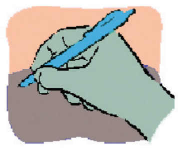
4 Foundation of Accounting for Business plan

Introduction



The objective of this chapter is to explain the functions of accounting and introducing the understanding of assets, liabilities, capital and effects of business transactions on them and the dual effects of any such transaction.
How business transactions would affect the elements of accounting equation would also be discussed.

Another objective is to understand how to prepare the accounting reports and the final statement on the basis of the process of accounting such as the income statement and the Balance sheet.

This chapter also gives you an understanding about the basis of accounting which would provide the required financial accounting data to prepare the business plan.

Role of accounting

Main activity of any business organization is to use its limited resources effectively and efficiently to achieve its anticipated business objectives. It's very difficult to obtain the resources sufficiently because they are limited in supply. Therefore, those resources should be controlled and managed (resource management) properly so that the maximum benefits can be obtained.

Importance of accounting for an entrepreneur

Accounting is important in many ways for an entrepreneur. They are as follows.

- To provide information to those who need it
- To compare the business with other businesses
- To make decisions
- To fulfil legal requirements

Accounting provides useful information for the proprietors, managers, future investors, and creditors or suppliers who are the stakeholders of a business to take economic decisions.

It is possible to assess how far a business is successful in achieving the profitability, liquidity and financial position by comparing it with the financial statements of the past. It is also possible to compare it with other similar competitors.

Profitability is how much is the profit earned from the total sales or capital invested. During a particular period (usually one year) financial strength (availability of sufficient cash) for day to activities is known as liquidity. Financial position refers to the assets equity and liabilities of a business.

The decision of what to do and how to do with regard to the future business activities also can be taken.
Legal requirements such as obtaining a loan (Feasibility reports), payment of income taxes can be fulfilled. We can now look at the meaning of accounting, in a simple way.

Accounting simply refers to the recording of transactions taking place in a business and preparing accounting reports with the help of such records.

Functions of accounting can be summarized as follows:-

Collection of data
↓
Recording of data
↓
Classifying of data
↓
Summarising of data
↓
Analysing and Interpreting of data
↓
Communicating of data

Let us look at each of the functions mentioned above.

Collection of data

Accounting data with regard to the transactions and events of a business would be primarily entered in the documents called source documents. A particular value for a particular period can be calculated with the help of the source documents collected.

Recording of data

Accounting data collected through source documents would be recorded in the prime entry books. Subsidiary books, journals and day books are known as prime entry books.

The business transactions which are taking place in a business would be recorded in the prime entry books before they are recorded in ledger accounts. Same type of transactions taken from the source documents would be recorded in these books according to sequential order (Chorological order) in which they are taking place. Examples for such books are the purchase journal, the sales journal and the cash book.

Classification of data

This is to sort out the data in the subsidiary books or prime entry books and record them in the appropriate ledger.
These ledger accounts are normally classified into following accounts according to common characteristics.

- Asset accounts
- Equity accounts (Capital accounts)
- Liability accounts
- Revenue accounts
- Expenditure accounts

Summarising

Summarising is to present the accounting data in brief so that economic decisions can be taken. Financial statements or accounting reports would be used for this purpose
Example :-
- Income statement
- Balance sheet or statement on financial position of the business

Analysing and interpretation

This refers to analyse, interpret and explain the data expressed in the financial statements, further. Very often accounting ratios are used for this purpose.

Example :- The profit earned during the year is Rs. 50,000 and Rs. 500, 000 has been invested. If the profit earn is expressed as the percentage of capital it would be,

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

$$\frac{50{,}000}{500{,}000} \times 100 = 10\%$$

Communicating information

This refers to the supply of information through financial statements to the parties who are interested (Stakeholders) in the business. Profitability, financial position and information on changes of financial position take an important place in such information.

Accounting Equation

An equation explains the relation between two variables. A variable is a changing element. Accounting considers the business and its owner as two independent entities. This is identified as accounting entity concept. Therefore, business transactions and accounting reports would be presented entirely as the business not as the owners.

Accounting equation shows two variables:

- Assets of the business
- Amount owing to the outsiders including the owners for their investment on the assets.

Therefore, according to this accounting equation it can be defined as mathematical presentation of relationship between the resources of the business and parties who supplied those (Liabilities).

Let us see how accounting equation is built-up.

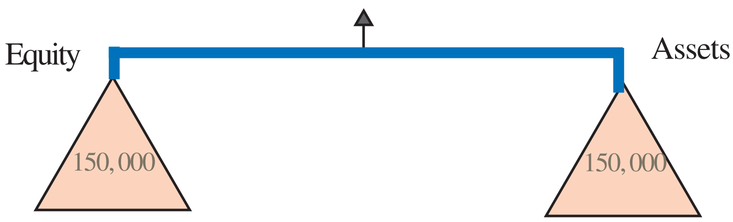
Step 1

The introduction of capital by the owner

Example :- Gayan puts Rs. 150,000 as capital and starts his business.

- The business receives cash Rs. 150,000 as asset.
- A liability of Rs. 150,000 is created as a result of this. This is also known as capital.

Equity (capital)	=	Assets
Rs. 150, 000	=	Rs.150, 000



Step 2

The business can obtain resources not only from the owners but also from outsiders (e.g.Banks). It creates an ownership on the assets of the business. This is called “liability”.

Example :- Gayan has borrowed Rs 50,000 from a bank for his business which he started with Rs 150,000 as capital. The accounting equation would change as follows.

Equity	+	Liability	=	Assets
Capital	+	Bank Loan	=	Cash
Rs. 150 000	+	Rs.50 000	=	Rs.200 000

Elements of Basic accounting equation.

- Assets
- Equity (capital)
- Liabilities

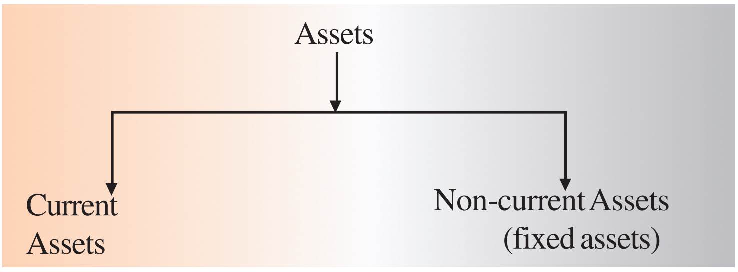
Assets

The economic resources a business possesses are called assets.

Assets should have the following features.

- It is a result of a past transactions of the business.
- Bring economic benefits to the business in the future
- Cost of assets should be reliably measured.
- The business can legally own it.
- Lies under the control of the business

Assets can be classified into two, according to changes due to operations of the business.



Current Assets

Assets which have life of less than 12 months and would change greatly in course of day to day activities are known as current assets.

Current assets are also known as short-term assets, and liquid assets

Important features of current assets are given below

- Vast changes may occur due to the day to day business (operational) activities.
- Life span of less than 12 months from the balance sheet date.
- Comparatively higher liquidity.

Example :- trading stocks, debtors, income receivables, pre-payments, cash in hand, cash at bank

Non-current assets

The assets which have a life span of more than 12 months and which do not change in great deal due to the operational or day today activities are simply known as non-current assets.

They are also known as fixed assets or Long term assets. Important features of non-current assets are given below.

- There are no vast changes on these assets due to the day to day activities of the business.
- Life span is more than 12 months from the balance sheet date.

- These assets are bought for the own use of the business and not for resale. (To use in the production activities, administrative activities or to let or lease)
- Comparatively less liquidity.

Example:- The assets of a business such as land and buildings, motor vehicles, machines and equipment and furniture.

Assets are generated from the owners and from outside contributors.

It can be expressed in the following way.

Assets = Capital + Liabilities

Equity (capital)

This is also known as net assets.

The equity of a business is the balance after deducting the outsiders' liabilities from the total assets.

This can be shown as follows

Equity = Assets - Liabilities

Liabilities

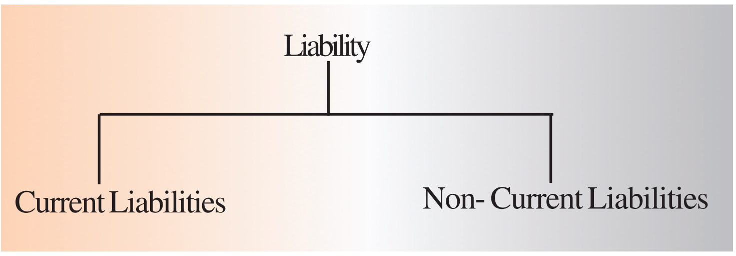
The liabilities of business are the balance after deducting the equity or capital from the total assets.

Liabilities of a business have the following features.

- It is created from a past transaction. It is an obligation to the outsiders of a business. An obligation or a liability is to act in a particular way to fulfil a particular liability.
- When these liabilities are settled the economic benefits of assets would flow out or reduction of assets would occur.
- The amount to be paid can be measured.
  Example :-Bank loan to be paid Rs. 120,000

A transaction of past bank loan is still an existing liability (outstanding) as it has not been settled

Liabilities can be classified into two according to the period of settlement (Maturity)



Let us examine each.

Current Liabilities

These are the liabilities which are to be settled within 12 months from the balance sheet date.

Example :- Trade creditors, Accrued expenses, bank over draft and Income received in advance.

Non-Current Liabilities

These are the liabilities which are to be settled during a period of more than 12 months (one year)

Example:- Bank loan
Mortgage loan

Collateral securities have to be submitted to obtain long term loans.

Effects of transactions on the Accounting Equation

Exchange of resources between a business and outsiders is known as transactions or economic events.

Example:- Payment of Rs 150 00 to creditors of the business, writing off Rs 5 000 of the debtors as bad debts.

There will be changes on the assets, equity and liability because of these transactions. They can be measured by money. Let us understand about the effects on the basic accounting equation due to the transactions.

1)Gayan starts the business by providig Rs. 150,000 as capital.

Business and the owner of the business are considered as separate independent entities according to the accounting entity concept. The business receives a cash asset of Rs. 150,000 because of this transaction. And the accounting equation would be as follows

C	=	A
Equity	=	Assets
Capital Rs.150, 000	=	Cash Rs. 150, 000

02. He obtains a loan of Rs. 50,000 from Sumana Bank.

The asset of cash would increase. Liability of Rs. 50,000 would appear as this sum has to be repaid to the bank. Then equation would change as follows.

C	+	L	=	A
Equity	+	Liabilities	=	Assets
Capital 150, 000	+	Bank Loan 50, 000	=	Cash 200, 000

03. Purchases goods worth Rs. 35,000 for sale

Asset of cash would be reduced by Rs. 35,000 and the asset of goods (stocks) would appear. There are no changes in equity and liabilities. The equation would then change as follows.

C		+	L	=	A	
Equity		+	Liabilities	=	Assets	
Capital	150, 000	+	Bank Loan 50, 000	=	Cash	165, 000
					Stock	35, 000
	150, 000		50, 000			200, 000

04. Buys a machine for Rs. 20,000 for the use of the business.

Asset of cash would decrease by Rs. 20,000 and would be Rs. 145,000. Asset of machine would be Rs. 20,000. There is no change in other items such as stocks, equity and liability. Equation would change as follows.

C	+ L	= A	
Equity	+ Liabilities	= Assets	
Capital 150 000	+ Bank Loan 50 000	= Cash	145 000
		Stock	35 000
		Machine	20 000
150 000	50 000		200 000

05 Payment of monthly building rent Rs. 5,000

The asset of cash would change into Rs. 140,000 reducing by Rs. 5000. The capital would also be reduced by Rs. 5000 because rent is an expense and changed into Rs. 145,000 There would be no changes in other assets or liabilities. Then the equation would change as follows.

C	+ L	= A	
Equity	+ Liabilities	= Assets	
Capital 145 000	+ Bank Loan 50 000	= Cash	140 000
		Stock	35 000
		Machine	20 000
145 000	50 000		195 000

06. Partial repayment of the Bank loan Rs. 8000

Asset of cash would be reduced by Rs. 8000 and the long term liabilities of Bank Loan would also be reduced by Rs. 8000 There is no change in other assets or capital. Equation would change as follows.

C	+ L	= A	
Equity	+ Liabilities	= Assets	
Capital 145 000	+ Bank Loan 42 000	= Cash	132 000
		Stock	35 000
		Machine	20 000
145 000	42 000		187 000

07. Sales of stocks worth (cost) Rs. 15 000 and receipt cash Rs.23 000

Effect of this transaction is a decrease stocks worth Rs.15000 and changed into Rs. 20 000. Profit of Rs. 8 000 would be earned as a result of selling goods at Rs. 23 000 the cost of which is Rs. 15 000 only, and this profit would be added to the capital. Capital would be Rs. 153,000 and cash would increase up to Rs. 155,000 .Accounting equation would change as follows as a result of this.

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	153 000	+	Bank Loan	42 000	=	Cash	155 000
						Stock	20 000
						Machine	20 000
	153 000			42 000			195 000

08. Purchases goods worth Rs. 25,000on credit from Saman for resale

Stocks of goods would increase by Rs. 25,000 and change up to Rs. 45,000. The amount Rs. 25,000 will have to be paid and there will appear a liability of Rs. 25,000 which is known as creditors. No other changes will occur on other items. Accounting equation will be as follows after this

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	153 000	+	Bank Loan	42 000	=	Cash	155 000
			Creditors	25 000		Stock	45 000
						Machine	20 000
	153 000			67 000			220 000

09. Further Rs. 25,000 out of Rs. 30,000 which Gayan received from a lottery is put into the business

The capital would increase by Rs. 25,000 due to the extra capital put by Gayan and the capital would change as Rs. 178,000. Asset of cash also would increase by Rs. 25,000 up to Rs. 180,000. Equation change is as follows.

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	178 000	+	Bank Loan	42 000	=	Cash	180 000
			Creditors	25 000		Stock	45 000
						Machine	20 000
	178 000			67 000			245 000

10. Sale of stock of goods worth Rs. 32,000 on credit to Asiri for Rs. 45,000

Asset of stock would reduce by Rs. 32,000 and would be Rs. 13,000. At the same time an asset of debtors would appear Rs. 45,000 as this amount is to be received (receivable). The profit Rs. 13,000 would be added to the capital and it would be Rs. 191,000 as a result. Equation would be as follows.

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	191 000	+	Bank Loan	42 000	=	Cash	180 000
			Creditors	25 000		Stock	13 000
						Machine	20 000
						Debtors	45 000
	191 000			67 000			258 000

11. Gayan draws back Rs. 6 000 out of the business for his personal use

The owner would take cash, goods, fixed assets for his private use. This is known as drawings and capital would reduce as a result. So, the capital would be reduced by Rs. 6 000 and would become Rs. 185,000. Asset of cash would be reduced by Rs. 6 000 and it changes as 174,000 Accounting equation would be,

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	185 000	+	Bank Loan	42 000	=	Cash	174 000
			Creditors	25 000		Stock	13 000
						Machine	20 000
						Debtors	45 000
	185 000			67 000			252 000

12. Depreciation of machines valued at Rs. 2000

Depreciation of fixed asset is a loss. It is considered as an expense and deducted from capital. So, capital would be deducted by Rs. 2000 and changed as Rs. 183000. Value of machinery would be Rs. 18000 after the deduction of Rs. 2000 Equation would be.

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	183 000	+	Bank Loan	42 000	=	Cash	174 000
			Creditors	25 000		Stock	13 000
						Machine	18 000
						Debtors	45 000
	183 000			67 000			250 000

13. Receipt of Rs. 3400 extra income

Asset of cash would increase as a result and it would increase, by Rs. 3 400 up to Rs. 177 400. Capital would also increase, by Rs. 3 400 up to Rs. 186,400. Equation would change as follows.

C		+	L		=	A	
Equity		+	Liabilities		=	Assets	
Capital	186 400	+	Bank Loan	42 000	=	Cash	177 400
			Creditors	25 000		Stock	13 000
						Machine	18 000
						Debtors	45 000
	186 400			67 000			253 400

Accounting equation of the above No 13 can also be shown as follows.

Assets

Fixed assets
Machine 18 000

Current Assets
Cash 177 400 + stock of goods 13 000 + Debtors 45 000

Liabilities

Long term liabilities
Bank loan 42 000

Current liabilities
Debtors 25 000

So, it would be

Equity + Liabilities			=	Assets		
Capital	+ long term liabilities	+current liabilitie	=	Fixed assets	+	current assets
186 400	+ 42 000	+ 25 000	=	18 000	+	235 400

Dual effects of transactions

Any transaction has two effects. Activities of accounting can be carried out properly by identifying the dual effects of transactions.
These dual aspects of transactions can be understood clearly by posting them to the debit side or credit side of ledger accounts.

Business Transaction	Dual effect
01. Gayan starts the business providing Rs. 150,000 as capital	Creation of asset of cash Account Rs 150,000 Creation of a liability capital account Rs 150,000
02. Obtains a bank loan of Rs 50,000	Increase of asset of cash by Rs.50,000 Creation of a liability of Rs 50000 as Bank loan
03. Bought stock of goods Rs 35 000 for resale	Decrease of asset of cash by Rs 35 000 Creation of an asset of stock Rs 35 000
04. Bought a machine for Rs 20,000 for business use	Decrease of cash Rs 20,000 Creation of an asset of machine Rs 20,000
05. Payment of monthly building rent Rs 5000	Decrease of asset of cash by Rs 5000 Creation of an expense of building rent Rs 5 000
06. Repayment of part of the bank loan Rs 8000	Decrease of asset of cash by Rs 8 000 Decrease of the liability of bank loan by Rs 8 000
07. Receipt of cash Rs 23 000 by selling and goods which is worth Rs 15000	Increase of asset of cash by Rs 23 000 creation of sales revenue of Rs 23 000
08. Bought goods on credit from Saman for resale Rs 25 000	Increase of goods by Rs 25 000 Creation of creditors as a liability Rs 25 000
09. Additional capital put by Gayan Rs 25 000	Increase of an asset of cash by Rs. 25 000 Increase of equity capital by Rs 25 000
10. Sold goods on credit to Asiri Rs. 45000 and cost of goods is Rs 30000	Creation of a sales Revenue Rs 45000 Creation of an asset of debtors Rs 45000

Business Transaction	Dual effect
11. The owner of the business takes Rs 6 000 cash from the business for his own use	Decrease of asset of cash by Rs 6000 reduction of capital by Rs 6 000 (as a result of the creation of Drawings Rs 6 000)
12. Depreciation of machines to the value of Rs 2 000	A Loss of Rs 2 000 as the asset depreciates. Decrease of the asset of machine by Rs 2 000
13. Extra income of Rs 3 400 earned and received cash	Increase of the asset of cash Rs 3 400 creation of extra income Rs 3 400 as an income

Activity 01

Complete each of the columns by stating the effects of the following transactions to the accounting equation.

Transaction	Equity	+ Liability	= Assets
01. The proprietor starts the business of textiles putting Rs. 40 000 as initial capital	Capital + 40 000		Cash + 40 000
02. Bought textiles for cash Rs. 24 000 for resale			
03. Payment of carriage inwards Rs. 2 500			
04.Purchase of furniture Rs.4 000			
05. Sale of textiles for Rs. 18 000 cost of which is Rs. 12 000			
06. Rs. 30 000 cash taken from the bank as a loan			

	Equity +	Liability =	Assets
07. Payment of Interest on bank loan Rs. 1 500			
08. Purchase of textiles on credit Rs. 25 000			
09. Payment of cash Rs. 4 00 to creditors			
10. Sale of stock of textiles worth Rs. 14 000 for Rs. 21 000 on credit			

Activity 02

Complete the columns showing effects of the transactions given in your answers to activity 01. Add up each column downward after that.

Trans-action no.	Equity +	Liabilities		= Assets		
	Capital +	Bank Loan +	Creditors	Cash +	Stock of goods +	Furniture
01	40 000			40 000		
02						
03						
04						
05						
06						
07						
08						
09						
10						

The format which is used for the recording the debit and credit to show the dual aspect of transactions correctly is known as a ledger accounts. Traditionally, an account format takes the shape of English alphabet letter 'T' left side of which is known as debit and the right side would be known as credit.

A model of a Ledger Account

Debit | | | | | | | Credit

Date	particulars	F.P.	Cash	Date	particulars	F.P.	Cash

Basically, ledger accounts can be classified into five. Each ledger account would be recorded according to the dual aspects of a transaction. Rule of double entry would be a guiding principle here. The following chart would explain you the double entry rules.

Type of ledger Account	Double entry Rule	Relevant Account
i. Assets	Rules on Assets 1. increase of assets Debit 2. decrease of assets Credit	Dr Assets Account Cr xx xx (1) (2)
ii. Liabilities	Rules on liabilities 1. decrease of liabilities Debit 2. increase of liabilities Credit	Dr Liability Account Cr xx xx (1) (2)
iii. Equity (Capital)	Rules on (Equity) Capital 1. decrease of Capital Debit 2. increase of Capital Credit	Dr Capital Account Cr xx xx (1) (2)
iv. Revenue	Rules on revenue 1. decrease of revenue Debit 2. increase of revenue Credit	Dr Income Account Cr xx xx (1) (2)
v. Expenses	Rules on Expenses 1. Increase of Expenses Debit 2. Decrease of expenses Credit	Dr Expense Account Cr xx xx (1) (2)

Let us consider the ways how various transactions are analyzed and recorded in the relevant accounts according to the rules (Principles) of double entry.

Example.

1. 01.01.2008 Gayan starts a business putting Rs. 150,000 as the initial capital.
2. 01.02.2008 Purchases goods for cash Rs. 80,000 for resales
3. 01.05.2008 Obtains a bank loan Rs. 60,000
4. 01.08.2008 Sells goods for cash Rs. 34,000
5. 01.10.2008 Repays the bank loan partialy Rs. 4,000
6. 01.12.2008 Pays building rent Rs. 6,000

Analysis of transactions

Transaction	Analysis of transactions	Relevant double entry rule for each transactions
1. Starts the business with Rs. 150, 000	Asset of cash increases Debit Increases capital of owner Credit	cash account Debit capital account Credit
2.Purchase of goods for resale Rs. 80, 000	Increases stock of goods Decreases the asset of cash	Stock of goods (Purchases) account Debit Cash account Credit
3.Obtain a Bank Loan of Rs. 60 000	Increases asset of cash Increases liability of Bank loan	Cash account Debit Bank loan account Credit
4.Cash Sales Rs. 34, 000	Increases asset of cash Increases sales revenue	Cash account Debit Sales account Credit
5.Payment of part of bank loan Rs. 4, 000	Decreases liability of bank loan Decreases asset of cash	Bank loan account Debit Cash account Credit
6.Payment of building rent Rs. 6, 000	Increases expense of building rent Decreases asset of cash	Building rent acc. Debit Cash account Credit

Debit — **Cash Account** — Credit

Date	Particulars	F.P.	Cash	Date	Particulars	F.P.	Cash
2008				2008			
1 1	Capital		150 000	1 2	Purchase (stock)		80 000
1 5	Bank Loan		60 000	1 10	Bank Loan		4 000
1 8	Sales		34 000	1 12	Building Rent		6 000

Debit — **Capital Account** — Credit

Date	Particulars	F.P.	Cash	Date	Particulars	F.P.	Cash
				2008			
				1 1	Cash		150 000

Debit — **Purchase (stock of goods) Account** — Credit

Date	Particulars	F.P.	Cash	Date	Particulars	F.P.	Cash
2008							
1 2	Cash		80 000				

Debit — **Bank Loan Account** — Credit

Date	Particulars	F.P.	Cash	Date	Particulars	F.P.	Cash
2008				2008			
1.10	Cash		4 000	1.05	Cash		60 000

Debit — **Sales account** — Credit

Date	Particulars	F.P.	Cash	Date	Particulars	F.P.	Cash
				2008			
				1.08	Cash		34, 000

Debit — **Building rent account** — Credit

Date	Particulars	F.P.	Cash	Date	Particulars	F.P.	Cash
2008							
1.12	Cash		6 000				

Income statements

The financial report that is used for calculation of profit and loss for an accounting period is called the income statement.

Profit of the business is used on many occasions to assess the profitability or efficiency. Elements of income statements are .

- Revenues
- Expenses

Let us look at them briefly.

Revenue

Revenues are inflows of economic benefits which bring profits to the business and make the owners' equity increase during an accounting period.

Sales income from investments, interest received profit from the sale of fixed assets are some of the examples for revenues. These are identified as revenue income or operational profit.

Expenses

The share of the cost which contributes to generate income during an accounting period is called expenses.

Outflows of the business, depreciation of assets and losses are included in the expenses. Expenses reduce the owners' capital: selling expenses administration expenses, distribution expenses and the depreciation of assets are some of the examples for such expenses.

Let us see how we can prepare an income statement using the transactions which affect the items in the accounting equation.

Example

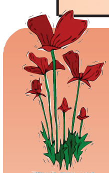
1. Sale of stock of goods worth (cost) Rs.45,000 for Rs. 63,000
2. Payments of advertising expenses Rs.8,000
3. Monthly electricity is to be paid Rs. 3,000
4. Depreciation is to be charged at 10% on machines worth Rs.30,000 annually.
5. The fixed savings account balance of Rs. 60,000 brings 10% annual interest
6. Only Rs. 6,000 of employees' salary out of Rs.9, 000 has been paid in cash.
7. A part of the building where the business is done has been rented out. Monthly rental of Rs.4,500 would be received.

8. Rs. 2,000 out of Rs. 42,000 Debtors will have to be written off from the books as bad debts.

Prepare the income statements of Vimukthi's business assuming January 2008 as the accounting period.

Vimukthi stores
Income statements for the month ending on
31.01.2008

	Rs.	Rs.
Income		
Sales	63 000	
Interest Income	500	
Building Rent income	4 500	
		68 000
Expenses		
Selling expenses	45 000	
Advertising expenses	8 000	
Electricity	3 000	
Depreciation of machines	250	
Salary	9 000	
Bad debts	2 000	
		67 250
Net income / Net profit		750



Activity 03
Prepare the income statement for the month of January 2008, using the following information

- Sold goods for cash Rs. 36,000 the cost of which is Rs. 24,000
- Payment of rates (Local governments tax) Rs. 1,800
- Monthly electricity bill paid Rs. 4,500
- Value of investment which earns 10% income anually is Rs. 75,000
- Sale of stock of goods the cost of which is Rs. 30,000 for Rs. 48,000
- Annual depreciation of 12% is to be charged on the furniture RS. 20,000
- Annual insurance premium Rs. 12,000
- (Miscellaneous) income received from various. Sources Rs.6,500

Balance sheet

A statement that shows the assets, liabilities, and (equity) the capital (Financial position) of business on a particular day is called the balance sheet.

This is an important document when a business tries to obtain financial assistance from a financial institution (E.g. from a bank)

Net profit calculated by income statements would be added to the capital. If it is a net loss it would be deducted from the capital.

There are three important elements in the balance sheets which show the financial position of the business.

* Assets
* Liabilities
* Capital

Prepare the balance sheet of the business "Vimukthi" as at the 31st January 2008 using the following information.

Capital	270 000
Net profit	180 000
Machinery and equipment	150 000
Motor Vehicles	450 000
Stock of goods	160 000
Trade debtors	50 000
Cash in hand	145 000
Bank loan repayable in 5 yrs	200 000
Mortgage loan repayable in 3 yrs	130 000
Trade creditors	125 000
Accrued payments	30 000
Bank over draft	20 000

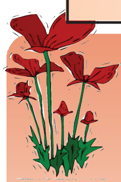
Vimukthi Stores
Balance sheet as at 31.01.2008

	Rs.	Rs.		Rs.	Rs.
Capital		270 000	Non current Assets		
Add:			Machinery and equipment	150 000	
Net profit		180 000	Motor vehicles	450 000	600 000
		450 000			
Non current liabilities			Current Assets		
Bank loan	200 000		Stock of goods	160 000	
Mortgaged loan	130 000		Debtors	50 000	
		330 000	Cash	145 000	355 000
Current liabilities					
Creditors	125 000				
Accrued payments	30 000				
Bank over draft	20 000	175 000			
		955 000			955 000

Balance would also be prepared in vertical format. Let us prepare the balance sheet in vertical format using the information given above.

Vimukthi Stores
Balance sheet as at 31.01.2008

	රු	රු
Non-current Assets		
Machinery and Equipment	150 000	
Motor vehicles	450 000	600 000
Current Assets		
Stock of goods	160 000	
Debtors	50 000	
Cash	145 000	355 000
Total Assets		955 000
Capital	270 000	
Add: Net profit	180 000	450 000
Non current liabilities		
Bank loan	200 000	
Mortgaged loan	130 000	330 000
Current liabilities		
Creditors	125 000	
Accrued expenses	30 000	
Bank overdraft	20 000	175 000
Total of equity and the liabilities		955 000



Activity 04

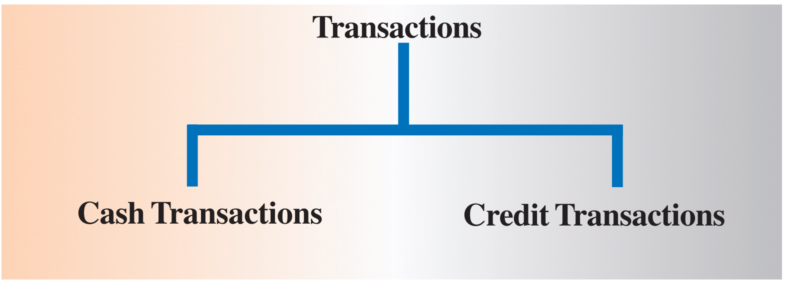
The following details of the "Shalika Traders" have been given to you. Prepare the balance sheet as at 01.01.2008

	(Rs. '000)
Land and Buildings	6, 000
12% Bank Loan	3, 200
Cash in hand	900
Debtors	750
Creditors	2, 400
Motor vehicles	8, 500
Prepayments	200

	(Rs. '000)
Accrued payments	300
Capital	9, 350
Net profit	2, 500
Stock of goods	1, 400

Books of original entry and source documents used for recording transactions

Transactions measured in terms of money in business are reported in the medium of money. Transactions can be classified into two as follows.



Transactions which take place in a business for outright payments are called cash transactions.

Example   Payment of employees' salary Rs. 8,000
            Purchases of goods for Rs. 15, 000

If a transaction is carried out on credit there is no exchange of money at that moment

Example   Bought goods worth Rs. 20, 000 from Shalika Traders.
            Sale of goods to Sureka for Rs. 45, 000

It is very important to mention the name of the person or organization when any credit transaction is taking place.

Recording of transactions begins with the source documents. These are the documents which contain all relevant details about the transactions in the business including details of the persons connected, the monitory value, and other conditions of sale.
This is a written proof that a transaction has actually taken place.

Example. Payments voucher is a proof for payment of cash. Receipt is a proof for receipt of money.

Purchase invoice is a proof for the purchase of goods on credit

Advantages of source documents

- It is a written proof of a transaction which has actually taken place.
- It can be used as a prime source document on a transaction.
- Ability to call for responsibility as there is a signature to it.
- It includes the complete details with regard to the transaction taken place.
- Based on this transactions can be recorded in the books of accounting.

Let us consider some of the source documents.

Invoice

A document issued by the seller to the purchaser stating the relevant details of the transactions.

As far as the buyer is concerned this is known as the purchases invoice and in seller's point of view it is the sellers' invoice.

Example The invoice prepared by the Shalika company according to the order of the Gayan's business is given bellow.

Invoice
Shalika Company Limited
No-1222, Main Street
Naotunna
Telephone : 4868223

No: 1322
Date 01012008

The Manager ,
Gayan Book Shop ,
Main Street
Walasgala

As per Your purchase order No A/ 425 and dated 15.12.2007

No:	Particulars	Quantity	Unit Price	Value Rs.
	Drawing books	25	45.00	1 125.00
	CR books	130	30.00	3 900.00
	Children's poetry books	40	50.00	2 000.00
	Half sheets	10 pkt.	250.00	2 500.00
	Rhonio sheets	10 pkt.	200.00	2 000.00
	Photo copy paper	30 pkt.	325.00	9 750.00
				21 275.00
	Less 10% trade discount			2 127.50
				19 147.50

(All cheques should be drawn in favour of Shalika Company Limited and crossed.)

Manager

Terms : 5% cash discount if paid within 30 days Except
nett : 60 O&C

Except O & C means except omissions and commissions. There may occur errors of omissions or commission when the invoice is prepared and the seller is ready to alter it.

Terms of sale have been mentioned as 5% and 30 days Net : 60. Full total has to be paid within 60 days if paid within 30 days 5% discount would be deducted.

Recipt

This is a documents issued by a business certifying that a certain amount of cash is received and certified by an authorized officer.

This is also known as cash memo, receipt for cash received, and receipt for payment rendered.
Though the format of a receipt may differ from a business to business there are some common characteristics that can be identified. Following is an example for a receipt issued by a business institute.

Receipt

Anoma Bookshop
82 Araliya Road
Naotunna
Telephone: 2030278
Date ....

No : 20513

Recieved with thanks,

.... on the invoice no......................and recievable Rs. .... Money.........................
by cheque / cash.

Rs ....

Signature on a stamp.

Payment voucher

Payment voucher is a source document used by a business when it makes cash payments.

Very often payments would be made by cash or cheque. Payment vouchers in respect of employees' salary, electricity and payments to creditors' are normally prepared.

A format of a payment voucher is given below. Examine it.

Shalika Company Ltd.
Payment voucher

Rs...................................... Date
....

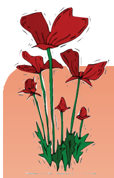
Rupees
....
....

is paid to

Details / description
....
....
....
....
....

Invoice no...... Bill no........... Recipt no ....

Voucher No
....
Cheque No
....
Cash
Rs..
Date paid
....
Approved by
....
Account No.
....



Activity 05

Prepare a payment voucher using the follwing data.

Date	- 04.01.2208
Amount	- Rs.4580.75
Details of the payments	- Electricity payment for the month December 2007
Payment to be made to	- Sri Lanka Electricity Board No 435 Galle
Electricity Bill No.	2875
Cheque No.	0004441092
Account No. (money should be sent to)	4792524925
Name of the business	Shalika Company Limited

Prime entry books / Books of original entry

Prime entry books are a set of books in which we record the information on transactions in source documents according to the chronological order they took place.
Though, there are many prime entry books we first consider the following prime entry books only.

- Cash book
- Sales journal or sales day book
- Purchase journal or purchase day book.

Cash book

Cash book is the prime entry book which we use to record first the cash receipts and cash payments in the business.

The relevant source documents for cash transactions such as receipt and payment vouchers would be taken as basis for the recording in the cash book. All types of receipts and payments made by cash would be recorded in the cash book.

Debit side of the cash book would be used for recording cash receipts and the credit side of the cash book would be used to record the payment of cash.
Receipt of cash would increase the assets of the business as cash belongs to asset accounts. When cash payments are made, asset of cash would decrease. It is done according to the principle of double entry relevant to assets.

A model of commonly used in single column cash books which resembles the English letter "T" would be as follows.

Debit Cash Book Credit

Date	Rece. No	Particula	L. F	Cash Rs.	Date	Vou. No	Particular	L. F	Cash Rs.

Transactions recorded in the debit side of cash book	Transactions recorded in the credit side of cash book
Capital paid in cash	Cash taken by the proprietor for personal use
Cash sales	Purchase for cash
Obtain bank loan	
Receipts from the debtors	Payment to the creditors
Receipt of cash from the disposals of machines furniture and other fixed assets.	Repayment of bank loans
	Purchases of machinery furniture and other fixed Assets for cash
Investment income interest receipts.	Payment of insurance, salaries and other expenses by cash.

Let us consider how we can prepare a cash book using the following details on the transactions which took place during the month of January 2008 and calculate the cash balance on the 31.01.2008

Date	Receipt No	Voucher No	Details
2008 1 1			Put cash Rs.120,000 to start the business
01 02		001	Bought furniture Rs.15, 000 for business use
01 03		002	Bought goods for Rs.65, 000 for resale
01 04		003	Payment of carriage inwards Rs.2, 000
01 05			Obtained a bank loan Rs.50, 000
01 06	001		Sold goods for cash Rs.35, 000
01 07	002		Cash received from debtors Rs.12, 000
01 08		004	Repayment of bank loan Rs.2, 500
01 10	003		Sold goods for cash Rs.16, 000
01 18		005	Payment of salary Rs.8, 000
01 23			Received from debtors Rs.24, 000
01 30		006	Bought goods for Rs.18, 000 for resale
01 31		007	The proprietor took cash Rs.4, 000 for his own use.
01 31	005		Miscellaneous income received Rs.13, 000

Cash Book

Date	Receipt No	Particular	F. P	Cash Rs. Rs	Date	voucher no	Particular	F. P.	Cash Rs
2008									
0101		Capital		120 000	0102	001	Furniture		15 000
0105		bank loan		50 000	0103	002	Purchase goods		65 000
0106	001	Sales		35 000	0104	003	Carriage –in		2 000
0107	002	Debtors		12 000	0108	004	Bank loan		2 500
0110	003	Sales		16 000	0118	005	Salary		8 000
0123	004	Debtors		24 000	0130	006	Purchases		18 000
0131	005	Miss. Inco		13 000	0131	007	Drawings		4 000
					0131		Balance c/d		155 500
				270 000					270 000
0201		Balance b/d		155 500					

Activity 06

Draw up the cash book of Shalika Company Ltd for the period ended on 31.01.2008 and find the cash balance as on the 31.01.2008 January

01 Capital put by Shalika Rs.185,000
02 Bought goods for resale Rs.65,000 (payment voucher No.002)
03 Carriage inwards was Rs.2,500 (Voucher No 003)
05 Sold goods for cash Rs. 28,000(receipt No. 001)
06 Cash received from debtors Rs.12, 500(Receipt No. 002)
08 Obtained a bank loan Rs. 40,000
12 Building rent paid Rs.6,000 (payment voucher No. 004)
15 Took cash for personal use Rs.5,000(payment voucher No.005)
18 Bought machinery for business use (payment voucher No.006)
20 Sold goods for cash Rs.30, 000 (Receipt No. 003)
22 Repayments of bank loan Rs.4,000 (pay voucher No.007)
24 Investment income received Rs.8,000 (receipt No. 04)
25 Cash received from the disposal (sale of) of furniture Rs.3,000 (Receipt No. 005)
27 Payment to the creditors Rs.17, 000 (payment voucher No.009)
29 Employees' salaries paid Rs.6, 000(payment voucher No.009)

Purchase journal or purchase day book.

The information on goods bought by a business on credit only for the objective of resale is recorded in the prime entry book known as purchase day book or purchase journal.

The invoice received from suppliers (purchase invoice) is used as the source document for the preparation of purchase journal.

Purchase journal can be prepared using the model given below.

Model of a purchase journal

Date	Invoice No	Supplier	description of goods			Value	Total Value	L. P
			Details	Quantity	Unit Price			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)

01 Date column	The date mentioned in the invoice would be entered
02 Invoice No.	The printed no. mentioned in the invoice received from the supplier would be entered
03 Supplier	The name of the person or business that supplied the goods would be entered.
04 Details	Name of the item bought would be entered
05 Quantity	Quantity of goods bought
06 Unit Price	Unit Price of the goods bought
07 Value	The value mentioned in the invoice. If trade discount is deducted, that value should be mentioned here
08 Total value	The net value of all the values of invoices after deducting the trade discounts, should be mentioned here
09 Ledger page No.	This is the page number in which the supplier's account exists.

The total of the purchase day book would be debited to the purchase ledger acount. Net totals of each invoice date would be credited to the suppliers, (creditors) account, and the double entry would be completed after that.

Let us see how a purchase day book or journal is prepared whith an example.

Eg. Chitra buys and sells textiles. Following information is for the month of January 2008

Date	Invoice No.	Supplier	Details of the goods bought
2008 1 5	152	Ramya	60 completed shirts at Rs. 450 each 120 completed trousers at Rs 800 each (Deducted trade discount 5%)
2008 1 12	214	Suramya	500 Metres of Silk at Rs 50 per metre 200 Metres of poplin at Rs 60 per metre 200 Metres of white cloth at Rs.40 per metre (Deducted trade discount 8%)
2008 1 25	316	Suba	40 Japanese sarees at Rs. 1500 each 60 Indian sarees at Rs. 1200 each
2008 1 30	165	Ramya	50 Bed sheets at Rs 150 each 40 Towels at Rs 125 each.

Purchase Journal / purchase day book

Date	Invoice No	Sup-plier	Description the goods			Value	Total Value	L. P.
			Details	Quantity	Unit price			
2008				Rs.	Rs.	Rs.		
1 5	152	Ramya	Shirts	60	450	27 000		
			Trousers	120	800	96 000		
						123 000		
			Less 5% trade discount			6 150	116 850	
1 2	214	Suramya	Silk	500 m	50	25 000		
			Poplin	200 m	60	12 000		
			White cloth	200 m	40	8 000		
						45 000		
			Less 8% trade discount			3 600		
							41 400	
1 25	316	Suba	Japanees Sareas	40	1 500	60 000		
			Indian Sarees	60	1 200	72 000	132 000	
1 30	165	Ramya	Bed sheets	50	150	7 500		
			Towels	40	125	5 000	12 500	
1 31		(Posted) Transferred to purchase Account					302 750	

Activity 07

Following are the details of the credit purchase transactions of Perera's trade which involves in buying and selling of school stationeries and of the period ended 2008 January 31st

Jan. 05 Baought goods from Kurera invoice No. 45

80 Drawing books at Rs.30 each
50 CR Books at Rs. 80 each
120 Children's poetry books at Rs 20each
(Trade discount 10% deducted)

Jan 12 Baought goods from Livera under the invoice no. 216
20 Dozens of ball point pens at Rs. 115 a dozen
15 Dozens of sharpners at Rs. 45 a dozen

Jan 20 Baought goods from Sigera under the invoice No. 82
25 Packets of half sheets at Rs 200 a packet
40 packets of photocopy sheets at Rs. 300 a packet
30 Packets of Roneo sheets at Rs. 225 a packet

Write the purchase Journal with description columns for the month of January 2008 and enter the information given above.

Sales journal or sales day book

The information of goods sold on credit which were bought with the intention of resale is recorded in the prime entry book known as sales journal or sales day book.

Sales journal is prepared on the basis of the information given in the sales invoice. Trade discounts are deducted when credit sales are taking place and, should be subtracted from the value mentioned in the invoice.

A model of a sales journal

Date	Invoice No.	Debtors	Details of the goods				Total Value	Ledger page No.
			Details	Quantity	Unit price	Value		

Total value of the sales journal would be transferred to the credit side of sales account. Net totals of each invoice would be credited to the debit side of the debtors' account on the relevant date. The double entry for credit sales would be completed then.

Activity 08

Details of the credit sales of the Perera's Trade for the month ended 31 January 2008 are given below.

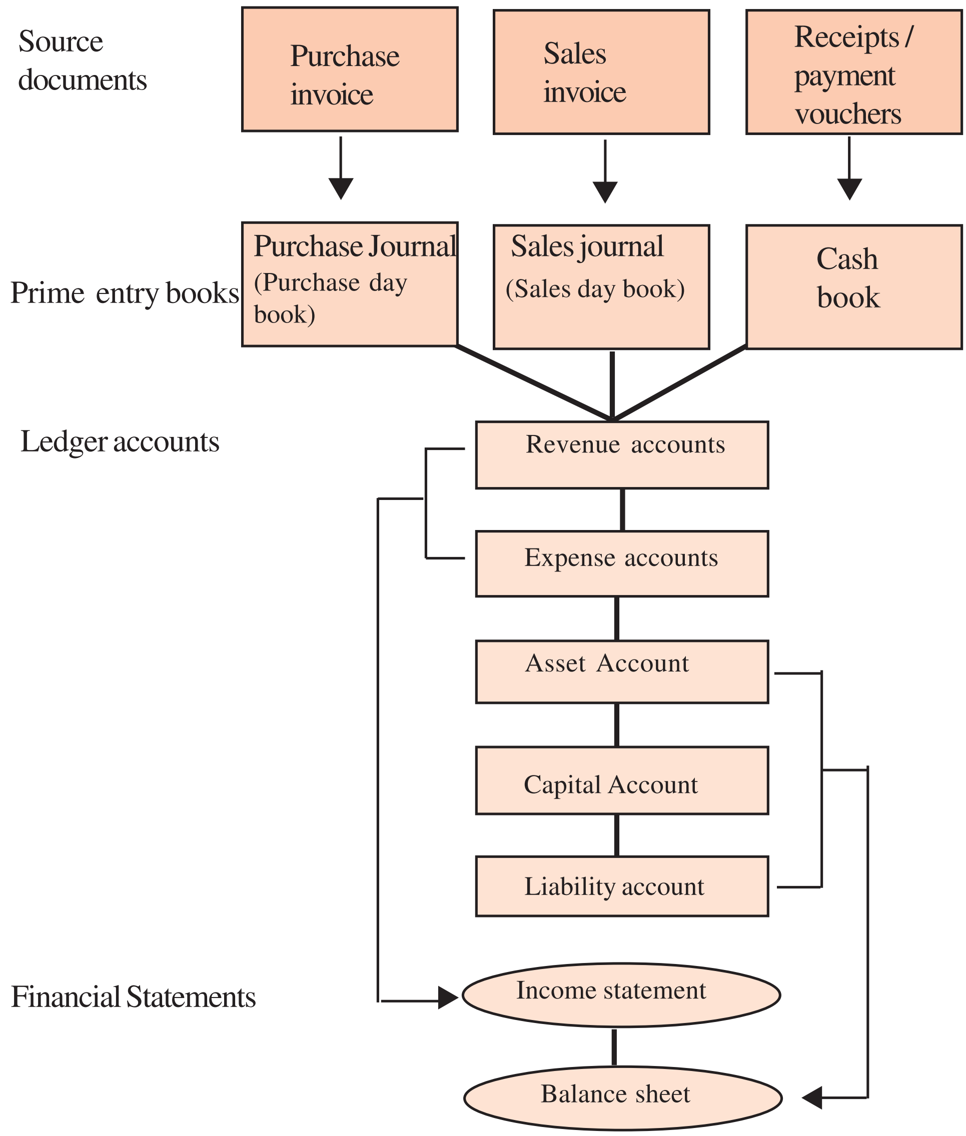
08. The goods sold under invoice No. 006, to Kumudu
    05 Drawing books at Rs 45 each
    30 CR books at Rs. 120 each
    40 Children's story books at Rs. 30 each
    (Deducted trade discount 5%)

18. The goods sold under invoice No. 007 to Manel
    10 Dozens ball-point pens at Rs 160 a dozen
    08 Dozens sharpeners at Rs. 60 a dozen
    (Deducted trade discount 5%)

25. The goods sold to Nelum under the invoice No. 008
    10 Packts of half sheets at Rs 250 a packet
    25 Packets of photocopy papers at Rs 340 a packet
    08 Packets of Roneo sheets at Rs 300 a packet
    (Deducted trade discount 5%)

28. Calculators were sold to Kumudu at Rs 400 each under the invoice No. 009

Write up the sales journal from the above.


Source documents
Purchase invoice
Sales invoice
Receipts / payment vouchers
Prime entry books
Purchase Journal (Purchase day book)
Sales journal (Sales day book)
Cash book
Ledger accounts
Revenue accounts
Expense accounts
Asset Account
Capital Account
Liability account
Financial Statements
Income statement
Balance sheet

Summary

Importance and necessity of accounting arise in resource management in a business due to scarcity of such resources. Functions of accounting are collection of source documents relevant to transactions, reporting them in monetory values, classification, summarizing, analyzing interpretations and providing accounting information to the parties who require them.
The owner and his business would be considered as a separate entity according to the business entity concept. Accounting equation has been formed on this basis. Basic elements of accounting equation are assets, equity (capital) and liabilities and changes which would be due to the transactions that take place in the business. Dual impact of transactions can be explained on the basis of double entry principles of recording.

Profit or loss would be calculated for an accounting period by the inclusion of revenue and expenses in the income statement. Assets, capital and liabilities would be included in the balance sheet and the financial position would be shown.

These source documents would be credited for cash transactions as well as for credited transactions. Prime entry books would be prepared on the basis of the information mentioned in the source documents.

Basis of accounting would be used when financial information is revealed through the business plan.

Activity 09

i)Basic accounting equation is as follows:

Assets = Capital + Liabilities

Show the accounting equation above in the following way :
- To show in terms of capital
- To show in terms liabilities

ii)Fill in the blanks in the following.

Assets	=	Capital +	Liabilities
90 000		60 000	....
120 000		....	40 000
....		90 000	50 000
150 000		....	0
....		160 000	0

iii) Fill in the blanks with the appropriate accounting terms :

1. Assets = Liabilities + ...
2. Fixed Assets + ... = ... + Capital
3. Fixed Assets +.................. = Long term Liabilities + Capital

iv) Fill in the blanks in the following table.

	Fixed Assets +	Current Assets =	Capital +	Long term Liabilities+	CurrentLiabilities
01	40 000	60 000	....	25 000	30 000
02	50 000	....	90 000	35 000	45 000
03	....	120 000	150 000	40 000	20 000
04	120 000	160 000	180 000	20 000	....
05	145 000	195 000	200 000	....	45 000
06	250 000	....	210 000	0	90 000
07	350 000	242 000	....	0	125 000
08	....	20 000	95 000	95 000	36 000

Activity 09

(02) i) Collect original source documents relevant to the following transactions.

1. Goods sold for cash
2. Payment of employees' salaries
3. Trading goods bought on credit
4. Trading goods sold on credit

ii) Complete the following table with regard to the transactions mentioned above.

Activities / Transactions	Source documents	Prime entry book to record this
1.Goods sold on credit	....	....
2. Payment of employees' salaries	....	....
3. Goods bought on credit	....	....
4. Goods sold on credit	....	....

iii) State why the following source documents are needed.

Source document	Reason
1. Cash receipt	
2. Payment voucher	
3. Purchase invoice	
4. Sales invoice	

Activity 10

Nishanthi started a business in buying and selling of cosmetics and beauticulture products. She has given you the following information of her business for the period ended on 31.03.2008

She has started the business with Rs. 600 000 out of one million rupees she won from a lottery draw. She has started the business on the 1st of January 2008. She bought furniture worh Rs. 25 000 equipment at a cost of Rs. 12 000 and beauty culture and cosmetic products for Rs. 245, 000.

She has bought a motor vehicle at a cost of Rs. 400 000 of which she has paid Rs. 250 000 from a bank loan that would be repaid within 05years, and the annual interst on the loan is 12% No interst has been paid so far.
Rs. 35 000 advertisement expenses, Rs.4 500 telephone charges Rs. 6 500 electricity charges and Rs. 8 000 other expenses have been paid and earned Rs. 420 000 service income Rs. 60 000 out of the total income earned has to be recieved from the debtors, by 31.03.2008 remaining stock of cosmatic products on that day is Rs. 45 000. Fixed assets should be depreciated at the rate of 10% annually.

She requests you to prepare the following.

i) Recording of cash receipts and payments in the cash book during the 03 months period and the cash balance in the business on the 31.03.2008

ii) Prepare the income statements and find the net profit or net loss for the three months ended on 31.30.2008

iii) Draw up a balance sheet as at 31.03.2008