and so on
2. **Non Cumulative Preference Shares**
   If in any year, due to non availability of profits, company cannot pay the dividend, the amount of dividend would not be paid along with the dividend of next years.
3. **Participating Preference Shares**
   Participating preference shareholders have a right to participate in profits above the amount of regular dividends.

Debentures / Loan Stock

Debentures are a loan taken by the company from public at large. Debentures are issued just like Shares. A fixed %age of interest is paid on debentures by the company to the debentureholders

Types of Debentures

There are two types of debentures

- **Redeemable Debentures / Loan Stock**
  Are debentures that are issued for a specific period of time and are then taken back against cash at the expiry of that specified period. Redemption means to take back and canceled off.
- **Convertible Loan Stock / Debentures**
  Are debentures that are issued for a specific period of time and are then converted into Ordinary Shares at the expiry of that specified period and are canceled off.

Note: Interest on debentures is written in P&L account and in P&L Appropriation account

Reserves:

Are undistributeable profits. i.e., the profits which are not distributed among the shareholders as dividends rather the company saves some amount out of the profits for future contingencies (emergencies)

Format of Companies Profit & Loss Appropriation Account

For the year ended

		$	$
Net Profit (after interest on debentures)			XXXX
Less Corporation Tax for the year			(XXXX)
Profit after tax (PAT)			XXXX
Less transfer to reserves			(XXXX)
Less Preference shares dividends paid and proposed:			
	Interim	XXXX	
	Final	XXXX	(XXXX)
Less Ordinary Shares dividends paid and proposed:			
	Interim	XXXX	
	Final	XXXX	(XXXX)
Retained Earnings / Retained Profits / P&L for the year			XXXX
Add Retained Earnings / Retained Profits / P&L of previous year			XXXX
Retained Earnings / Retained Profits / P&L to be shown in balance sheet for the year			XXXX

Format of Balance Sheet of a Company
As at

	$	$	$
Fixed Assets			XXXX
Current Assets		XXXX	
Less: Creditors: amounts falling due within one year (Current Liabilities)		(XXXX)	(XXXX)
Less: Creditors: amounts falling due after on year (Long term Liabilities)			(XXXX)
Net Assets			XXXX
			=======
Capital & Reserves:			
Issued Ordinary Share Capital (e.g., 100,000 Ordinary shares of $1 each)			XXXX
Issued 10% Preference Share Capital (e.g., 50,000 shares of $1 each)			XXXX
General Reserves			XXXX
Profit & Loss (transferred from P&L appropriation account)			XXXX
			XXXX
			=====

Accounting Ratios

Markup
It is the %age of profit (gross profit) on cost i.e., cost of goods sold
e.g.,
If
scenario 1
Opening Stock = $10,000
Purchases = $55,000
Closing Stock = $15,000
Mark up = 25%
So Gross Profit = COGS × Mark Up %
COGS = Opening Stock + Purchases – Closing Stock
= 10,000 + 55,000 – 15,000
= $50,000
And Gross Profit = 50,000 × 25% = 12,500
And if we calculate Sales
Sales = COGS + Gross Profit
50,000 + 10,000 = $60,000

==========

Margin
It is the %age of profit (gross profit) on Sales
If
Scenario 2
Sales = $80,000
Margin = 20%
Gross Profit = 80,000 × 20% = $16,000
And COGS = Sales – Gross Profit
= 80,000 – 16,000 = $64,000

==========

If COGS is given and along with it Margin % of Gross Profit is given and it is asked to calculate Gross Profit We can`t find out Gross Profit using Margin applied on COGS.
For COGS, Markup %age is required and not the Margin %age so have to change Margin % into Markup %.
This is done by subtracting neuminator from denominator e.g.,
If Margin = $33^{1/3}$ % then Markup is

Margin

$$33^{1/3}\% = \frac{1}{3}$$

Markup

$$\frac{1}{3-1} = \frac{1}{2} \times 100 = 50\%$$

And to show the Markup in %age multiply 1/2 with 100
And if

Scenario 3
COGS = $60,000
Margin = $33\ ^{1/3}$ % which when converted to Markup = 50% (as above)
So Gross Profit = 60,000 × 50% = $30,000

If Slaes are given and along with it Markup % of Gross Profit is given and it is asked to calculate Gross Profit We can`t find out Gross Profit using Markup applied on Sales.
For Sales, Margin %age is required and not the Markup %age so have to change Markup % into Margin %.
This is done by adding neuminator in denominator e.g.,
If Markup = 25% then Margin is

Markup

$$25\% = \frac{1}{4}$$

Margin

$$\frac{1}{4+1} = \frac{1}{5} \times 100 = 20\%$$

And to show the Markup in %age multiply 1/2 with 100
And if
Scenario 4
Sales = $80,000
Markup = 25 % which when converted to Margin = 20% (as above)
So Gross Profit = 80,000 × 20% = $16,000

Other Ratios

Profitability Ratios

1. **Return on Capital Employed**

ROCE = (Net Profit / Capital Employed) × 100

Whereas
Capital Employed = Opening Capital + Net Profit – Drawings + Long term Loan
OR
Capital Employed = (Opening Capital + Closing Capital) ÷ 2

Note:
While comparing two businesses, the business with the higher ROCE would be preferred. This ratio shows that more profit is earned with the given amount of Capital Employed and that the business is efficient, Capital is employed in an effective manner.

2. Gross Profit Ratio

GP ratio = (Gross Profit / Sales) × 100

Note:
While comparing two businesses, the business with the higher GP ratio would be preferred. This ratio shows that either the business COGS is lesser or Sales Price per unit is increased because increasing sales units would increase the cost of goods sold in the same proportion so sales wouldn't increase. And the Gross Profit remains the same.
COGS could be lesser due to cheap purchases.

3. Net Profit Ratio

NP ratio = (Net Profit / Sales) × 100

Note:
While comparing two businesses, the business with the higher NP ratio would be preferred. This ratio shows that how effectively the business is controlling it costs (expenses). Lower expenses result in increase in Net Profit.

Liquidity Ratios

Liquidity is being able to pay debts as they fall due.

1. Current Ratio

$$= \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

This ratio indicates whether there are sufficient short term assets to meet the short term liabilities
This ratio may be expressed as either a ratio to 1, with current liabilities being set to 1, and it indicates the "number of times" the relative size of the amount of current assets compared with total current liabilities.
The ideal ratio depends upon the nature of the business and the sector in which the business operates (e.g., for retailers this ratio is often below 1:1), but the ideal range for this ratio is between 2:1 to 1:1
If this ratio is more than 2:1 say this comes 4:1, it means current assets are 4 times the current liabilities, which shows that the resources are not efficiently employed. Either Stock is more which shows more storage costs have to be paid or there is a chance of stock obsolescence. Stock could also go out of fashion leading to zero value (total loss).
Taking it to debtors, if debtors are more, there is greater risk of bad debts, business could face cash flow problems, the money if recovered could be invested to earn further profits so if debtors payments are slow, it shows a decrease in relative profits
Then cash and bank balance could be more, keeping cash in hand and at bank reduces it purchasing power over time due to inflation. This cash and bank balance could be put to further business activity resulting in generating profits

2. Liquid / Quick / Acid Test Ratio

$$= \frac{\text{Current Assets – Stock}}{\text{Current Liabilities}}$$

This ratio indicates whether there are sufficient short term assets (excluding Stock) to meet the short term liabilities. The ideal ratio depends upon the nature of the business and the sector in which the business operates (e.g., for retailers this ratio is often below 0.75:1), but the ideal range for this ratio is between 1:1 to 0.5:1
If this ratio is more than 1:1 say this comes 3:1, it means current assets excluding Stock are 3 times the current liabilities, which shows that the resources are not efficiently employed.
Either debtors are more, there is greater risk of bad debts, business could face cash flow problems, the money if recovered could be invested to earn further profits so if debtors payments are slow, it shows a decrease in relative profits
Then cash and bank balance could be more, keeping cash in hand and at bank reduces it purchasing power over time due to inflation. This cash and bank balance could be put to further business activity resulting in generating profits

3. Rate of Stock Turnover

$$= \frac{\text{Cost of goods sold}}{\text{Average Stock}}$$

This ratio shows, how efficient a business is maintaining an appropriate level of stock. OR
How efficiently, stock is being converted into sales. A higher answer shows an inefficiency in making sales and higher stock levels leading towards again, high storage costs, stock obsolescence and stock being out of fashion.
This ratio is also measured in "no. of times" and it shows the number of times the average stock, Sales have been made.
COGS = Opening Stock + Purchases – Closing Stock
And

$$\text{Average Stock} = \frac{\text{Opening Stock + Closing Stock}}{2}$$

Efficiency Ratios

1. Debtors / Sales ratio

$$= \frac{\text{Debtors}}{\text{Sales}} \times 100$$

This ratio shows how much %age are the debtors from total sales i.e., credit sales are this much %age of the total sales.
Then comes

2. Debtors Collection Period / Debtors payment Period

This ratio shows how much money has been tied up in debtors. OR
Number of days debtors pay the business

$$= \frac{\text{Debtors}}{\text{Sales}} \times 365$$

A big answer i.e., more number of days represent that debtors pay the business slowly and the business could face cash flow problems. This situation could be avoided and the number of day of debtors payment could be reduced by giving discount allowed to debtors and rescheduling their debts etc etc.

3. Creditors / Purchases Ratio

$$= \frac{\text{Creditors}}{\text{Purchases}} \times 100$$

This ratio shows how much %age are the creditors from total Purchases i.e., credit purchases are this much %age of the total Purchases.
Then comes

4. Creditors payment Period

Number of days business pays its Creditors

$$= \frac{\text{Creditors}}{\text{Purchases}} \times 365$$

A big answer i.e., more number of days represent that the business pay the Creditors slowly and the business could do this to improve its cash flows but on the other hand the trust of the business creditors is shaken. Moreover delayed payment could also increase business costs if the creditors charge the business "Interest on Overdue Creditors"

Pay Roll Accounting

Pay
Amount that the employees earn per hour or per week

Salary
Amount that the employees earn per month or per year

There are two ways for pay of the employees

1. **Piece Rate Pay**
   Employees are paid according to the number of units they produce

2. **Hourly Pay**
   Employees are paid according to the hours they work

Gross Pay The amount of salary or pay before the deductions are made

Net pay The amount of salary or pay after the deductions are made.

Overtime payment
It is the amount employees get for working more than normal or allowed hours

Bonus Payment
The amount employees pay when their hard work enables the company to earn abnormal profits or quality of performance by the employees or on production levels achieved

Income Tax Deduction
The wages and salaries of all employees are liable to income tax deducted from them. The employer deducts the tax from employee`s salary / pay and sends it to the Tax Collection Deptt. Of the Government.
Employees are also eligible for certain allowances which are deducted from their incomes while calculating how much they are liable to pay income tax

National Insurance
National insurance contribution is made by every employee to the state and in return every employee can claim from the state the following:

- Incapacity benefits
- Jobseekers Allowance
- Maternity Allowance
- Retirement pensions etc etc

Pension Contributions
An employee may belong to the company`s occupational pension schemes. The money paid into the fund will be partly funded by the company (employer) and partly by the employee. This amount of the pension contribution paid by the employee is deducted while calculating the net pay of the Employee on which tax has to be paid.

Format for Calculating Net Pay

Gross Pay / Earnings
Less:
Income Tax
National Insurance Contribution
Superannuation Fund
Net Pay

Accounting Conventions / Accounting Concepts / Accounting Principles

Principle of Prudence:

Anticipated gains shouldn't be recorded and anticipated losses should be recorded
OR Incomes and assets shouldn't be overstated
e.g.,
Provision for Bad debts, Depreciation etc
If provision for bad debts and depreciation are not recorded, expenses are understated and profit / income is overstated.
In the same way, both provision for bad debts and depreciation are subtracted from the assets, if not recorded, these wouldn't be subtracted from the assets so assets are overstated

Historical Cost Concept

Assets are normally shown at their (cost of purchase + all capital expenditures) in the financial statements. And not at their revalued amounts. Accumulated depreciation is deducted to arrive at the NBV

Principle of Going Concern

Financial statements are drafted on an assumption that the business is going concern i.e., business would continue for a force able future period. That is the business would continue for the next 4 to 5 years.
If the business is not going concern i.e., it is expected that the business would be wound up / shut down or a larger portion of the business is expected to shut down in the near future, historical cost concept doesn't hold. Now the assets are no longer shown in the financial statements at their cost of purchase rather assets are shown at their fair value / market value in the financial statements

Money Measurement Concept

Only those items / transactions should be recorded in the financial statements which have a monetary value. The items / transactions which don't have a monetary value are not recorded in the financial statements. E.g., Expert and trained employees are considered to be an asset for the business but as no monetary value can be placed on them so expert and trained employees are not recorded in the financial statements
Moreover, accounting can never tell everything about a business e.g.,

- Whether the business has good or bad managers
- Whether there are serious problems with the work force
- Whether a rival product is about to take away many of the best customers
- Whether the Government is about to pass a law which will cost the business a lot of extra expense in future.

Business Entity Concept

Affairs of the business are to be treated as being quite separate from the non business activities of its owners.
OR
Owners and business are treated as two different things, though everything is managed by the owner, owner does everything for the progress of the business but still owner cannot use the business money for his / her personal purposes. If the owners do so such amount would be treated as **"Drawings"**
Drawings reduce the Capital.

Dual Aspect Concept

This states that there are two aspects of accounting, one represented by the assets of the business and the other by the claim against them. In other words for every Debit, there is always an equal and opposite Credit.
This could best be explained with the help of "**Accounting Equation**"

Assets = Capital + Liabilities

Consistency Concept

This states that the business should be consistent with the policies, methods and procedures adopted in one accounting year to the future coming accounting years. Its allows comparability i.e., the financial results are compared overtime.

e.g., IF in one accounting year, Straight Line Method has been used for calculating depreciation on the Plant & Machinery, in the coming years the same method of providing depreciation on Plant & Machinery should be used. If the in the coming years business uses Reducing balance method to calculate depreciation on the Plant & Machinery, consistency principle has not been applied

Accruals Concept

Incomes / Expenses of a year should be recorded in the same year irrespective of the date of receipt / payment respectively.

If Rent for the month of December 20X8 is to be paid in January 20X9, the Income Statement for the year ended 31 December 20X8 would contain in the Rent for the month of December as well following the accruals concept

Materiality Concept

All those items are considered to be material that effect the decision making power of the stakeholders. Stakeholders are the persons who have a direct interest in the business. E.g.,

- Investors
- Government
- Employees
- Banks / Creditors etc

A paper clip box bought would be treated as an expense in the year of purchase though it might be used for more than one accounting period but it is done so because the amount involved in the paper box is immaterial.
Similarly, a cheap metal ashtray would be charged as an expense in the year of purchase, though it might be used for the coming 5 years but it is done so because the amount involved is immaterial

Substance Over Form

When the legal form of a transaction differs from its commercial reality i.e., real substance, accounting would record the real substance involved in that transaction e.g., take the example of a leasehold Car
A leasehold car doesn't belong to the business until all the installments have been paid and the legal possession is taken over by the business
But
From an economic point of view, the business has used the car for business purposes, just like any other car which has been bought by the business against cash down payment
So
Substance over form gives the right to the business to show the leasehold car in the balance sheet under leasehold assets and to show the remaining installments as liabilities against such lease.

The accounting entry for Lease is

When lease is taken

DR---------- Leasehold Assets (Shown as Fixed Assets in balance sheet)	1000,000	
CR---------- Lease Liability against leasehold assets (as LTL in balance sheet)		1000,000

Each year the installment is $50,000 from the Principle and interest is @10%

When lease installment is paid

DR---------- Lease Liability against leasehold assets (LTL will decrease)	50,000	
DR---------- Lease Rentals (recorded as an expense in Income Statement)	5,000	
CR----------Bank		55,000

After the payment of first installment the Fixed Leased hold Assets would be shown in the balance sheet at NBV (Cost – Accumulated Depreciation)
LTL (Long term Liabilities i.e., Lease Liability against Leasehold Assets would be shown in the balance sheet at 950,000
And Lease Rentals would be shown as an expense in the Income Statement worth $5,000
Bank would decrease with the amount of $55,000

Matching Concept

Expenses are matched against revenues. Take the example of depreciation; it follows both Prudence Concept and Matching Concept.
Why an asset is being depreciated because assets have been used to make products and when products are sold, revenue is generated and in generating revenue, assets value decrease which is a loss and as this loss / expense has been made to generate revenue so this loss / expense (depreciation) should be recorded as an expense in the year in which sales are recorded following Matching Concept