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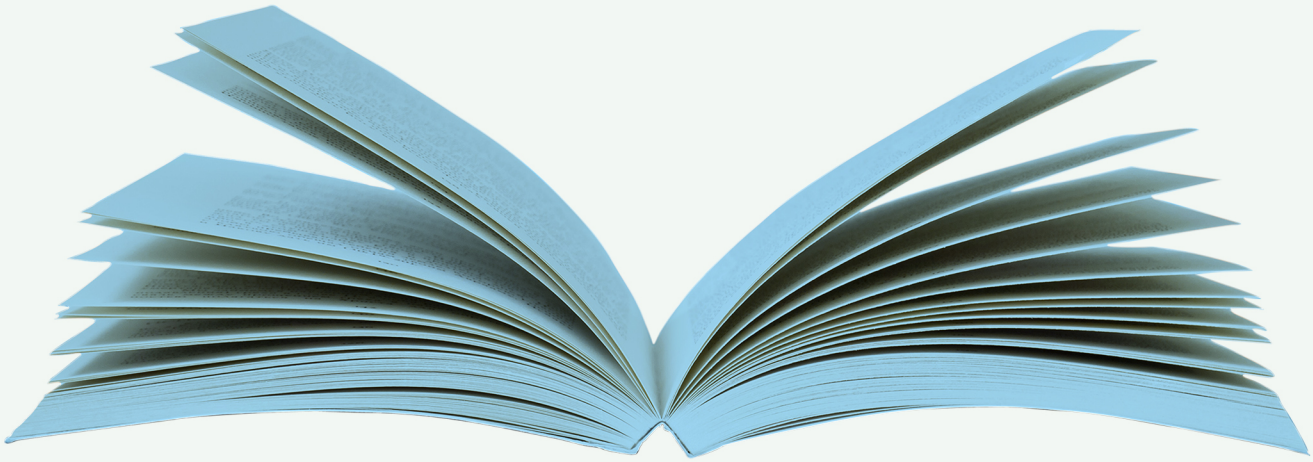
Accountancy



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Contents

Preface

Accounting is the process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated. Accounting is the language of business.

Chapter 1 Categories

1. Financial Accounting (Page 2) is a major branch of accounting that describes the collection, recording, and extraction of financial information, in order to periodically summarize profit and loss, the balance sheet, and cash flow in accordance with legal, professional, and capital market requirements (Accounting Standards (Page 41)). The main task is to prepare regular financial reports.
2. Management Accounting (Page 4) is the branch of accounting for internal use, to which end an organization provides information only accessible to its insiders in order to assist decision-makers. The mission of managerial accounting is to utilize, inform, and control the functions of management.

1.1 Financial Accounting

Financial Accounting is about **Financial Reporting**.

There 2 mainstream: International Financial Reporting Standards (IFRS) - Used in most countries Generally Accepted Accounting Principles (GAAP) - Used in USA, Canada, India, UK(before 2005)

Many countries use the International Financial Reporting Standards (IFRS), which is established and maintained by the International Accounting Standards Board.

IFRS (Page 2)

GAAP

1.1.1 IFRS

IASB The most common financial accounting standard.

1.1.1.1 Conceptual Framework

The framework is not a Standard

The main goals of the framework are: Objectives of financial statements

Identification of characteristics to ensure quantitative information in the statements.

Explain the procedure of recognizing and measuring elements of financial statements

Assets

```
 An asset is a unit of resource under control of an entity result in economic
benefits inflow rose from past event.
```

THERE are 3 essentials:

1. The resource must contain future economic benefits
2. The entity must have control over the future economic benefits
3. There must be a past event

Liabilities

```
An liability is present obligation of the entity rose from past event.
```

Present obligation is one of the 3 essentials; giving up resources;past transaction or event

Income

Expenses

1.1.1.2 Tax Purpose

The tax-effect accounting desire to identify net tax-effect of all perodic transactions recognised.

Because tax purpose is different from accounting purpose, as there are several accounts not possible posted to Tax department, e.g.

There 2 methods: Current Tax

Determines current tax liability Analyses differences between accounting and taxable profit

```
Current tax worksheet
```

Deferred Tax Determines net effect of deferred taxes and deductions arising from current period transactions Analyses differences between accounting and tax balance sheets

```
Deferred tax worksheet
```

1.2 Management Accounting

Management Accounting involves: Costing Management: how to determine the use of overhead in manufacturing/service business. Traditional procedure: find a single cost driver assigned to cost pool. There are several recently emerged more flexible Activity based costing. ABC, etc.

1.2.1 Budgeting

Budgeting Systems is profit loss plan target at operating, it also be used to evaluate business performance. However, to avoid budget padding, the budget focus more on accuracy than amount or performance, this often different from other evaluation tool.

It's not going to adjust for new opportunities, in contrast,

In relevant cost analysis, managers exclude sunk cost, allocated fixed cost and utilized fixed cost.

Chapter 2 Contents

2.1 Principles of accounting

2.1.1 Accounting Operations: Credit & Debit

Accounting approaches the world of economic transactions from the viewpoint of Capital Transformation. Accounting books record the source of the Capital and the form it takes after passing through a company's productive & administrative mechanism. Since Accounting wants to capture these two pieces of information (whence the Capital comes - to what it is transformed), it needs two operations - and Accounting has indeed two and two only operations: Credit & Debit. Traditionally we always say "Debit & Credit" and we always put "Debits" to the "left" (of a page) and "Credits" to the "right" (of a page). But causally speaking, the act which the operation "Credit" captures comes first: because Credit shows the source of the Capital, while Debit shows to what the capital has been transformed before. That's why "A Debit must always equal the corresponding Credit".

Suppose now that the company's Board of Directors, after receiving the cash from the shareholders, decides to spend it in order to buy new productive equipment, striking a deal with a supplier to pay him or her after 60 days from purchasing the equipment. In order to reflect this transaction we need to record two different Accounting Entries.

A) The purchasing of the equipment under 60 days credit terms. Here, since we are buying "on credit", the supplier essentially supplies us with Capital (for 60 days). So we will Credit the Suppliers Account in order to show that we initially are buying the equipment using the suppliers capital, and we will Debit a Fixed Assets account (with equal amount) in order to show that we transformed this capital into Equipment.

B) The cash payment for the equipment after 60 days. Here Accounting sees that capital available to us in the form of Cash (the initial shareholders capital increase in cash), is transformed into Capital returned to supplier. So we will Credit our Bank Account (to show whence capital comes), and we will Debit the Suppliers Account to show to what we have transformed this capital (into Capital Returned to the Supplier).

2.1.1.1 For each transaction, the sum of credits equals the sum of debits

The difficulty is the exercise of correct categorization of which accounts to debit , which to credit, and by what amounts.

2.1.1.2 The first categorization of accounts is whether the account is an asset account, liability account, equity account, income or expense account, cash account

In general, debits increase the left side, and credits increase the right side (of the equation : assets= liabilities + equity).

Hence , debits increase asset accounts , credits increase liability accounts, credits increase equity accounts. Income can be thought as increasing equity, so credits increase income accounts. Expenses decrease equity, so it is the opposite of Income, so debits increase expense accounts.

(After a while, it becomes almost automatic to record an expense as a debit to an expense account, and a credit to an asset account (cash) , or a credit to a liability account (payable); a sale as a debit to cash , or a debit to accounts receivable, and a credit to sales account; a inventory purchase as a debit to inventory, and a credit to cash , or a credit to accounts payable ; a loan as a debit to cash in bank, and a credit to bank loan account (liability) .

It is also customary, that debits are written down first , then credits, when recording initially in chronological order in the general journal).

Once these are gotten used to by practice , there may be also a need to think of *contra-accounts*, such as contra-asset accounts such as accumulated depreciation, or contra-equity accounts such as Recovered Bad Debts previously written off.

2.1.2 Forms of Capital

As the above example indicated, "capital" in the world of Accounting, can take many forms. We can state the following all-encompassing definition: **Any debt of a company, with or without interest, that is not paid in cash or otherwise settled, at the moment it is recorded in the Accounting Books, becomes capital given to the company.**

Essentially then, "capital given to a company" is the amount that the company must return to its creditors. And we record as "capital" even temporarily unpaid debt. For example, suppose that from the payroll of a certain month, you have deducted from the employees' salary a payroll tax that you should pay to the State. If this payment, according to the relevant laws, must be executed three months after the month to which it originates, then for these three months, the state has given to you an amount of capital equal to the Payroll tax amount.

2.1.3 So what are we actually seeing in a Balance Sheet?

In a Balance Sheet we have three main headlines: Assets, Liabilities, Owner's Equity (aka Equity). In many countries, Assets are shown in the left of the page, while Owners' Equity to the top right and Liabilities to the lower right.

Now, it is a fundamental Accounting rule that "Assets = Owners' Equity + Liabilities". But why?

...If we use the "Capital Transformation" approach, we can understand why: "Assets" are of course what the word Assets means. But at the same time they show to us to what the company has transformed the capital given to it by... whom?

a) The Shareholders ("Owner's Equity"), and b) Everybody Else (Liabilities). In Equity we see the amount that is to be returned to the Shareholders, after all Assets are liquidated and all Liabilities are paid in full. In that sense, "Owners' Equity" is also a liability for the company: A company does not own anything - it owes all of its Assets to somebody, Third Parties or its Shareholders. A company is a separate entity from its owners.

In Liabilities, we see the amounts that the company owes to third parties - Suppliers, Banks, Internal Revenue Service, etc. At the same time they show to us "whence the capital came".

So the right side of a Balance Sheet shows how much capital and from whom the company has managed to get at the specific moment of the balance sheet (from third parties-"Liabilities" or from its own shareholders-"Equity"). On the left side of the Balance Sheet, we see to what the company has transformed this capital-"Assets". **Again, we are talking about the same capital, the same quantity.** So the "right side" (Equity + Liabilities) **must** equal the "left side" (Assets).

2.1.4 Alternative views of accountancy principles

Accountancy may have been an elaboration of an accidental discovery, much like the tale Archimedes and the bathtub discovery of water volume displacement equals floating object volume. Some idly rich mathematicians found that assets equals liabilities plus equities.

The official story is that accountancy was first systematically expounded by Luca Pacioli in the Renaissance, who in a section of a mathematical book he is generally thought to have written, describes the Venetian method, or **double entry accounting**.

Double entry accounting maintains the assertion or constraint that **assets = liabilities + equity**. It gives rise to the concept of periodic **trial balances**, where the equation is checked at the end of a period. There is also a concept of **closing entries**, where in addition to the more permanent account types of **asset** accounts, **liability** accounts,

and **equity** accounts, there are *temporary* operational **income** accounts and **expense** accounts, which are updated ideally throughout a period of operation, or as a minimum, before the end of a reporting period with journalised historical data, and **closed off** , i.e. *the result of income minus expenses is added to equity , and the temporary income and expense accounts made to have zero balances for the next reporting period*.

There is also the concept of **accrual** vs **cash** accounting : cash accounting requires an entry whenever cash is exchanged , so doesn't record borrowings or loans , and therefore isn't very sufficient , whereas accrual accounting makes a recording whenever an enforceable or highly probable obligation arises for the future movement of cash to an entity (receivables, a subtype of asset), or out of an entity (liabilities) occur.

Because there are transactions that are accrued , they record an obligation, later transactions are needed to record when obligations are met. Some obligations gradually are met over time, so are calculated according to the amount of time that has expired since the last calculation was made and recorded , and these fall under the category of **adjusting entries**. Examples of end of period adjusting entries include the recording depreciation, usage of prepaid expenses such as insurance, rent , the performance of services paid in advance by customers (unearned revenue fulfillment). End of period adjusting entries are made before the closing entries that closes off temporary income and expense accounts and updates equity.

There are other uses of adjusting entries, such as in adjusting entries for subsequent periods. These occur because end of period deadlines may be straddled by the periods for which prepayments exist, or periods for which current liabilities fall due, and because these are only partially accounted for in the end of period adjusting entries.

2.1.4.1 Illustrative example of role of adjusting entries

Pay day is fortnightly and last falls on June 23 for the last accounting period, so on 30th June, a **end of period adjusting entry** is made to salaries payable for the employee Joe who earns $2000 per fortnight, and an entry is made to salaries payable for $1000, or 7 days of 14 days. Closing entries then close off the salary expense account to zero balance, as profit is calculated as sum of income minus sum of expenses and added to equity (owner capital) , and any owner drawings are subtracted from capital. Then pay day occurs on 7th of July in the next period, but instead of debiting $2000 from salary expense as usual, $1000 is debited from salary payable (which removes the previous recorded liability), and $1000 is debited to salary expense , (the other side of the double entry is a credit of $2000 to the cash-in-bank asset account , which is unchanged from the normal entry). This non-regular apportioning of an entry to account for end of period adjustments is termed **adjusting entries for subsequent periods.** As a side note, this irregularity of entry can be avoided by making *preempting adjusting entries at the beginning of a period* , which are quite artificial : these are called **reversing entries** .

In the previous example, the *opening reversing entry* would be a debit to salary payable of $1000 and a credit of salary expense of $1000, leaving the salary expense account in the situation of being $1000 in credit (if there is only Joe on the payroll) since the salary expense account was cleared to zero with a closing entry from the last period (this situation seems artificial because expense accounts are normally in debit). However, this allows the normal pay day entry on the 7th July for $2000 dr to salary expense, to leave the salary expense account in the correct $1000 DR balance, given the other $1000 had been previously accounted for in the previous period (it was recorded as the end of period accrued adjusting entry to salary expense mentioned at the start of the example ; even though there had been no exchange of cash at the time, the work had been done and therefore owed).

2.1.4.2 Basic financial statements from the adjusted trial balance

The usefulness of double entry accounting is that the equation assets equals liabilities plus equities should always hold after each double entry , and can be done once after adjusting entries are made , called an **adjusted trial balance** . From the adjusted trial balance, 3 different parts can be used to produce 3 basic reporting statements, the income statement, the statement of change of equities and the ending balance sheet.

Each statement depends on the previous statement. The income statement is a summary of the temporary income and expenses accounts, and states a profit. The profit is shown in the statement of change of equity, where *beginning capital* amount is added to the *profit* from the period, any *drawings* amount subtracted, and the **ending capital** amount is determined.

Thirdly, the balance sheet shows the ending amounts of the permanent accounts (excluding income and expense accounts , which have been closed off), with the **ending capital** from *the statement of change of equity* as the capital stated in the equity section. It will show that the sum of the asset accounts less the sum of the liabilities , is equal to the ending capital (equity).

2.1.4.3 Why financial statements, or why accountancy?

Another view of accountancy principles is existential justification. When isn't it necessary to practice accountancy ? Some people feel accountancy is mainly of benefit when a certain threshold of money is involved ,and there is use of other people's money. It is those other parties that need to be accounted to. Otherwise, accountancy becomes an exercise of not letting oneself defraud oneself unwittingly.

2.1.4.4 If a need for accountancy exists, what qualities make it sufficient?

If it is given that a need exists for accountancy - e.g. some hotshot is playing with some retiree's lifetimes earnings, and could lose it to some undeserving employee of a merchant bank who spends it on cocaine and a collection of porsches , it may be useful to name what qualities might make the results of doing accountancy useful.

4 memorable qualities might be **understandable**, **relevant**, **reliable**, and **comparable**.

Financial statements should be understandable : usually they are, because there is almost a standard format for statements of income, change in equity, balance sheet, and cash flow. Even so, it is still common practice that these understandable items aren't analysed by spruikers of investing opportunities in a standard way.

Even if the statements are understandable, they could suffer from being irrelevant or unreliable.

Relevance / materiality means if something is included or excluded from financial statements, it can affect the economic decisions of investors if the opposite was true. Including immaterial stuff can paint a too rosy picture, and excluding material stuff can be hiding big problems.

Reliability sounds like relevance, and it begs the question as to whether something can be relevant and unreliable, but it appears to mean that one should not take the accrual principle too far. Examples of accrual in action, is the allowance for bad debts, and provisions for contigent liabilities. As an example of something unreliable is making a recording of an asset some financial product backed by subprime mortgage parcels. Another , which might also lack relevance, is having a major controlling shareholding in a company financed by margin lending, and this amount of equity included in the previous balance sheet. The major shareholder is a separate accounting entity, so doesn't have to reveal his liabilities in the balance sheet, but the amount stated as shareholder equity is in hindsight , unreliable, after a margin call is made.

Another example of unreliable accounting, is having an accumulated provisions for the possibility of fire account as a cash account reserved in theory for the provision, instead of buying prepaid insurance for a specific amount , as the latter is more reliable because there is documentation , a provisioned amount is certain and it is probable that it sufficiently provides for the contingency.

Finally , comparability means that accounting is done similiar enough to other companies to make comparisons , as well being able to compare the accounts between different accounting periods of the same company, because enough information is given when policy changes are made, e.g. to the type of accounting made for inventory.

2.2 Introduction to Accountancy

2.2.1 What are the Rules of Accounting?

Accounting is the mechanism used to record activities and transactions that occur within a business.. In its simplest terms, Accounting is the "language of business." However, in order to have an understandable record, a standard set of rules for accounting within the U.S. has been established. These rules are called the **Generally Accepted Accounting Principles** (GAAP), and all U.S. businesses are expected to follow them.

The **first general rule** of accounting is that every transaction is recorded. It has been said that businesses that do not record transactions, or incorrectly record transactions, are committing fraud, although this is not necessarily the case. Fraud is part of a much broader area called material misstatement which also can include error. An error is not necessarily fraud under the law. While there are exceptions to this rule, the guidance for applying those exceptions is specifically defined by GAAP, and is applicable to all businesses.

The **second general rule** of accounting is that transactions are recorded using what is called a "double-entry" accounting method. Originally developed in Italy in the 1400s, double-entry means that for a complete record of a transaction, two entries are made. *For example, if you have $5 in cash, and want to buy some gasoline for your lawn mower, you take your portable gas can and your money to the gas station and exchange $5 in cash for $5 in gas. This transaction is recorded as an increase in the asset "gas" for $5, and a corresponding reduction in the asset "cash" for $5. In this example, one transaction contained two entries.* This takes a little time to get used to, but it is a critical concept in basic accounting. Double entry is tied to the concept of Debits and Credits, which you will learn about in the next section. The act of recording transactions is commonly referred to as making journal entries. In a few more paragraphs, we'll discuss what a journal entry looks like.

The **third general rule** of accounting is that every recorded transaction is captured in a log called the "General Journal."

In general, "Accounting is the art of recording, classifying, summarizing and interpreting a business transaction."

To make this easier, we can follow the golden rules of accounting. Accounts are one of three basic types:

Type	Represent	Examples
Personal	Accounts related to	Individuals; partnership firms; corporate entities; Capital;

	individuals, *firms*, *organizations*, or *companies*	Drawings; non-profit organizations; any local or statutory bodies including governments at the country, state or local levels
Real	Accounts related to *assets of a tangible or intangible nature*	• Tangibles – Plants and machinery, furniture and fixtures, computers and information processing equipment • Intangibles – Goodwill, patents, copyrights, trademarks, purchase
Nominal	*implications of financial transactions during each fiscal term till finalization of accounts at term end*	rent, salary, discount, utilities, dividends

Example: The *Sales* account is opened for recording the sales of goods or services. At the end of the financial period, the total sales are transferred to the revenue statement account (*Profit and Loss Account* or *Income and Expenditure Account*).

Similarly, expenses during the financial period are recorded using the respective *Expense* accounts, which are also transferred to the revenue statement account. The net positive or negative balance (profit or loss) of the revenue statement account is transferred to reserves or capital account as the case may be.

THE GOLDEN RULES OF ACCOUNTING:

Type	Debit	Credit
Personal	The receiver	The giver
Real	What comes in	What goes out

Nominal	All expenses and losses	All income and gains (profits)

2.2.2 The Nature of Accounts: Definitions

An '**account**' is a specific location for recording transactions of a like kind. For example, in the gas-for-cash transaction above, two accounts are used, a "Cash" account and a "Gas" account. Unused by that example, but described is an account for "Equipment" which would include the portable gas can and the lawn mower.

The basic types of accounts are:

'**Assets:**' items of value that the company owns or has right to. Examples include: cash, real estate, equipment, money or services that others owe you, and even intangible items such as patents and copyrights.

'**Liabilities:**' obligations that are owed to other parties. Examples include: wages payable, taxes due, and borrowed money (also called debt).

'**Equity:**' the ownership value of a company. Examples include: common stock and retained earnings (we'll describe retained earning below in "Financial Statements")

'**Revenues:**' the mechanisms where income enters the company (note that revenue and income are not the same thing--they are used here to describe each other in basic terms only).

'**Expenses:**' the costs of doing business. Examples include: salary expense, rent, utilities expense, and interest on borrowed money.

'**Income:**' in U.S. business and financial accounting, the term 'income' is also synonymous with revenue; however, many people use it as shorthand for net income, which is the amount of money that a company earns after covering all of its costs.

2.2.3 Overview of the accounting cycle

When a transaction occurs, a document is produced. Most of the time, these documents are external to the business, however, they can also be internal documents, such as inter-office sales. These documents are referred to as a source document. Some examples of source documents are:

- The receipt you get when you purchase something at the store.
- Interest you earned on your savings account which is documented in your monthly bank statement.
- The monthly electric utility bill that comes in the mail.

These source documents are then recorded in a **Journal**. This is also known as a **book of first entry**. The journal records both sides of the transaction recorded by the source document. These write-ups are known as **Journal entries**.

These Journal entries are then transferred to a **Ledger**.The group of accounts is called ledger. A ledger is also known as a **book of accounts**. The purpose of a Ledger is to bring together all of the transactions for similar activity. For example, if a company has one bank account, then all transactions that include cash would then be maintained in the Cash Ledger. This process of transferring the values is known as **posting**.

Once the entries have all been posted, the Ledger accounts are added up in a process called **Balancing**. (This will make much more sense when you learn about Debits and Credits. Balancing implies that the sum of all Debits equals the sum of all Credits.)

A particular **working document** called an **unadjusted trial balance** is created. This lists all the balances from all the accounts in the **Ledger**. Notice that the values are not posted to the trial balance, they are merely copied.

At this point accounting happens. The accountant produces a number of **adjustments** which make sure that the values comply with accounting principles. These values are then passed through the accounting system resulting in an **adjusted trial balance**. This process continues until the accountant is satisfied.

Financial statements (Page 14) are drawn from the trial balance which may include:

- the Income statement (Page 15)
- the Balance sheet
- the Cash flow statement

Finally, all the revenue and expense accounts are closed.

2.2.3.1 Financial statements

We all remember Cuba Gooding Jr.'s immortal line from the movie Jerry Maguire, "Show me the money!" Well, that's what financial statements do. They show you the money. They show you where a company's money came from, where it went, and where it is now.

There are four main financial statements. They are: (1) balance sheets; (2) income statements; (3) cash flow statements; and (4) statements of shareholders' equity. Balance sheets show what a company owns and what it owes at a fixed point in time. Income statements show how much money a company made and spent over a period of time. Cash flow statements show the exchange of money between a company and the outside world also over a period of time. The fourth financial statement, called a "statement of shareholders' equity," shows changes in the interests of the company's shareholders over time.

2.2.3.2 Income statement

EXAMPLE:

```
        Mr.X
    Income Statement
For the year ended 30 june,2010

_____________________________________
sales ------------------2000
less saless return--------100
Net sales revanue ----------------------1900
less of goods sold
  purchase----------------1700
  less purchase return----200          1500
Gross Profit---------------------------400
less operating expenses
salary-------300
Rent---------150
Advertising--200                      650
Net Loss-------------------------------250


        Mr.X
    Balance Sheet
As at 30 june,2010

_____________________________________

current Assets:
     cash----------------------------RM 2050
Non-current Assets:
    furniture----------------------------300
    Office Equipment --------------------900
Total Assets-----------------------------3250

     LIABILITIES
Creditor---------------------------------550
     OWNER EQUITY
Capital--------3250
less:Net loss---250
less: Drawings--300                    2700
Total Liabilities and Owner's Equity-----3250
```

Remember..when you are calculating always think as an accountant.

2.2.3.3 Debits and Credits

For the purposes of accounting, please forget what you know about credits and debits. In accounting, debit (Dr.) and credit (Cr.) have nothing to do with plastic cards that let you buy stuff. In fact, what most beginning accounting students need to know about Dr/Cr can be boiled down to two sentences.

Debit is on the left. Credit is on the right.

How are debit and credit rules applied to different types of accounts?

DEBIT……NATURE OF A/Cs…….CREDIT

Increase……..ASSETS……..Decrease

Decrease……LIABILITIES……Increase

Decrease……..REVENUE…….Increase

Decrease……..EQUITY……..Increase

Increase……..EXPENSES…….Decrease

Increase……..DRAWINGS…….Decrease

In case of ASSETS and EXPENSES; increases go to the debit side, while decreases go to credit side. On the other hand, in case of LIABILITIES, REVENUE and EQUITY; increases go to the credit side and decreases go to debit side.

An account will have either a "**normal credit balance**" or a "**normal debit balance**", depending on the type of account. The normal balance indicates which side of the account the amount goes to when the account balance increases. For example, the account 'Cash' has a normal debit balance: receiving cash results in a debit entry, spending it results in a credit entry.

Debits and credits may be derived from the *fundamental accounting equation*. They result from the nature of double entry bookkeeping. Two entries are made in each balanced transaction, a debit and a credit. This allows the accounts to be balanced to check for entry or transaction recording errors.

Date	Description	Post Ref.	Dr	Cr
2005 Feb 1	account1		350	
	account2			350

Fig. 2.1: Example Journal - Page 1

Owner's Equity = *Assets* - *Liabilities* is written from the perspective of the owner. In accounting this is generally rewritten from the perspective of the business or commercial entity the books detail:

Assets = *Owner's Equity* + *Liabilities* (Fundamental Accounting Equation)

Entries in the books are in pairs and track the advantage or asset of the company simultaneously with the disadvantage or liability. In this view the Owner's equity is a claim of the investor against the company.

- On the left side or *Assets* side of the Fundamental Accounting Equation:
  - Transaction halves which increase the business assets are "debits" on the left side of the equation.
  - Transaction halves which decrease the business assets are "credits".
- On the right or balancing side or *Owner's Equity* + *Liabilities*:
  - Transaction halves (i.e. the part of the transaction) that increase the Owner's Equity are credits to the company books as they are claims of what the company owes the owner or investor
  - Transaction halves that decrease the Owner's Equity (dividends paid or loss writeoffs) are beneficial to the company's future financial position by reducing claims and are considered debits.
  - Liabilities incurred by the business entity (which are tracked by the books) are credits
  - Liabilities reduced or paid off are debits.

2.2.4 Separate Entity Concept

Even when a business has a single owner we make a distinction between the owner's assets and the assets of the business. For example if the owner gives a van to the business this will count as capital introduced, if the owner takes a salary this will be accounted for as drawings.Famous case laws are "salomon vs salomon & co.ltd",Lee vs Lee's air farming ltd." etc

2.2.4.1 Journal Entries

All accounting transactions are first recorded in a *journal*. The most common of these is the **General Journal**, sometimes also known as the Book of Original Entry, because it is the first place a transaction is entered into the books. Journal Entries are made from *source documents*, which can be anything from receipts to invoices to bank statements.

Date		Description	Post Ref.	Dr	Cr
2005 Jan	1	Cash		10,000	
		Sales			10,000
		To record cash sales.			
	6	Equipment		15,000	
		Accounts Payable			15,000
		To record purchase or equipment on credit			

Fig. 2.2: General Journal - Page 1

These two entries show the premise of *double-entry accounting*. Note that the *form* of what is written is as important as the actual text:

- Debits are always recorded first, followed by the credits.
- In keeping with the rule of "Debit = Left, Credit = Right", all accounts that are credited have their titles indented ("Sales" and "Accounts Payable" in this example).
- The year and month are only recorded once in the date column. They are recorded again at the top of every new page, and whenever the month or year changes. However, a new page is usually started at the beginning of each month, because end-of-period entries are normally recorded on a separate page.
- A description of each entry is placed on the line below the entry. While this is not required, it is good practice because, at times, account titles may not be enough to describe what actually occurred for a specific transaction.
- A blank line is inserted between entries.

The process of recording entries to a journal is called **journalizing**.

2.2.4.2 T-Accounts


```
Form:                                Example:
    Account Name                            Cash
    -------------                       -------------
    Debit  |Credit                    $750.00 |   100.00
           |                            65.00 |    80.00
   _______|_______                    ________|________
 Subtotal | Subtotal                   815.00 |   180.00
   _______|_______                    ________|________
  Balance | Balance                   $635.00 |
```

One representation of an account is called the **T-account**, shown above. A T-account contains just the basic elements of the account, so it lacks the necessary detail for use in bookkeeping operations. However, it has its uses as both an illustrative tool and a quick reference.

Each account needs to have a unique *Account Name*, such as Cash, for ease of reference later on. In modern accounting systems, you will often see an account number alongside the name in order to facilitate report generation and computer entry. Under the bar are the debit (from the Latin *debere*, to owe) and credit (*credere*, to believe) columns.

As it shows in the example above, the balance of a T-account can be figured by first totaling each column. Second, subtract the smaller subtotal from the larger, and finally placing the total in the larger number's column.

2.2.4.3 Ledger Accounts

While a T-Account is useful for quickly summarising an account's balance, it only contains a fraction of the information that was recorded in the Journal.

2.2.4.4 Types of Accounts

Assets = Liabilities + Owner's Equity

A central axiom for accounting is the accounting equation above. Depending on the type of company involved, Owner's Equity may be "Shareholder's" or simply "Equity", but the equation holds. The list of all of the accounts (along with their respective account numbers) is called the **Chart of Accounts**

Asset accounts indicate what a company owns. This can be actual possession or the right to take possession, such as a loan extended to another company. Some assets are identifiable by the term *"Receivable"*. Assets have a normal debit balance.

Liability accounts indicate what a company owes to others. Examples of liabilities include loans to be repayed and services that have been paid for that the company hasn't performed yet. Many liabilities can be identified by the term *"Payable"* in their account name. Liabilities have a normal credit balance.

Equity accounts are a group of accounts that represent the amount of owner's equity in the business. There are four main types of Equity accounts:

- **Revenue accounts** indicate revenue generated by the normal operations of a business. Fees Earned and Sales are both examples of Revenue accounts. Revenue accounts have a normal credit balance.
- **Expense accounts** indicate the expenses incurred by a business during normal operations. Most account names ending in "*Expense*" are classified as expenses. Expenses have a normal debit balance.
- The **Owner's Equity** or **Owner's Capital** accounts (for a Proprietorship/ Partnership) or the **Shareholder's Equity** accounts (for a Corporation) indicate the owner's equity in the business. As the accounting equation indicates, equity is the difference between the assets of the company, and the company's debts. Equity accounts are directly affected by Revenue and Expenses, and the standard Equity accounts have Credit balances.
- **Dividends** represents equity removed from the business by the owners. In a proprietorship or partnership, each owner has an **Owner's Withdrawals** account. In a corporation, equity is removed by way of dividends, and a Withdrawal account is not needed. Since these accounts represent capital removed from the business, they have a Debit balance.

The effects of debits and credits on the types of accounts is shown on the following table:

Assets		Liabilities		Equity							
				Capital		Dividends		Revenues		Expenses	
⬆ Debit **Increases** *Normal Balance*	⬇ Credit **Decreases**	⬇ Debit **Decreases**	⬆ Credit **Increases** *Normal Balance*	⬇ Debit **Decreases**	⬆ Credit **Increases** *Normal Balance*	⬆ Debit **Increases** *Normal Balance*	⬇ Credit **Decreases**	⬇ Debit **Decreases**	⬆ Credit **Increases** *Normal Balance*	⬆ Debit **Increases** *Normal Balance*	⬇ Credit **Decreases**

2.2.4.4.1 Summary of types of account

The main axiom to remember is that:

- *Assets = liabilities + equity'*
- Debits and credits are opposite , for any one type of account.
- At the first level of the equation, on the left, debits increase, on the right, credits increase.

- Common assets accounts, that are short-term, liquid, or current, are cash in bank, accounts receivable, inventory. They are on the left.
- common non-current asset accounts include property , plant and equipment. They are on the left, however changes to their value is accumulated in contra-asset accounts, called accumulated depreciation, and hence they are contra to debit being positive, credits increase accumulated depreciation. They can be thought of as negative asset accounts on the left, paired with a non-current asset account which shows cost value, or revaluation value, in which case they are also paired with a revaluation reserve account to show the amount of revaluation (in order for the above equation to stay in balance after revaluation).
- Common current liability accounts are accounts payable, bills payable, salaries payable. They are on the right , so credit increases the liability and debit decreases.
- common non-current liability accounts include bank loans , debentures and mortgage payable, which all incur interest expense and are either repaid in full or incrementally over time with cash in bank. These are on the right too, so an initial credit establishes the long term liability, and debits coupled with cash in bank credits (decrease) account for repayment.
- Common equity accounts are divided according to the entity type: for a sole trader, it is owner capital ; for partnerships, there is a owner capital account for each partner; for companies, there is shareholder's equity, and a retained earnings account to hold accumulated profits. Equity is on the right, so credit increases *equity*.
- Other accounts arise from temporary , periodic operations, and are **temporary accounts**. They mainly deal with recording accumulated changes to equity, and are usually divided into Incomes and Expenses. *Income accounts move equity positively, so Credit increases Income accounts*. *Expenses move equity negatively*, so increase in these accounts decreases equity, ie in the same direction as Debit, so *Debits increase expense accounts*.
- Common income accounts are (operating) revenue, dividends, interest, gains.
- Common expense accounts are (operating) expenses such as Cost of Goods sold, salary expense, utilities expense (telephone, electricity), rent expense, insurance expense.
- When equity decreases, assets decrease by the same amount, or liability increases, in order to meet the equation.
- As expense accounts decrease equity, they usual decrease assets , usually as a decrease in cash in bank.
- A special type of expense is depreciation, which decreases non-cash / non-current assets, and for depreciable assets, usually there is a contra-asset account set up, called accumulated depreciation for each type of asset, to record the accumulated depreciation expense. When the accumulated depreciation equals the current assessed value of the non-cash asset, the asset can be disposed of, and *written-down* , so both the asset and accumulated depreciation are removed from the statement of accounts.
- Another special type of expense is bad debts expense, as they also do not decrease cash asset directly, but decrease accounts receivable asset. There is a contra-asset account which records bad debt expense accrued

estimation,*allowance for bad debts*, which is eventually balanced in the equation with a decrease in accounts receivable asset when bad debts are determined to have occurred, and are *written down*, and accounts receivable asset as well as the allowance have the amount determined to be bad debt *written off*. *Allowance for impairment of accounts receivables* is another name for the allowance account, and it is deducted from the accounts receivables account on the balance sheet , in order to show that the accounting equation balances in the period when the estimated bad debts expense is incurred.

2.2.5 Basic Accounting Principles

Historical Cost Principle: Assets and liabilities should be recorded at the price at which they were acquired. This is to ensure a reliable price; market values can fluctuate and be different between differing opinions, so the price of acquisition is used.

Matching Principle: Expenses should be matched with revenues. The expense is recorded in the time period it is incurred, which means the time period that the expense is used to generate revenue. This means that you can pay for an expense months before it is actually recorded, as the expense is matched to the period the revenue is made.

Revenue Recognition Principle: Revenues should not be recorded until the earnings process is almost complete and there is little uncertainty as to whether or not collection of payment will occur. This means that revenue is recorded when it is earned, which means the job is complete.

2.2.6 Financial Statements

The **Income statement** is a list of all inflows and outflows of economic benefits(revenues and expenses).

Company Name
Income Statement
For The Year Ended December 31, xxxx

Gross Revenues
-Cost of goods sold
= Gross Profit
-operating expenses
=Income from Continuing operations before taxes and special

items
+ other revenues
- other expenses
-taxes
=Income from continuing operations
+/- extraordinary items (net of tax)
NET INCOME

The **balance sheet** is a list of all a company's assets, liabilities, and owners' equity.

Company Name
Balance sheet
December 31, xxxx

ASSETS
Current Assets
+ Fixed (or non-current) Assets
=TOTAL ASSETS
LIABILITIES
Current Liabilities
+Long-Term (or non-current) Liabilities
=TOTAL LIABILITIES
OWNER'S EQUITY
Common Stock
+Retained Earnings
=TOTAL OWNERS EQUITY
=TOTAL LIABILITES AND O/E

The **statement of cash flows** is a listing of the inflows and outflows of cash.

It follows the general subdivision of business activity into trying to make money by operating activities, investing activities, and financing activities. *Operating activities* include the main business that is concentrated on, and paying taxes on this business, as well as interest for liabilities from owning non-current assets such as machinery to run the business. *Investing activities* include cash used for investment in plant and equipment or recovered from sale of plant or equipment, and money made outside of the main business activity using resources available from the business : this include investing cash available in other investments , receiving cash interest or dividends

from continuing other investment. *Financial activities* are cash activities undertaken when other entities invest in the operations of the main business. So finance activities include cash from issuing shares in the company, cash given as dividends to shareholders, cash from borrowing and cash out due to borrowing repayment.

Hence this derives a list of activities to account for cash flow:

- operating activities - cash from operations : customer receipts, and supplier payments ; cash paid for taxes; cash paid as interest for borrowings to operate plant and equipment.
- investing activities - cash out for purchase plant and equipment, and cash in from sale of these ; cash put in other investments; cash received from dividends received and from interest earned related to running other investments.
- finance activities - cash in from issuing shares, cash out from payment of dividends ; cash in from borrowing money, cash out for repayment of borrowing

A few items are reported as netted if they are sufficiently short term or liquid (such as other investments, equity shareholding changes) : e.g. "quick turnover, short maturity and large - AASB 7";, but many items are required to be reported as gross i.e. cash out and cash in for the same type of item are required to be reported separately e.g. property sale and purchase, interest paid and interest earned , borrowings and repayment of borrowings.

Company Name
Statement of Cash Flows
For The Year Ended December 31, xxxx

---

cash receipts from customers.....xx
cash payments to suppliers.....(xx)
cash payment of taxes.....(xx)
cash payment of interest on property,plant&equipment.....(xx)
Cash provided by Operating activities.....xx
cash invested in/(divesting from) other investments.....(xx)
cash used for plant and equipment.....(xx)
cash recovered from sale of plant and equipment.....xx
cash from dividend income from other investments.....xx
cash from interest from other investments.....xx
Cash Provided by investing activities.....xx
cash from issuing (buy back of) share capital.....xx
cash from long-term borrowings.....xx

cash used as repayment of long-term borrowings.....(xx)
cash paid as dividend to shareholders.....(xx)
Cash Provided by financing activities.....xx

Net cash increase (decrease) in cash held.....xx
cash held at beginning of period.....xx
cash held at end of period.....xx

2.2.7 Basic Accounting Classes Course Notes

- accounting transactions are entered as journal entries consisting of the Account name, and either a debit (left side) amount or credit (right side) amount. For each entry the debits and credits must balance, and overall on the trial balance (lists all the debits and credits for all the accounts) must always balance.
- There are 5 main classes of Accounts:
  - **Assets**: Anything of value that the business owns. This includes tangible assets such as cash, accounts receivable, inventory, buildings, and machinery, as well as intangible assets such as copyrights, trademarks, and goodwill. Asset accounts normally have a Debit (left side) balance. In transaction entries, a debit to an asset account shows an increase in its amount, while a credit (right side) indicates a decrease in the asset value.
    - Example: Buying Equipment for Cash. One asset (Equipment) increases, and therefore it is Debited. Cash, which is also an asset, is decreased with a Credit.

```
Equipment (debit)                $40,000
    Cash (credit)                            $40,000
```

- **Liabilities**: Debts and obligations that the business owes. This includes accounts payable, payroll liabilities, and long term debts (such as bonds). Liabilities accounts normally have a Credit (right side) balance. In transaction entries, a credit to a liability account signifies an increase in its amount, while a debit (left side) indicates a decrease in the liability value.
  - Example: Buying Inventory on credit. Merchandise Inventory (an asset) increases with a debit, and Accounts Payable (a liability) also increases with a credit.

```
Merchandise Inventory (debit)     $100,000
    Accounts Payable (credit)               $100,000
```

Equity: This is essentially the value that accrues (accumulates) to the owners (shareholders, sole trader…). This ranges from Partner 1's capital, Partner 1's profits, retained earnings, etc. Equity accounts normally have a Credit (right side) balance. In transaction entries in the journals, a credit to an equity account signifies an increase in its amount, while a debit (left side) indicates a decrease in the equity value. Always keep the accounting equation in mind:

```
Assets = Liabilities + Equity
```

Since Assets normally have a Debit balance and both liabilities & equity normally have a credit balance, therefore applying the equation above, we always check that the trial balance has a NET value of Zero (the total debits and credits should match).

- **Revenue**: This is the entire amount of income made through the sale of goods/ services, and is sometimes referred to as Income or Sales. Depending on the nature of the goods / services being sold, companies track this account either as one big account (e.g. Sales) or as many separate accounts (e.g. Sales Prod 1, Sales Prod 2, Freight Income etc.). Revenue accounts normally have a Credit (right side) balance, and therefore a credit to a revenue account signifies an increase in its amount, while a debit (left side) indicates a decrease in the revenue amount. A decrease of revenue would take place in circumstances such as for example sales returns and discounts (explained further down).
    - Example: Recording cash sales. Cash is debited because it is an increase in an asset account, and Sales is credited because a Revenue account is increased.

```
Cash (debit)                $112,000
Sales (credit)                          $112,000
```

- **Expenses**: These are the general costs of doing business. This would include operating expenses such as Salaries Expense, Rent Expense, and Advertising Expense, as well as non-operating expenses such as Loss on Sale of Assets. Expense accounts normally have a Debit (left side) balance. In transaction entries, a debit to an expense account signifies an increase in its amount, while a credit indicates a decrease (which rarely occurs, unless an error needs to be corrected).
    - Example: The company rents office space at $15,000 per month. Rent Expense is debited, and Cash is credited.

```
Rent Expense (debit)        $15,000
    Cash (credit)                       $15,000
```

- Some very important aspects to remember in addition to the above:
    - **Depreciation, Amortization, and Depletion** are used to allocate the cost of an asset over its useful life. Depreciation is the allocation over time of tangible assets, Amortization is the allocation over time of intangible assets and Depletion is the allocation over time of natural resources.**Accumulated depreciation** is a contra-asset account (with a normal Credit balance) used to keep a running total of the depreciation to date. The book value of any asset at any time is the Original Cost less any accumulated depreciation. Contra-asset accounts are listed in the assets section of the balance sheet

along with the corresponding asset account, making it easier to see what the assets original cost was and what it is presently valued at. Allowance for Uncollectible Accounts Receivable is also a contra-asset account with a normal credit balance which is netted against the Accounts Receivable account.
    - **Sales Returns and Allowances & Sales Discounts** are **contra-revenue accounts**, and the normal balance of this account is a Debit. These are used to offset the revenue credit balance.
    - **Cost of Goods Sold** (COGS): This account is used to track how much you paid for goods / material that was held in inventory until it was sold. COGS normally is a debit balance. This account is recorded in entries when a sale is made, and COGS is debited for the cost, while inventory is credited (asset account=>decreased) for the cost.
    - **Credit Notes/memo/refunds** are used to refund customers if they return products bought from the company. The entry for this transaction is usually :

```
    Revenue (Debit)              sale price
    Inventory (Debit)                   Cost of product
              COGS (Credit)             Cost of product
              Cash or A/R (Credit)       sale price
```

- a summary :

```
 assets ( current asset (cash in bank + accounts receivables - allowance for bad debts)  +
( non-current asset - accumulated depreciation) )
  = liability ( current liability + non-current liability )
  + equity ( capital + ( issued share equity + retained earnings )
  + change in equity ( income (revenue + gains )  - expenses ( operating + depreciation +
bad debt ) - drawings )
```

2.3 The Accounting Equation

The fundamental accounting equation, which is also known as the balance sheet equation looks like this:

Assets = Liabilities + Owner's Equity

or

Assets = Liabilities + Capital

On the left-hand-side of the equation are the resources (assets) of the business. Or more correctly, the term assets "represents" the value of the resources of the business. On the other side of the equation are claims of ownership on those assets. Liabilities are the claims of creditors (those "outside" the business). The equity, or owner's equity, is the claim of the owners of the business (those "inside" the business).

This equation is kept in balance after every business transaction. Everything falls under these three elements in a business transaction.

2.4 Double Entry

Double Entry is the principle of accounting which requires that every transaction has two effects one of which is a debit and the other of which is a credit of the same amount. What this means is that the total of the Debits must always equal the total of the Credits.

In this example we deposit 10 units of currency into our bank account.

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2005 Feb	1	Bank (Asset)		10	
		Cash (Asset)			10

Since the total of the Debits equals the total of the Credits we say the transaction is Balanced.

2.4.1 The Accounting Equation

$$A = Assets$$
$$L = Liabilities$$
$$F = Owners' \ Funds$$
$$C = Capital$$
$$D = Drawings$$
$$P = Profit$$

The Value of the business is the value of its assets less the value of its liabilities and this value belongs to the owners of the business:

$$A - L = F$$

The Owners fund must also equal the amount the owners have put into the business (Capital) less any amounts they have taken out (Drawings) plus any profit. For the time being we assume the business is profitable.

$$A - L = C - D + P$$

We add

$$D + L$$

to both sides to remove the minus signs.

$$A + D = C + P + L$$

We call items on the left hand side Debits and items on the right hand side Credits. Then:

$$Total\ Debits = Total\ Credits$$

In order that this equation holds we must also ensure that a loss is on the opposite side to a profit and therefore a loss is a debit.

Note that items of income increase profit so they are also credits, while expenses decrease profit and are therefore debits.

2.4.2 When to Debit, when to Credit?

Another look. Debit (Dr) and Credit (Cr) only refer to which side of the double entry an account/value goes to. Debit on left, and Credit on right. The **normal** of an account refers to which side it normally increases on, whether it be good or bad for the company.

The D.E.A.D. C.O.I.L. Mnemonic

- Debit side
  - Expenses
  - Assets
  - Drawing (of Equity)
- Credit side
  - Owner's Equity
  - Income
  - Liabilities

Another-nother look.

Debit/Credit-ishness of an account comes from the elements of the accounting equation, Owner's Equity=Assets - Liabilities, and lots of flipping.

Start by looking at the Dr. side.

1. If your account is an Equity term, flip it.
   - Equity terms are Capital, Drawing, Income, Expenses. These are the financial borders of the business.
2. If it's a Liability, flip it.
   - Liabilities are negative (well, it's good to have access to resources now, but they still are a hole that demands filling). Remember, if somebody prepaid you for a something you haven't fulfilled, that's a liability too!
3. If is an "evil parallel universe" (https://en.wikipedia.org/wiki/Mirror,_Mirror_%28Star_Trek:_The_Original_Series%29) form of an Asset, Liability,or Equity, then flip it (again, if need be).

    - Expenses are equity accounts, in a negative way. Drawing is a negative overlay to Capital, and gets flipped here, too. Depreciation (an overlayed contra-asset), flips as well.
4. You now know the **normal** of the account. One last flip if the account needs to be reduced.

Within all of this flipping, Debit/Credit has two meanings, whether a term is negative to the company's finances, and whether it is external to the company. By demanding each entry set to balance, the journal tracks motions of money (or widgets, labor..) in the company. Changes of value are expressed as a motion into yet another account, such as moving part of the "Merchandise" Asset (as Cr) into the "Damaged Goods" Expense (as Dr).

As a mnemonic device for students: Note that only Assets and Expenses show an Increase for Debits and Decrease for Credits. All other accounts are the reverse. First memorize the acronyms AID (Assets Increase Decrease) & EID (Expenses Increase Decrease)and then keep in mind that the table reads Debits on the left and Credits on the right.

Debit/credit

Account	Debit	Credit	Account Debit Credit
Assets	Inc.	Dec.	A I D
Expenses	Inc.	Dec.	E I D
Liabilities	Dec.	Inc.	
Shareholder Equity	Dec.	Inc.	
Revenue	Dec.	Inc.	

2.5 Debtors

Debtors are people who have taken your stuff but have not paid for it yet. Debtors are people who "owe" you. So debtors are assets. When somebody buys something from you on credit they become your Debtor.

In this example we will sell some things to Bob on credit:

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2005 Feb	1	Debtors – Bob (Asset)		10	
		Sales (Income)			10

Later WHEN Bob pays us.

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2006 Feb	1	Cash (Asset)		10	
		Debtors – Bob (Asset)			10

Note that when a bank sends you a bank statement, they show you the position from the bank's point of view, not yours. So when you have a debit position, you owe the bank money - the balance is an asset of the bank. When you are in credit, the bank owes you money

2.6 Creditors

Creditors are people that you owe money to. So if Example Company Ltd bought a motor car on credit, the accounting entries would be as follows:

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2006 Feb	1	Motor vehicle (Asset)		10,000	
		Creditors (Liability)			10,000

Later we make a payment

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2006 Feb	1	Creditors (Liability)		100	
		Cash (Asset)			100

Whew! Those repayments are going to take some time...

As we saw when we discussed with debtors, when you receive a bank statement the bank shows you the position from the bank's point of view. When you are in credit, you have the asset and you are a creditor of the bank - the account is a liability account for the bank, as it owes you money , if and when you can withdraw all your money. When you are in debit, you are a debtor to the bank, and the bank is your creditor, and your account with the bank is an accounts receivable or asset to the bank.

2.7 Prepayments

Prepayments, also called deferrals, result from cash payment proceeds an expense or revenue recognition. The most common example of a prepaid expense is unearned revenue.

Often, businesses pay for services from which they have not yet benefited e.g. rent is often paid in advance.

The double entry for a prepayment is:

Date		Description	Post Ref.	Dr	Cr
2005 Feb	1	Prepaid Rent (Asset)		50	
		Cash (Asset)			50

Fig. 2.3: Journal - Page 1

Later when the rent is actually due the entry is:

Date		Description	Post Ref.	Dr	Cr
2005 Mar	1	Rent (Expense)		50	
		Prepaid Rent (Asset)			50

Fig. 2.4: Journal - Page 1

2.8 Accruals

An accrual is the effect of receiving goods or services before cash payment. This will most often result in a liability on the company's books, usually as a payable. Another type of accrual results from recognizing revenues before payment. Note this does not include unearned revenue, which is a deferral.

Sometimes a business uses a service (e.g. electricity) which it has not yet been invoiced for. The double entry for this is:

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2005 Feb	28	Electricity (Expense)		130	
		Unpaid electricity (Liability)			130

Later when this bill gets paid

Journal - Page 1

Date		Description	Post Ref.	Dr	Cr
2005 Mar	12	Unpaid electricity (Liability)		130	
		Cash (Asset)			130

It is possible for an accrual to be made for telephone call charges in the period while the line rental (paid in advance) is a prepayment.

2.9 Depreciation

Depreciation relates to an entity's change in fair market value and how the fluctuation in value is processed as a tax-deductible expense.

2.9.1 Property, plant, and equipment

IFRS system definition:

According to paragraph 6 of IAS 16: Prpety plant and equipment are tangible items that:

1. are held **for use in the production or supply of goods or services, for rental to others, or for administrative purposes**; and
2. are expected to be used during **more than one period**.

Associate cost

paragraph 17

Inclusion:

Exclusion:

Allocation the cost based on fair values, for example. A acquire furniture and buildings for 15000 and 90000, while the total cost are 90000 in actual. Allocate to each asset

furniture 15000/105000*90000

land 90000/105000*90000

2.9.1.1 The cost model

tge depreciaiton methods : straight-line

2.9.2 Depreciation

Depreciation occurs over a period of useful economic life, in which the property, plant or equipment is used to generate income for the business.

Several methods can be used to calculate the depreciable cost of an asset over its life, the most commonly used are:

- Straight-line method
- Reducing balance method

2.9.2.1 Straight-line Method

The Straight-line Method reduces the Net-Book value of an asset by the same amount each period. This amount is determined by dividing the total value of said asset by some number of periods, then subtracted from the balance at the end of each period.

For example,if you purchased a sewing machine for $12,000 and you wrote it off over 12 months using the Straight-line method, you would divide the original cost ($12,000) by the term of useful life (12 months). In this case, $12,000 / 12 months = $1,000/month. To apply depreciation on this item, you would deduct $1,000 at the end of the first month to leave a balance of $11,000. The second month you would deduct another $1,000 leaving a balance of $10,000. At the end of the 12th month, you would deduct the last $1,000 from the previous (11th months) balance of $1,000, leaving you with a balance of $0.

At this point you would say that you have *written off* the sewing machine. In practice, things get a little more complicated. In this example it would not be fair to assume that at the end of the 12th month the machine would suddenly stop working, or be absolutely worthless, though for tax purposes it is considered to have zero basis. It is possible you could still sell the completely written off sewing machine for $1,000, causing you to recognize a $1,000 taxable gain.

The economic reasoning behind the Straight-line method is, essentially, the acceptance that depreciation is an approximation of the rate at which an asset transfers value to the Operations of a business by participating productively in it, and so we should use the most economical one (regarding computational effort) to calculate and record it in the accounting books. There are certain *Intangible Assets* for which the Straight-Line method can be considered the relatively more accurate one.

But for most *Tangible Assets* there is good argument that the Declining Balance method is more suitable (see below). Nevertheless, the simplicity of the Straight-line method had made it the prevailing one, accepted by economists, accountants, analysts, businesses, and even state authorities (for tax purposes).

2.9.2.2 Declining (or Reducing) Balance Method

The Net-Book value of an asset is reduced by the same proportion each period. That is, at the end of every period you reduce the value by a fixed percentage. Each period uses the previous period's balance to work out the amount.

For example, we purchase a motor-vehicle for $10,000 and we depreciate it by 10% per month. At the end of the first month we take $10,000 * 10% = $1,000, making the balance $9,000. At the end of the second month, we take the **balance** from the previous month and apply the 10% factor: $9,000 * 10% = $900. Note the change in depreciation: in the first month the expense was $1,000, but in this month it is $900. At the end of this second month, you subtract the new depreciation amount, resulting in $9,000 - $900 = $8,100. The depreciation for the third month, then, is $8,100 * 10% = $810; the remaining value at the end of the third month is $8,100 - $810 = $7,290. At the end of 12 months the balance would be $3138.11.

The economic reasoning behind the Declining Balance Method of Depreciation is that any asset (think of machinery to stay focused), no matter how carefully serviced by its user, is most productive during the earlier periods of its productive use. Mathematically, the same depreciation rate will extinguish the value of an asset much more quickly under The Straight Line Method than under the Declining Balance Method. In the above example, a $10,000 value with a 10% monthly depreciation rate will be extinguished after 10 months of calculating and recording depreciation by the Straight Line method. But it will take ~22 months to extinguish 9/10 of the value under depreciation using the Declining Balance Method on the same value and with the same depreciation rate. So caution should be exercised when choosing the Declining Balance Method.

2.9.2.3 The "Useful Life" approach

Since Accounting Depreciation attempts to capture a real economic phenomenon, it must be based on economic reasoning. It is not a mechanical procedure or an arithmetic exercise. The prevailing concern when determining depreciation methodology should not be to "guess" the correct depreciation rate, but to estimate reasonably the useful life of the asset under depreciation in time-units, and then calculate the corresponding depreciation rate that will result in extinguishing the value of the asset from the books when the estimated useful life ends too, given the Depreciation method chosen.

In the Straight-Line method, the mapping of Useful Life to Depreciation Rate is easy. If "x" is the estimated useful life, say in years, then the Yearly Depreciation Rate "d" is d = 1/x. For example, if you expect that the company will use a vehicle for 10 years, then the Yearly Depreciation Rate for this vehicle is 1/10 = 0,1 = 10%, under the Straight-line method.

In the Declining Balance Method, things are trickier. First we must note that from a mathematical point of view, the value of the asset is never fully extinguished under the Declining Balance method, but it approaches arbitrarily close to zero. In practice, companies that use the Declining Balance Method, decide on a "materiality threshold" for the non-depreciated (residual) value of the asset, usually up to 10% of its initial purchase value. Essentially then, they calculate the depreciation rate which, under the Declining Balance method, will extinguish the largest part of the Value of the asset (i.e. 90% or 95%) at the end of its economic useful life. When they reach that point in time, they depreciate what's left in the next accounting period.

Now, the Declining Balance method is expressed as a Difference Equation. Denote "d" the depreciation rate, "r" the remaining value at the end of the estimated useful life, as a percentage of initial purchase value (=> 0 < r < 1) and V(t) the nondepreciated value of the asset at the end of period t. Denote also "n" the useful life of the asset, say in years. Then you have

$$V(t) = (1-d)*V(t-1) \quad \text{subject to} \quad V(n) = r*V(0) \text{ where } V(0) \text{ is the purchase value of the asset.}$$

Going backwards in the Difference equation and writing for period "n" you get

$$V(n) = (1-d)^n * V(0) \quad \text{together with} \quad V(n) = r*V(0)$$

Solving together the two equations you get

$$(1-d)^n = r$$

So we see that by estimating the useful life of the asset (the "n"), and given that we have chosen a residual value (the "r", as a percentage of the initial purchase value of the asset), we can uniquely determine the required depreciation rate "d" to use in our depreciation calculations so that our accounting books reflect, at least approximately, what happens in actual economic activity.

2.9.2.4 Review Questions

Volume 1 - Chapter 27

1. A firm buys equipment on 1 July 20X3 for £6,500. The equipment is to be depreciated on a monthly basis at 20% on cost. On 31 December 20X5 the equipment is sold for £2,700 cash.

(a) Show the provision for depreciation on equipment account for 20X3, 20X4 and 20X5. (b) Show the equipment disposal account as at 31 December 20X5

2. A company depreciates its machinery at the rate of 10% per annum using the reducing balance method. A machine is sold on 30 June 20X7 for £900 which had originally been purchased for £5,000 on 1 January 20X4. No depreciation is to be provided for in the year of sale.

(a) Show the provision for depreciation on machinery account for 20X4 to 20X7. (b) Show the asset disposal account to record the sale of the machinery (c) Show the entry in the profit and loss account for 20X7.

3. A firm sells equipment which had cost £15,000 for cash proceeds of £3,200. At the date of the sale, the balance on the account for depreciation for this equipment stood at £9,700.

Construct the asset disposal account for the equipment sold.

4. A firm purchases machinery on 1 January 20X5. The machinery cost £12,000 and is to be depreciated using the reducing balance method – using a rate of 25%.

Show the depreciation account for the first three years of the asset's life

2.9.2.5 Typical Policies

Type of Asset	Policy
Motor Vehicles	Reducing Balance 25%
Leasehold Property	Straight-line over the length of the lease
Freehold land	Never depreciated. Only fixtures on land can be depreciated as land never loses its "useful life"
Fixtures and Fittings	Reducing Balance 15%
Computer Equipment	Straight-line 3 years or companies may expense it when purchased

2.9.2.6 Answers to Review Questions

Volume 1 - Chapter 27

1. (a) Provision for depreciation on equipment 20X3 £ 20X3 £ Dec 31 Balance c/d 650 Dec 31 Profit & Loss 650

20X4 20X4 Dec 31 Balance c/d 1,950 Jan 1 Balance b/d 650

```
Dec 31 Profit & Loss 1,300
1,950 1,950
```

20X5 20X5 Dec 31 Equipment disposal 3,250 Jan 1 Balance b/d 1,950

```
Dec 31 Profit & Loss 1,300
3,250 3,250
```

1. (b) Equipment Disposal 20X5 £ 20X5 £ Dec 31 Equipment at cost 6,500 Dec 31 Provision for depreciation 3,250

```
Dec 31 Cash 2,700
Dec 31 Profit & Loss 550
6,500 6,500
```

2. (a) Provision for depreciation on machinery 20X4 £ 20X4 £ Dec 31 Balance c/d 500 Dec 31 Profit & Loss 500

20X5 20X5 Dec 31 Balance c/d 950 Jan 1 Balance b/d 500

```
Dec 31 Profit & Loss 450
950 950
```

20X6 20X6 Dec 31 Balance c/d 1,355 Jan 1 Balance b/d 950

```
Dec 31 Profit & Loss 405
3,250 3,250
```

20X7 20X7 Jun 30 Machinery disposal 1,355 Jan 1 Balance b/d 1,355

```
1,355 1,355
```

2. (b) Machinery Disposal 20X7 £ 20X7 £ Jun 30 Equipment at cost 5,000 Jun 30 Provision for depreciation 1,355

```
Jun 30 Bank 900
Dec 31 Profit & Loss 2,745
5,000 5,000
```

3. Equipment disposal account

```
£ £
```

Equipment at cost 15,000 Depreciation 9,700

```
Cash 3,200
Profit and loss 2,100
15,000 15,000
```

4. Provision for depreciation – Machinery 20X5 £ 20X5 £ Dec 31 Balance c/d 3,000 Dec 31 Profit & Loss 3,000

20X6 20X6 Dec 31 Balance c/d 5,225 Jan 1 Balance b/d 3,000

```
Dec 31 Profit & Loss 2,225
5,225 5,225
```

20X7 20X7 Dec 31 Balance c/d 6,919 Jan 1 Balance b/d 5,225

```
Dec 31 Profit & Loss 1,694
6,919 6,919
```

Chapter 3 Proposed additional sections

3.1 Accounting Standards

3.1.1 What are Accounting Standards?

Definitive benchmarks prescribed by a country's Accounting Standards Board (as in the UK), or Financial Accounting Standards Board (as in the US) for reporting of accounting data in financial statements. These rules must be applied to all financial statements in order to provide a true and fair view of the firm's financial position, and a standardized method of comparison with financial statements of the other firms.

3.1.2 Who sets Accounting Standards?

There are many different accounting standards in use in the world, ranging from full-accrual based accounting standards to cash- and tax-basis accounting standards. Each are known as Generally Accepted Accountancy Principles, or GAAP. Some significant GAAPs are as follows:

- IFRS - International Financial Reporting Standards - used for European Union listed entities, many other EU entities, Australian companies and others.
- US GAAP - used by US companies.
- UK GAAP - used by UK and Irish companies that have not adopted IFRS.
- Canadian PE GAAP - private enterprises in Canada have the option to use either IFRS or PE GAAP. Canadian public companies must use IFRS.
- Indian GAAP - used by Indian companies.

In commercial and non-profit accounting in the United State of America, the standard setter is the Financial Accounting Standards Board (http://www.fasb.org/home). For governmental accounting, GAAP is determined by the Governmental Accounting Standards Board (http://www.gasb.org/). Both of these entities are sections of the Financial Accounting Foundation (http://www.fasb.org/faf/).

The use of GAAP for publicly held business entities in the United States is mandated by the Securities and Exchange Commission (http://www.sec.gov/), a federal agency. Other business entities may find that other accounting standards may meet the needs of the users and therefore not adopt GAAP due to the extra costs required.

Accounting Standards in India are developed by Accounting Standards Board and these are issued by The Institute of Chartered Accountants of India Click here to view all Accounting Standards Issued by ICAI (http://icai.org/icairoot/resources/as_index.jsp)

In Bangladesh, The Institute of Chartered Accountants of Bangladesh adopt compatible IAS and followed them by the company as per Companies Act 1994.

There is currently a movement around the world to harmonise all accounting standards into one set of IFRSs. This is on ongoing project, primarily being undertaken by the International Accounting Standards Board (http://www.ifrs.org/Pages/default.aspx). This project is being coordinated with the standard setting bodies in the United States.

3.1.3 Compliance with Accounting Standards

IAS 1 is a base document of the IASB defining the contents of the general financial reporting statements (statement of financial position , statement of comprehensive income, statement of changes in equity, Notes ; cashflow statments have their own standard, IAS 7) . Paragraph 20 of IAS 1 allows non-compliance with standards when a fairer view can be achieved, but it must be disclosed how the non-compliance is fairer. Some countries, for example Australia, who attempt to harmonise with IASB, AASB 101 being the australian counterpart of IAS 1, forbids departure from the standards in all instances, due to Australia's incorporation of AASB financial reporting standards compliance in its Corporation Law , ostensibly to regulate corporation behaviour towards economically dependent shareholders. In the AASB 101, disclosure of how non-compliance will achieve a fairer view in the Notes is prescribed, rather than allowing statements to be non-compliant to achieve a fairer view, as in IAS 1.

3.2 Assets

An asset is an economic resource owned and controlled by an entity as a result of past events. and from which future economic benefits are expected to flow in the enterprise.

An asset can classified as: a. Current or non-current (see the definition below) b. Tangible or intangible (whether or not the asset has a physical existence).

The distinction between current and non-current assets is usually required in the presentation of the assets in the balance sheet.

Evidence of the existence of an asset is that an entity is exposed to the risks, as well as the rewards of ownership.

Importantly, the definition does not take into account legal ownership, but instead reflects substance. For example an asset leased under a contract which confers the

significant risks and rewards on the lessee, is capitalized by the lessee despite the fact that legal ownership resides with the lessor.

Assets can be disclosed as current or non-current. A current asset is an asset that forms part of the operating cycle of an entity e.g. inventory (stock) or trade receivables (trade debtors). Alternatively, a current asset is an item which is not a component of operating activity, but which has a maturity of less than 12 months. Cash and cash equivalents are always classed as current assets.

Non-current assets are assets that do not fall under the category of current assets.

3.3 Non-current assets

Non-current assets are assets held for longer term, usually because they are one of the classes property, plant or equipment. They are usually initially bought as investments and either are essential for operations of a business or increase the profitability of the business.

One framework to look at non-current assets is in terms of life cycle stages : acquiring , holding, disposal.

3.3.1 Fair value

The value that can be achieved in an arm's length transaction, after sales costs , or cost of disposal.

3.3.2 Carrying value

The value as recorded as the asset's debit amount, less the accumulated depreciation.

3.3.3 recoverable value

Usually the same as the fair value but can be value in use, if it is higher.

3.3.4 value in use

This may involve a lot of forecasting . For the intended time the asset is held, an estimate is made of the future cash flow generated in, and the future cash flow costs out, extrapolated back according to low-risk interest rates to present value (the future cash flows would have estimates of inflation and budgeted price increase though). This quantification of future economic benefit is added to the net cash flow from budgeted disposal.

3.3.5 Value relationships

- The target value is the lower of x and y where y is the higher of a and b, where x = current carrying value , y = recoverable value, a = fair value less disposal costs, and b = value in use less disposal costs.
- The aim is not to overstate the value, without secondarily understating it.

3.3.6 Acquiring, holding , disposal

These are the stages that costs may need to be recalculated.

3.3.7 Acquiring

- a non-current asset is valued as the fair value of the assets given up in exchange for acquiring the non-current asset.

Issues dealing with acquisitions are:

- when to capitalize or expend, if acquiring an asset that requires repairs, modifications to bring it up as fit for use to generate future economic benefit. Some "enhancements" may be better written down as expenses if they can't be justified as major repairs or modifications , that for instance, undergo depreciation later.
- fair value proportioning of non - whole business multiple package acquisitions. This means if one historical cost is applied to acquire a group of assets, each asset needs to be assessed for fair value, and the total of fair values found to be the denominator for each fair value to act as numerator to find the proportionate initial booked cost of each asset. This is because of the value if asset given up rule, meaning the total of book values must equal the value of asset given up (cash even), in the non-business combination case.

- goodwill (intangible asset) or bargain (gain income) can be recorded for *whole businesses* acquired at cost different to fair value, as the **business combination** of your entity and the acquired entity means the acquired entity's assets are booked at fair value under the subsidiary entity.
- current assets acquired under the above two cases are recorded at fair value (and aren't included in apportioning in non business combination case), unless it is a debtor account (accounts receivable), then the difference between book value and fair value can recorded as a credit to bad debt allocation if fair value is lower.

Other points to consider:

- liabilities can be acquired, like accounts payable, and a are similarly credits to the entities accounts payable liability , like acquired bad debt allocations.
- shares are liquid assets which have a fair value when disposed of, and can be exchanged at fair value for acquisition of non-current assets.

3.3.8 goodwill

Goodwill applies to business combinations, where the asset being bought is a whole business and not the assets of a business.

Goodwill is recorded separately as a form of intangible asset on acquisition , and impairment expenses can be recorded against it (see impairment of non-current assets). Goodwill cannot be onsold, but another entity can purchase the subsidiary business with a new agreed amount of goodwill.

Sometimes, the acquirer or buyer pays less than the fair value of the assets making up the acquired business, so the opposite of goodwill is a **bargain**, which is classed as an *other income* or **gain** (not arising from normal operations, and hence not *profit*), and equals the total fair value of the acquired business's assets , less the bargain amount paid to acquire it, as agreed to by the acquiree (the former owner).

3.3.9 held assets - depreciation

There are several methods of depreciation available. The most easily understandable are straight line depreciation , and unit of use depreciation. They all share in common a target residual value in order to give depreciable amount, and the concept of useful life. Useful life can be thought of simply as time e.g. years, but in units of use depreciation, it can be number of units produced, number of operating hours, tons of raw material processed , etc. Another kind of depreciation is diminishing balance, where there is logarithmic rate of depreciation, e.g. a fixed % of the remaining balance of asset value after subtracting accumulated depreciation is determined to be the current period's rate of depreciation. This might be applied to an asset that exhibits greater ability for producing economic benefit when newer and more efficient.

If beginning with the concepts of useful life and residual value, the diminishing balance method can be easily expressed with the years-remaining-over-sum-of-years method, where the ordinal values of each year in the useful life is summed to give the denominator (e.g. 3 years useful life, 1 + 2 + 3 = 6), and the years remaining of life is the numerator, of the rate of depreciation for a given year (e.g. year 1 is 3/6, year 2 is 2/6, year 3 is 1/6). (The rate of depreciation is applied to the initial cost of the asset, not the cost less accumulated depreciation).

When analysing income statements to determine **cash** flow, *depreciation is a non-cash expense* and should be added back in as it doesn't contribute to outflow of cash like other expenses do eventually.

3.3.10 held assets - impairment testing and revaluation model

- If there is an indicator that the book value of an asset is greater than the recoverable value, than assessment of the recoverable value is made, and if the suspicion is correct, then the asset has an impairment loss expense and accumulated impairment loss contra-asset recorded. The accumulated depreciation can be renamed *accumulated depreciation and impairment loss* in order to summarise negative changes to asset value.
- assets held at historical acquisition cost are following the cost model until a revaluation is made, and then they are in the revaluation model, and a revaluation surplus equity account is created for the asset (assuming the asset is going to be re-valued higher). The asset is debited for the surplus and the revaluation surplus equity account is credited for the surplus. Any accumulated depreciation should be **written-back** to the asset, just as in disposal, to come to the new re-valued asset value, with zero accumulated depreciation.

For downwards re-valuation, it is similiar to asset impairment, except the expense of the lost amount from re-valuation is not recorded against *accumulated depreciation and impairment loss* contra-account, but against the asset, since previous accumulated depreciation and impairment loss will be written back in the process of revaluation.

- A downgrade from either impairment testing or revaluation should be credited to revaluation surplus until it reaches zero. Then revert to either crediting the asset account if doing revaluation, or crediting the impairment loss contra account (sometimes combined with accumulated depreciation contra-account) if doing impairment assessment.
- depreciation and impairment losses still apply as usual, in the revaluation model, after revaluation has been made.

3.3.11 held assets - minor repairs are expensed, whereas major repairs are capitalised

When a major repair is performed , this can be added to the asset , along with accumulated depreciation, in order to come up with a new asset value. Otherwise minor repairs are expensed against accounts payable or cash, but disposal expense of remaining depreciation value of old parts for major repairs are expensed against the asset (expensed against means act as credit side of double entry to a debit expense).

3.3.12 Disposal

A pre-step in disposal is to always check the date of disposal and calculate any unrecorded depreciation upto the date of disposal, and make a debit to depreciation expense against a credit to accumulated depreciation , to update accumulated depreciation, prior to making the recordings for disposal.

The former heuristic was to record disposals at book value (carrying amount) as a kind of disposal expense debit, along with a zeroing debit to accumulated depreciation (contra-asset), against a credit for the acquisition or revalued cost of the asset (the historical cost as recorded not including accumulated depreciation). A separate transaction was a credit of the purchase price to a special income account credit "proceeds from sale" , against a debit to cash in bank ,or in the case of exchange, against a debit to the new non-current asset account of the asset being acquired.

The new net method is to record the difference between the carrying amount and the sale price as a gain or loss, and any loss on scrapping of assets with residual value or loss on scrapping from removal costs as a net loss. The net gain or loss is then reported in the income statement, which previously could only be shown if a separate entries of disposal expense (residual value and disposal costs) and proceeds from sale were two items shown in the income statement regarding the assets disposal. This net method of asset disposal disclosure loses the disclosure of the residual value of the asset at disposal in the income statement.

- If the proceeds from sale is less than the book value, then the loss will be shown in the income statement when profit = income minus expenses. Gain is similar.
- if the proceeds from sale is less than the fair value, but the fair value is greater than the book value, then the above still applies. But if proceeds from sale < fair value < book value, there may be an argument to do some fancy book work and record the impairment in asset value , e.g. as a impairment loss expense debit, and a accumulated impairment loss credit (viewing impairment as a depreciation-like contra-asset account). Some authorities suggest renaming accumulated depreciation to accumulated depreciation and impairment loss.

- The other cases are book value < proceeds from sale < fair value, and book value < fair value < proceeds from sale. In the latter case, no one is worried who has put money in the company because a gain was made, but in the first a loss was made, despite the books showing a gain. Ideally , the book value should be revalued to fair value, the revaluation surplus recorded, and the book value adjusted before the sale. Then the loss would be shown in the income statement.

3.4 Liabilities

A liability is an obligation to transfer economic benefit as a result of past events.

Importantly, this definition does not take into account the legal position. It reflects the substance of the arrangement rather than the legal form.

Current liabilities represent liabilities that form part of the operating cycle e,g trade payables (trade creditors), or if not part of the operating cycle have a maturity of less than 12 months.

3.4.1 accounting for employee liabilities

- Some employee liabilities are deductions from gross pay, and can be recorded to offset the salary payable liability (they reduce the salary payable by accumulating other liabilities payable) , against a total periodic (fortnightly/ monthly) salary expense.

```
                        DR   CR
salary expense          A
salary payable               B
superannuation               C
worker's comp insurance      D
employee's tax payable       E

A = B + C + D + E
```

Common liabilities that fall in this category are the non-expiring ones like superannuation, worker's accident/disability insurance, and pay-as-you-go taxation. Worker's insurance and taxation can be accumulated for lump-sum annual payment.

- Sick leave can be seen as provision type of liability, where an estimate is made based on historical sick leave about amount of total sick leave will be taken in the coming year, and expensed against a provision for sick leave. Since sick leave

doesn't accrue from year to year, unused sick leave provision can reduce the next period's sick leave expense (similar to ageing of accounts receivable bad debts provision).

3.4.2 Definition in concept context

With respect to the central equation:

- Assets = Liability + Equity

Liability and Asset share similar adjectives of past , present, and future in their definitions:

- Arising out of defined **past** events
- A **present** obligation (liability) / right (asset)
- for the **future** outflow (liability) / in flow (asset) of resources (being the concrete form of abstract economic benefit)

(Equity is defined as *assets less liabilities*).

And they both have the same recognition criteria : probable , and measurable.

These definitions may be changed soon, to emphasise concepts such as "presently enforceable" , "present right of control over resources(asset)/obligation of economic burden(liability)", by some accounting bodies.

3.4.3 Exercises

1. define asset, liability , and equity, in the framework of 3 sentences about past, present and future , using the words *resource*, *economic benefit*, *right* and *obligation*
2. Discuss the meaning : "the future economic benefit has to be both probable and measurable in order for either an asset or liability to be recognized"..

3.4.4 The role of probable in defining provisions and contingent liabilities

Probable is more than 50% likely to occur because there was a past obligating event. The past obligating event defines a future payment event which is

1. on a specific date
2. on demand from the obligating party
3. linked to another obligating event by specific agreement

A contingent liability suffers from recognition criteria failure, it can't be reliably measured, or isn't probable.

Contingent liabilities become provisions , which are recognised liabilities on financial statements, when they become probable and can be reliably estimated (measured).

A reliable estimate of economic burden serves as measurability for provisions: e.g. product warranty provision: if minor repairs cost 5% of the total cost and an estimated 5% of products may require minor repairs within 2 years of sale, and major repairs cost 20% and 1% of products may require major repairs in 2 years, then a provision is made for 5% x 5% + 20 % x 1% of budgeted total sales (0.25% + 0.2% = a 0.45% of sales amount set aside as credit to warranty provision liability account , and the warranty expense of 0.45% recorded at the start of the same period as the expected sales . On a warranty being claimed, cash in bank is credited and warranty provision debited to settle this instance of liability with economic outflow).

3.4.5 Assessing financing as buyer or seller using financial ratios

The ratios concerned are classed as liquidity ratios and stability ratios.

3.4.6 liquidity ratios

- the quick ratio - this is current assets except inventory and prepaid assets over current liabilities.
- If inventory and prepaid assets are included, then it is the current ratio.
- quick ratio should be > 0.9 .

3.4.7 stability ratios

- assets = liabilities + equity . Equity / assets = (assets - liability) / assets = 1 - liability / assets.
- equity / assets = equity ratio.
- liability / assets = debt ratio. < 0.6 ok.
- from above, equity ratio = 1 - liability ratio
- 1/ equity ratio = assets / equity = capitalisation ratio. < 2.5 ok. (1/2.5 = 2/5 = 0.4 = acceptable equity ratio threshold).

3.4.8 How to use

1. If more than one years balance sheet is available, a company being considered for investment can be assessed by calculating the liquidity and stability ratios (or quick ratio and capitalisation ratio, to be concrete).
2. the calculation is *(current assets total - inventory - pre-paids) divided by current liabilities* for each year's balance sheet.
3. If the quick ratio is going down and is significantly less than 1, then liquidity might be a future problem and the company might collapse. *A quick ratio less than 1 means that if all the current liabilities are demanded, even by collecting all the current receivables and handing over all cash equivalent assets, there will still be remaining current liability*.

- If the capitalisation ratio is > 2.5, then

```
assets / equity > 2.5,
(liability + equity) / equity > 2.5
liability/equity + 1 > 2.5,
```

liability/equity > 1.5

- try to work out if near current liabilities have been hidden in non-current liabilities, or that contingencies exist that would turn non-current liabilities into current liabilities.

3.4.9 Accounting like considerations for taking on liability to increase finance

If assets = liability + equity, and if (big if) more assets can be employed to efficiently increase income, then:

- increase liability - take on long term borrowings (non-current liabilities), which will have periodic interest expense as well as principal repayment at a fixed long-term date.
- increase equity - issue shares in the company, dilute control possibly, with the promise of retaining less profits through dividend payments (public drawings) periodically.
- the risk of increase liability is risk of failure to pay the principal and insolvency. Can liquidity ratios predict this ?
- the risk of issuing equity as shares is the loss of control of the company, with fewer retained profits due to dividend obligations, a drop in market value due to

perceived dilution of share value, more mouths to feed and hence decreased EPS (earnings-per-share) for a given profit.

3.4.10 an example concrete problem statement

From the borrowing viewpoint, if a high probable profit is thought to be likely by increasing assets held through financing, then whether it is better to finance by issuing shares, or by increasing long term borrowings. In the first, the downside is dilution of control and dilution of earnings per share, and in the latter, the downside is increased defaulting risk, decreased liquidity ratios.

- given A= assets, L = liabilities , P = gross profit before tax of 't'% and additional interest, S the current issued shares, if an increase in assets 'a' results in a increase in gross profits 'p' ,is it better to increase by 'a' by issuing 's' shares at 'a'/'s' per share, or borrowing 'a' at an annual interest rate of 'i'% , where an annual interest of 'i' % times 'a' will be incurred ?
    - in the first , net profit after tax is P + p * (100 - t) % , giving an earnings per share of (P + p * (100 - t)/100) / (S + s) , and a debt ratio of L / (A + a)
    - in the second, net profit after tax and interest is (P + p (100 - i) / 100) * (100 - t) / 100 , giving an EPS of (P + p (1 - i/100) * (1-t/100) / S , and a debt ratio of (L + a) / (A + a)

Rough steps in financing:

1. budget and forecast increase profit and increase in assets required. May require lots of management accounting.
2. Model results of increasing liability , increasing equity or a combination of both, in order to increase assets.
3. analyse consequences of possible different actions.
4. choose, lead action
5. review results and learn

3.4.11 Examples

When trying to avoid liability, a company may issue a 1 for x renounceable share issue, and sweeten the decline in EPS for shareholders by offering a discount in market value of the diluting share offerings. This of course brings the market share value down. This really annoys professional brokers as well, because they have to back pedal their BUY recommendation and qualify that growth prospects will suffer a short-term earnings downgrade.

In contrast: Before the recent GFC, many companies were being financed with large borrowings , because earnings were good and banks were happy that companies were keeping up with interest payments as well as growing money on trees to meet the principal payment. No one really wanted earnings-per-share to go down by asking

shareholders to pay for growth. But with the onset of stifled cash-flow , it was found that fair value should have been applied to some fake cash equivalents, like sub-prime backed bonds, so the numerator of the quick ratio suddenly dropped for many companies, and financial entities had to sell their investments: non-current liability flicked the contingency switch and became current, increasing the denominator of the quick ratio. The quick ratio went from comfortably above one, to a lot less than one. Growing by debt became corporate criminality in some instances. Debt restructuring can occur, but if this involves the permanent devaluation of investors interests e.g. share revaluation, where secured major investors such as banks are prioritized over unsecured shareholders ('the punters') , then either the smaller shareholders have to bear major losses so the major investors will continue lending because their interests are secured, or the major finance investors refuse to continue lending, because they cannot obtain their required degree of security, and the company cannot obtain money to pay current liabilities when they fall due, and the company becomes insolvent.

3.5 Cash

- Money
- Prompt payment for goods or services in currency or by check

Cash is necessary for finalization of business transactions.

- With respect to special journals, and specialized ledgers, or prime books of accounting, cash control forms one of the main motivating factors for the system of use.
  - Separating bookkeeping from cash handling as a form of internal fraud control. Similarly, job rotation and enforced holidays and limited overtime help to prevent cooking of books.
  - centralising payment and receipts of cash for better tracking and easier bank reconciliation.
  - documents that support bookentries, such as invoices and receipts issued, can be numbered , so that any lost numbers in a series can be accounted for , without relying on just the bookkeeping
- cash budgetting is like a concession that despite accrual accounting making the tracking of credit sales and purchases easier, it is still necessary to minimise the risk of a cash flow problem by trying to predict how much cash is being used or received for a given period . Estimation are often made in terms of percentages of a period income or expense arriving in subsequent periods, and with income, a percentage of eventual bad debt (with expense, there is usually no deliberate planning of jibbing creditors). After adding the different stages of cash collection for a given period (e.g. a month), a projection can be made as to what the cash balance may be, or what remains to be collected in trade debtors balance, and a plan for cash outflows can be made (e.g. how much to pay the creditors for each period). Financing cash flow , with interest, principal repayments, and projected

borrowing needs, can also be factored out period by period. Cash budgetting falls partly in management accounting.

3.5.1 cash at bank reconciliation

This serves as a confirmation that what is written down as the current balance at cash in bank account can be eventually accounted for by what is being recorded through the bank statement, as the bank statement is an arm's length record of cash transactions. The aim is to have everything recorded in both the books and the bank statements, and recorded correctly.

- items that appear both in the bank statement and the cash receipts or cash payment journal are likely to be correct , and the item in the bank statement and the relevant journal can be marked off.
- this leaves items in the bank statement, and the journals, that aren't marked off.
- items in the bank statement only, may be missing in the journals.
- items in the journals, may be missing in the bank statement.
- or items in either, may not be correctly entered, either by the bookkeeper (more likely), or by the bank's bookkeeper (less likely).
- items that were missing in the journals in the last period, may be present in the journals this period (less likely).
- items that were missing in the bank statement last period, may be present in the bank statement this period (more likely).
- items that haven't been accounted for from previous periods, should be also checked, and accumulated like bad debt records if still not confirmed.
- any items that are found to be bank only recorded transactions, like electronic transfers, bank fees and interest, should be

updated to the journals.

- cash payments journal entries incorrectly recorded can be more easily detected from the bank statement if they were paid by cheque and a correcting entry should be made (in the general journal).
- cash receipts incorrectly recorded may be more easily correlated with bank statements if cash received is banked daily.
- Checking original receipts to customers may help in finding incorrectly recorded receipts in cash receipts journal.

In summary , there is a list of outstanding deposits and payments from the previous reconciliations, which should be checked first against a current bank statement; then run through the cash payments and cash receipts journal sequentially, and tick off each against a corresponding bank statement; unticked bank only items should be written to the journals if missing; anything left in the journals is either outstanding (unpresented cheques, undeposited payments), or incorrect (and written back in the previous step), and should be reversed.

After doing the above, then a bank reconciliation statement can be done (assuming a credit balance at the bank):

```
Balance at Bank                1200 CR
less unpresented cheques        200
  1022 blogs bales   100
  1025 purple taxis   25
  1027 corn cutters   75
add outstanding deposits        100
Balance at cash in bank         1100 (DR)
```

3.5.2 Cash budgetting

An example budget may run for one quarter. Like bank reconciliation, there may be a present record of future cash receipt and cash payment, such as accounts receivable and accounts payable, in the current balance sheet . These should be included in the cash budget, as they are likely to fall due and be settled in the budgetted quarter. A cash budget may include predictions of cash flow , based on previous patterns of cash flow. e.g. 60% of credit sales are collected in the same month, with 30% collected in the next month, and 8% collected in the second month.

Operating cash flows include sales revenue, and inventory purchases. Each can be divided into smaller periods of cash flow, e.g. immediate payment, payment within a month, payment in the next month, payment in 2 months, estimated bad debt (never paid, this pertains to sales revenue, as it would be unethical to plan for inventory purchases that are intended never to be paid). When these payments are viewed within a longer budget period, it is usually the ones at the end of the period that partial cash collections occur , of the sales or purchases that occur in the ending months for example. So if credit extends for up to 2 months, then the predicted 30+ days credit receipts for sales in the last month, and the predicted 30+ days credit payment for purchases in the last month, will not be part of the cash flow for the quarter being accounted for.

Apart from operating cash flows of sales and inventory purchases, there will be operating cash expenses such as wages, rent, interest, and any cash prepayments that fall due like rates and insurance. Depreciation is not a cash expense, and shouldn't be included.

In the second division of investing cash flows, sale of equipment and purchase of equipment and the cash that is exchanged in those transactions should be considered. Interest income from non-core investments is often cash.

In the third division, there may be regular cash flows of a financial nature, such as payment of dividends on shares, payment of principal on bank loans, and possibly extraordinary items like issuing of shares with cash from subscriptions.

These cash receipts and payments can be worked out for the period in question (e.g. a quarter), and the net cash flow can be determined , in order to see if there is any danger of a cashflow stoppage, because of excessive cash outflow.

3.6 Receivables

3.6.1 Classification of receivables

Receivables can be classified as accounts receivables or trade debtors, bills receivable and other receivables (loans, settlement amounts due for non-current asset sales, rent receivable, term deposits). Other receivables can be divided according to whether they are expected to be received within the current accounting period or 12 months (current receivables), or received greater than 12 months (non-current receivables).

3.6.2 Accounts receivables

Not all accounts receivables will be paid, and an allowance has to be made for bad debts. The allowance for bad debts can be calculated either as **percentage of net credit sales** or by **ageing method of estimating bad debts**. These are determined by historical accounting information

3.6.3 Allowance methods of accrual accounting for bad debts

e.g. *percentage of net credit sales* : two years ago of $1000 net credit sales, $50 was uncollectable, and last year net credit sales was $2000 , and an allowance of 5% was made for bad debts , so the bad debts allowance for this period is $100.

e.g. *ageing of accounts receivables* : overdue accounts receivable was divided into periods of 0-30 days, 30-60 days, 60-90 days, 90-180 days, and the amounts that were never paid that were due in each period was divided by the amounts that were eventually collected for each period, giving a predictably increasing percentage of bad debts , the longer the amounts were overdue e.g. 2% at 0-30 days, 4% at 30-60 days, 20% at 60-90 days, 40% at 90-180 days.

The allowance for bad debts is an estimate of how much of a period's reported accounts receivables will eventually be not collectible, and is an attempt to predict that a bad debt has occurred , which of course , is only known for sure when the bad debt has to be written off, which will occur a long time after the credit sale is made.

Hence, at the end of a reporting period, when reporting the accounts receivables , a bad debts expense is reported for that same period, which is equal to the allowance

that is made with either of the 2 methods The account , *allowance for bad debts*, is then **a contra-asset account** vs. accounts receivables asset account, and is hence increases with a contra to a debit (for asset accounts), so is increased by a credit. Hence the recording should be,

bad debts expense - debit

allowance for bad debts - credit (the custom is to show debit lines above credit lines).

3.6.4 Writing off a bad debt determined to be unrecoverable in allowance methods for accounts receivables bad debt

When the bad debt is determined in the future to be bad, an amount in the accounts receivable needs to be reduced (credited), and hence the transaction is

allowance for bad debts - debit

accounts receivable - credit

3.6.5 tracing of gst transactions in allowance method for writing off bad debts from the initial credit sale

GST , if applicable, according to the accrual principle, is collected at the time of a credit sale, so when the accounts receivable is debited to record the credit to sales account, it is also debited to record the GST cash receivable, and GST liability account is credited, at the time of the sale.

1. A/R - debit = sale amount + GST amount
2. Sales - credit sale amount
3. GST (Collections/Liability) - credit GST amount

In a good debtor situation, on the debtor paying,

1. the cash in bank account is debited for the sale amount + gst amount, and
2. the accounts receivable is credited for the equivalent total amount.

GST can be regarded as an accrual item, and not a cash item, and is related to the sale action, not the cash collection.

In a bad debtor situation, when **a bad debt is written off**, it is certain the GST that was owing can't be collected either, so the transaction is :-

1. to debit the allowance for bad debts for the sale amount,
2. debit the GST liability account for the GST amount, and
3. credit the account receivable for the sum of sale+GST,

to acknowledge the receivable can't be collected.

3.6.6 other differences between percentage of net sales allowance method, and ageing of accounts receivables allowance method

GST also highlights a difference between the net credit sales allowance method, and the ageing of accounts receivable allowance methods : in the latter, an overall weighted amount of the accounts receivables is calculated as the estimate of bad debts, but the allowance made should be less the GST that was collectible from the bad debt amount as well.

A more obvious difference between the two methods, is that the allowance of percentage of net credit sales does not take into account residual amounts in the bad debts allowance account, whereas the residual in the allowance account in the ageing of accounts receivables is regarded as part of the current ageing estimate for the bad debts : so in the percentage of net credit sales method, the allowance account *increases* by the allowance calculated for the current net credit sales, but in the ageing of accounts receivables method , the allowance is made *equal* to current ageing allowance calculated. Therefore, the bad debts expense recorded at end of period for the ageing of AR method will be the difference of the allowance calculated and the residual balance of the allowance for bad debts account.

3.6.7 Recovery of bad debts previously written off

This reverses the bad debt written off almost, so needs to account for gst recollected, accounts receivable previously written off, as well as cash. The amount is not recorded back in the bad debts allowance account though, it is recorded in a separate bad debts recovered account. The original transaction for writing off was

1. DR - Allowance for Bad Debts
2. DR – GST
3. CR - A/R,

so the reversal is is

1. DR - A/R,
2. CR - Bad Debts Recovered,
3. CR - GST

(In the above, sum of DR equals sum of CR). Bad Debts Recovered increases with Credits, so isn't an asset, and it isn't a liability, so it is actually an equity (income) account. The Allowance for Bad Debts account is not re-credited because this allows tracking of recoverable bad debts that were previously written off.

To record the cash recovered, a second entry is then

1. DR -Cash in Bank
2. CR - A/R

Recording the equivalent DR to A/R and Cr to A/R in the separate transactions may not be necessary, but it seems clearer.

3.6.8 Management indices for receivables

1. **Receivables turnover ratio** is net credit sales / average receivables.

average monthly receivable, or average quarterly, or mean of starting / ending receivable

1. **Average Collection period** is 365 / receivables turnover.

These ratios are useful in comparing the efficiency of debt recovery for this company , and for comparison with other companies of similar turnover.

3.6.9 ethical issues with receivables

Money can be made illicitly by employees by issuing false discounts, false sales returns, writing off false bad debts, omitting cash received, issuing higher than actual accounts owing statements to customers, so it advisable to have at least one person for accounts receivable bookkeeping, one person for cash receipt recording, one person for accounts owing issuing to customers. Collusion could be a problem. Examples of ethical problems , where intention is not to steal money but to assist marketing , include to overstate turnover, such as in the recent (2010) IT outsourcing industry scandal.

3.7 Investments

3.7.1 Investments in Debt Securities

Companies invest in all kinds of debt securities to include government securities (federal or municipal), corporate bonds, notes, and commercial paper. How a company accounts for these investment in debt is based on the managements intentions for these investments.

Based on managements intentions, debt investments can be broken down into three categories.

- Held-to-maturity - The company wants to hold the debt to maturity.

- Trading - The debt is intend to be traded in the near term for small profit gains.
- Available-for-sale - The company intends to sell at some point in the future. It isn't intended to be held to maturity, but it also wasn't intended to be traded,

When we talk about trading, we are talking about very short-term buying and selling. If a debt was going to be bought with the intention of selling within an accounting period, a company could justify that it was intended for trading. Why the difference? Later on when we talk about income recognition the method that we account for the resulting income differs.

3.7.1.1 Held-to-maturity securities

Held-to-maturity securities are recorded at amortized cost and not at fair value.

- Effective-interest method

3.7.1.2 Available-for-sale securities

Available-for-sale securities are recorded at fair value but changes to fair value are not included in net income until after the security is sold.

3.7.1.3 Trading securities

Securities that are for trading are recorded at fair value and unrealized gains or losses is reported in net income.

3.7.2 Investments in Equity Securities

- Fair Value Method (holdings less than 20%)
- Equity Method (holdings between 20% to 50% or significant influence)
- Consolidated Statements (controlling interest)

3.7.3 Investments in Derivative Instruments

- Forward Contracts
- Option Contracts
- Fair Value Hedge
- Bifurcation of hybrid securities

- Disclosures for derivatives

3.7.4 References

Kieso, Donald E., Weygandt, Jerry J., and Warfield, Terry D. (2007). Intermediate Accounting, 12ed. John Wiley & Sons. ISBN 0-471-74955-9 pages 837-882

3.8 Books of Prime Entry

An alternative introduction is under the Journals entry. Books of Prime Entry are a more efficient variation on double-entry accounting. In basic double entry, a double entry is made in the general journal, which is posted in the general ledger accounts. Originally, the Venetian method also suggested a preceding diary step, which makes sense as no thinking is required in double entry, so it may have been faster. In a manual system, books of prime entry act as the speed entry step: instead of trying to remember which accounts to debit and which to credit, and writing the names down for each entry for each transaction in the general journal, the general journal is reserved for infrequent accrual entries; the more frequent cash entries, and the most frequent accrual entries are divided into specialized journals of cash receipts and cash payments; credit sales journal and credit purchases journal (credit means 'on credit' here) ; and for medium frequency accrual entries , sales returns and purchase returns journal. Apart from not having to write account names each time, the column layout in these specialized journal help systemize the double entry rules; most of them can be totalled at the end of each month to provide monthly entries into control account ledgers, as well as reconciliation with summary monthly totals when a schedule of subsidiary ledger accounts is created. Cash reconciliation also is a monthly task, which is made easier by tracking with numbered transactions such as numbered cheque books where cheque numbers can be entered in the cash payments journal; for tracking cash receipts, it is recommended banking occurs daily so that end of month bank reconciliation is easier. Bank reconciliation involves looking at outstanding items from the last reconciliation then seeing which of these occurred in this period's bank statement; then a search is made for unpresented cheques , and unrecorded receipts, and then payments and receipits that occurred through the bank and not through the business. This makes the cash receipts and cash payments journal essential for reconciliation.

Books of prime entry OR books of original entry are books where transactions are first recorded. These may or may not be part of the double entry system.

The main books of prime entry are:

- **Sales day book**
- **Purchase day book**
- **Sales returns day book**

- **Purchases returns day book**
- **Bank Book**
- **Cash Receipts Book**
- **Cash Payments Book**
- **Petty Cash Receipts Book**
- **Petty Cash Payments Book**
- **Journal**

3.8.1 Sales Day Book

This is the book of prime entry for credit sales, where all credit sales of the day are listed and totaled. The total is then used as a single posting entry to the sales ledger and also posted to a sales control account in a single total to tally with the underlying sales ledger. However, individual debits are posted separately in the respective sales ledger (or debtors or receivables ledger accounts). An excerpt might look like this:

DATE	INVOICE	CUSTOMER	SALES LEDGER FOLIO	TOTAL AMOUNT INVOICED	(ADDITIONAL COLUMNS OF ANALYSIS INTO DEPARTMENTS ETC)
2006					
April 2	002345	Alexander & Co	0016	$ 4,257.50	
	002346	Benjamin Consulting	0168	$ 5,200.00	
	002347	ABS Company	0027	$ 6,800.00	
	002348	Butler W Company	0278	$ 1,680.40	
				$ 17,937.90	

3.8.2 Books for prime entry are synonymous with manual accounting system of special journals and subsidiary ledgers

Another description for books of prime entry, are a manual accounting system of special journals and subsidiary ledgers.

In a basic accounting system, or one that follows the original Venetian method, is to write a English statement of a transaction at time of occurrence in a diary. Then , a this entry , which has at least a detail of a date, an amount, a sentence describing what happened , is then transferred to the general journal as an entry as soon as possible, the entry will be a first step in accounting classification, naming accounts to debit and amounts to debit, and accounts to credit and amounts to credit, where sum of debits equals sum of credits, and the entry is dated. There may be a further description written in brackets under the debits and credits, which may describe more information , such as quantities sold, and to whom, or quantities bought, and from whom, and receipt numbers).

The general journal entry is then latter entered in the appropriate general ledger accounts , with a date and possibly a back reference to the journal page, and forward references in the journal entry to the ledger account ID numbers to indicate posting from the general journal to the general ledger of accounts.

In a special journal / subsidiary ledger system , or books of prime entry system, several constraints are added:

Instead of making an entry for every transaction in the general journal, there are several journals as named above.

The posting rules are:

- credit sales are entered in the day sales journals. Likewise, sales returns are entered in the day sales returns journals.
- purchases on credit are entered in the day purchases journal. Likewise, purchase returns are entered in the purchase returns journal.
- cash payments i.e. payments by cheque , or by eftpos, or via direct bank transactions such as bank fees and interest paid, are made to the cash payments journal.
- cash receipts i.e. payments by cheque, direct deposits , visa receipts with reference numbers ,are made in the cash receipts journal.
- At the end of each day, any entries into credit sales, sales returns, credit purchases, purchase returns, cash receipts, and cash payments, are posted to the relevant **subsidiary** ledger accounts. There will be subsidiary accounts receivables for each regular customer, and subsidiary accounts payable for each regular supplier.
- In general , credit sales are posted as debits to the relevant subsidiary account receivables, and cash receipts from that customer are posted as credits that account. Credit purchases are credits in the subsidiary accounts payables, and cash payments to the same supplier are debits to that same subsidiary accounts payable.
- At the end of each month, each column of the credit sales journal, credit purchases journal, cash receipts journal, and cash payments journal, as well as the sales returns and purchase returns journal, is totalled at the bottom of each column, and then posted to the relevant **control** ledger account. For instance, a more elaborate *credit sales journal* for gst collections , will have a *debit* column for *accounts receivables*, whose end of month total is posted to *accounts receivables* ***control***, as well as a credit column for sales ledger account, which is not posted daily but totalled for monthly posting, and a credit column for GST collections, which is also posted as a monthly credit to the *GST collections account* (liability). Likewise,*credit purchase journal* will have a *debit* column for purchases , a debit column for GST paid, and a credit column for accounts payable. The credits for accounts payable are posted daily to subsidiary accounts payable(creditors) , and the monthly total of accounts payable as a credit to accounts payable control. The GST paid debit column is posted as a monthly total to GST paid (a contra-liability account). The purchases are totalled monthly , and posted to the purchases account , which in the periodic inventory system , is , at period's end, added to the *beginning inventory* in the *income statement* to give *cost of goods available for sale*, and the stocktake determined *ending inventory* subtracted to find the *cost of goods sold*, which can be subtracted from gross revenue, to get gross profit.
- the reason for the daily posting to subsidiary ledger accounts , and the monthly posting to the control ledger accounts, is that a monthly *cross check* can be made by doing a monthly *schedule of accounts receivables*, and a *schedule of accounts*

payable : the sum of the ending balances of one type of subsidiary ledger accounts should equal the balance of the control account after the monthly control posting e.g. subsidiary accounts receivable balance sum equals accounts receivable control balance.

- the cash receipts journal and the cash payments journal have the expected main case of debit and credit columns , but have additional columns for special cases:
    1. **cash receipts journal** has a *debit* column for *cash in bank*, and a *credit* column for *accounts receivable* (because of cash payments from customers honoring credit terms) . However , there will be other debit and credit columns for other uses of cash receipts :-
        - *cash sales* will need a *credit* column for *sales*, and a *credit* column for *gst collections*.
        - *Discounts allowed for credit sales early repayment* will need a *debit* column for *discount allowed (financial) expense account*, and a *debit* column for *gst collections* , in order to reverse previously accrued gst collection equal to 10% of the discount allowed.
        - A sundry *credit* column may be needed for cash receipts such as *loans* (a credit to a liability account), or sale of non-current/ non-inventory assets.
    2. **cash payment journal**, for the main function of paying suppliers/creditors, has a *debit* column for *accounts payable*, a *debit* column for *gst outlays (refundable asset)*, and a *credit* column for *cash in bank*. Cash in bank is the source account for cash, and each credit to this asset account reduces its balance.
        - For the extended supplier case of *early payment* within discounted credit terms, there will be a *discount received*credit column (other income credit), and a *credit* for *gst outlays* (a reduction in refund for 10% of the discount allowed).
        - For the secondary cases of payment of bills, insurance, rent , rates , and for cash payments for supplies and equipment, a *debit* column for *other* or *sundry* cash payments (debits for assets purchased, or debits for expense accounts).
- The **general journal** is for other entries that are not related to cash or credit, such as period-opening, *reversing entries*; period-ending , *adjusting entries*, ; and *closing entries* transferring income and expense account balances to the summary profit and loss temporary account.
- Closing of temporary income and expense accounts can be to a temporary profit and loss summary account , made initially in the general journal, and then posted to the income accounts, expense accounts, and profit and loss summary account..
- **petty cash payments** may operate with the interest system, where there is a fixed interest amount for which a petty cash fund is reimbursed to, and on reimbursement, an entry is made in the *cash payments journal*, with debits for the previously petty cash expenses recorded in the petty cash voucher book, and a credit to cash in bank for the cheque that is used to reimburse the petty cash. (If there are also receipts of petty cash, then reimbursement might consist of the sum of unaccounted petty cash payments vouchers, less the sum of unaccounted

petty cash receipt vouchers, with possibly separate voucher books for payments and receipts).

3.8.3 Example daily posting of example Sales entires , to subsidiary accounts receivable accounts

referring to the example above of credit sales journal entry, at the end of the day, the journal entries are posted to the subsidiary receivable account ledgers.

```
                                                SALES LEDGER          TOTAL AMOUNT
DATE      INVOICE    CUSTOMER                   FOLIO                 INVOICED
2006
April 2   002345     Alexander & Co             0016                  $  4,257.50
```

Post as

```
Accounts Receivable Ledger AR-0016
CUSTOMER - Alexander & Co
DATE      INVOICE    POST-REF DEBIT       CREDIT        BALANCE
..                                                      4,520.00 DR
2 Apr 06  002345     SJ       4,257.50                   8,777.50 DR
```

```
          002346     Benjamin Consulting            0168
$  5,200.00
```

Post as

```
Accounts Receivable Ledger AR-0168
CUSTOMER - Benjamin Consulting
DATE      INVOICE    POST-REF DEBIT       CREDIT        BALANCE
..                                                      2,345.00 DR
2 Apr 06  002346     SJ       5,200.00                   7,545.50 DR
```

```
          002347     ABS Company                    0027                $  6,800.00
```

Post as

```
Accounts Receivable Ledger AR-0027
CUSTOMER - Benjamin Consulting
DATE      INVOICE    POST-REF DEBIT       CREDIT        BALANCE
..                                                          0.00 DR
2 Apr 06  002347     SJ       6,800.00                   6,800.00 DR
```

```
        002348     Butler W Company               0278                $  1,680.40
```

Post as

```
Accounts Receivable Ledger AR-0027
CUSTOMER - Benjamin Consulting
DATE     INVOICE    POST-REF DEBIT       CREDIT        BALANCE,
..                                                        500.00 DR
2 Apr 06  002348    SJ       6,800.00                  2,180.40 DR
```

- Any sales returns journal entries, are also recorded as credits daily in the relevant subsidiary account receivables ledgers.
- Any cash receipts journal entries related to trade debtor settlements are recorded as credits daily in the relevant subsidiary accounts receivables ledgers.
- At the end of the month, a schedule of subsidiary accounts receivable balances is made, and the sum of the balances noted.
- At the end of the month, the total of entries in the sales journal, less the total in the sales returns journal, less the total in the accounts receivable credit column of the cash receipts journal, should equal the total of the schedule of subsidiary accounts receivable.
- credit purchase journal entries are similarly posted in the subsidiary accounts *payable* daily, as well as cash payment journal entries related to settlement of trade creditor accounts ; similarly monthly total of trade creditor account ending balances should equal totals of credit purchase journal, less credit purchase return journal, less cash payment journal purchase column total.
- any credit purchase or sale of non-current assets such as office furniture and equipment should not be entered in the credit purchases or credit sales journal, which are reserved for recording sale of trade inventory. Since they are non-frequent, they are entered in the general journal instead, and when paid for, are entered in the sundry debit column of the cash payments journal, or the sundry credit column of the cash receipts journal.

3.9 Year End Adjustments

The revenue recognition principle is the basis for making adjusting entries at the year end. These are necessary to better match the revenues and expenses that occurred during the accounting year. Adjusting entries are used to record the economic events. Examples of adjusting entries are:

A prepaid expense is an economic benefit paid for in advance of its use. We pay insurance premium for a year. If this period does not coincide with the accounting period then at the year end an advance part of the premium is for the next year. We have to adjust this amount of advance payment as Prepayments (or sundry debtors) Account to reflect that the amount is not yet utilised to the benefit of the company but an asset with future benefit yet to be utilise. Unless similar expenditures are adjusted at the year end, the profit for the year is not accurate.

Similarly, expenses incurred during the year but not yet paid must be accounted for by adjusting by charging to the respective expenditure account and temporarily held in credits on the sundry creditors account as if the amount is owed to the external party.

Another kind of year end adjustment is where there is no financial activity to prompt the record of such transactions. Under this category are apportion of depreciations, provision of directors fees, provision for proposed dividends etc.

Notice all these actions of adjusting is just to reflect on the true and fair situation so that the profits, assets and liabilities of the company is fully stated and recorded completely according to the economic and financial effects.

3.10 The Trial Balance

A trial balance (OR a list of account balances) is a list of all ledger balances (which form part of the double entry system only) shown in debit and credit columns. The totals of each columns should be the same if all debits and credits are entered systematically.

The trial balance is not a financial document officially, but it is just a method used to test the accuracy of the double entry bookkeeping methods. Because of this, the exact format may vary but in practice many trial balance reports appear very similar. A common format is to list the balance sheet accounts first, followed by the income statement accounts.

3.11 Journals

General Journal:

most common journal to record every transactions affecting accounting system. All transactions in this journal will be posted to general ledger.

Special Journals:

used to record common transactions of 4 types:

1. sales on credit to "sales" journal (SJ);
2. purchases on credit to "purchases" journal (PJ);
3. cash received to "cash receipts" journal (CRJ);
4. cash paid to "cash payments" journal (CPJ)

The Ledger postings must contain 4 parts: Date, Details, Ref (which journal: GJ, SJ, PJ, CRJ or CPJ) and Amount

However, the special journals do not cover all required transactions in general ledger, the rest should use GJ.

The General Journal parted the other accounts which are generally:

- Sales returns not yet paid for;
- Purchase returns not yet paid for;
- Non-inventory credit transactions (e.g. Equipment acquired on credit)

- Adjusting entries on balance day ;
- Closing entries;
- Reversing entries;
- Correction entries;

Comparability: The Genral Journal adopted to more industries rather than Special Journals, while it has less efficiency and spend longer time; furthermore, the special journals have division of labour which is clearly focusing on Internal control which is significant for managerial accounting.

3.12 Provisions

Provisions are a form of liability. An example of a provision is provision for honoring warranties on defective products sold.

They can encompass mainly liability that requires settlement within 12 months, therefore they may be regarded as current liabilities. They are not the same as normal liability because there is uncertainty about when they fall due, and the exact amount required for settlement when they fall due, and to whom it is due, but some reasonable estimates can be made from past events as to how much will be due , and that settlement will be probably required for the amount. Hence provisions meet the recognition criteria of probable and measurable for liabilities.

Future costs can not be provisioned, because a liability by definition requires an outflow of economic benefit or is a current economic burden owed to other entities, and not to the self entity. A future cost is an expense , not a liability, and is expended when it occurs, and not settled.

Contingent liabilities are like poorly known provisions, where the amount of liability may be inexact, the probability of occurrence is not highly probable, and although cannot appear in the financial statements (e.g. as a liability in the balance sheet) , would make the company look pretty bad if not reported in some way when they are known to have a significant possibility (5-50%) of occurring, so they must be disclosed in the notes to financial statements to discharge the duty to materiality and prudence. An example is a future possible legal settlement cost. Similar to provisions, contingent liabilities are liabilities that cannot be corrected by present decisions to rectify the future obligation, even though the obligations have not certainly occurred.

3.13 Capital and Reserves

Capital is an investment of money invested by the owners of a business with the intention of earning a return. Accounting usually treats the capital as money owned by the owners of the business, or money owed to the owners.

Reserves are funds set aside and may be specifically for a certain purpose or may be a general surplus funds. Various reserves such as Share Premium Reserves, Unappropriated Profit Reserves, etc. These reserves are usually created as excess funds and not to meet a liability (as in a provision).

3.14 Disclosures

Financial statement disclosures can be broken down into the following categories:

- Primary financial statements
- Nature of operations
- Basis of reporting
- Significant accounting policies
- Financial statement accounts
- Broad transaction categories

3.14.1 Primary financial statements

Disclosure name	Disclosure description	Disclosure type
Balance sheet	Reports assets and liabilities and equity as of a point in time. Also called statement of financial position.	Roll up of assets. Roll up of liabilities and equity
Income statement	Reports net income for a period of time. Also called statement of earnings	Roll up of net income(loss)
Cash flow statement	Reports cash flow for a period of time. Also called statement of cash flow	Roll up of net cash flow
Changes in equity	Reports changes in the line items of equity. Also called statement of changes in equity	Roll forward of each equity account

3.15 Balance Sheet

The Balance Sheet is a financial statement that lists the assets, liabilities, and the ownership equity of a business entity as of a specific date.

A balance sheet can be presented in many different ways. A classified balance sheet is one format where the accounts are listed in some logical manner such as:

- Assets are listed in order of liquidity with the most liquid to the least liquid form. This is usually classified into groups such as Current Assets and Fixed Assets.
- Liabilities are listed in order of when they are become due. The further subdivision may be Long Term Liabilities and Current Liabilities.
- Equity is generally presented with paid-up capital first and then various reserves and lastly the retained earnings.

The balance sheet could reflects the financial strength of a business. It depends on the type the business. A healthy balance sheet for a merchandiser would probably have a Current Ratio, i.e. Current Assets divided by Current Liabilities of 2 and a Debt Equity ratio of 1:2.

3.16 Income Statement

The Income Statement is a financial statement that lists income, expenses, and profit for a given periods of time.

Income and Expenses can be classified into operating Income and Expenses, administation Expenses, and Financial Income and Expenses.

```
Detailed Income statement for xxxxx retail Ltd , for year ending on 30th June, xxxx.
-------------------------------------------------------------------------
Operating Income
  Sales Revenue                        x
   less sales returns                  x
                                       --
  Net sales revenue                              x
  Less Cost of sales
   beginning inventory                  x
   add purchases                        x
                                       ---
   cost of goods available for sale           x
   less ending inventory                      x
   Cost of Sales                                 x
                                                ---
  Gross Profit                                   x
  add Other operating Income                     x
    Discount received                            x
                                                ---
                                                 x
Less expenses
  Operating  Expense
     Sales staff salary expense        x
     advertising expense               x
     stores rent expense               x
     stores depreciation expense       x
                                      ---
       Total operating expense                 x
  Administration Expense
     Office staff salary expense       x
     office rental expense             x
     telephone expense                 x
     utilities expense                 x
     office supplies expense           x
     office furniture and
     equipment depreciation expense    x
     insurance expense                 x
                                      ----
       Total administration expense            x
  Financial expense                     x
    interest expense                    x
    bad debts expense                   x
    discount allowed expense            x
                                       -----
       total financial expense                 x
                                              ---
                                                 x
                                                ---
Net profit excluding financial income            x
```

```
  add Investment income                          x
  add Finance income                             x
                                                ----
Net profit before taxes                          x
  taxation expense                               x
                                                ----
Net profit after tax                             x
                                                ====
```

3.17 Cash Flow Statement

This is a part of the financial statement required by law or the accounting standard.

A cash flows statement provides information beyond that available from other financial statement such as the Income Statement and the Balance Sheet. It is an

important information because cash flow is essential to the continued operation of a business. The main purpose of the statement, according to the Financial Accounting Standard Board (FASB) is to provide:

- Information about the changes of an entity cash or cash equivalents in the accounting period.
- Information about a company borrowing and debts repayment activities.
- The company sale and repurchase of its ownership securities.
- Other factors affecting the company's liquidity and solvency.

The normal format of The Cash Flow Statement is:

Statement of Cash Flows for the period 1/1/2005 to 31/12/2005.

	Debit +/−	Credit +/−
Cash flows from operating activities Cash receipts from customers Cash paid to suppliers and employees	Balance c/d	
Cash flow from investing activities		
Cash flow from financing activities		
Net increase/decrease/Change in the cash and cash equivalents		
Cash and cash equivalents at the beginning of period		
Cash and cash equivalents at the end of period		

Each of the above headings will have further details, such as Cash flow from operations with increase in account receivables, accounts payables, cash receipts from customers, payment for goods sold and operating expenses. The investing cash flow includes capital expenditures for long-term assets, sales of assets and investing in joint ventures etc. Financing cash flow includes debts financing, dispensing ownership funds and borrowings.

When activities that do not involve cash they are not normally disclosed on the statement, BUT the Standard requires such transactions to be disclosed by way of footnotes or on a separate schedule.

The importance of the Cash Flow Statement for investment decision making includes:

- Regular operations is sustainable or not.
- Sufficient cash generated to pay debts or not.
- The likelihood that the company needs further financing.
- Can unexpected obligations or opportunities be taken up by the company without difficulty.

3.17.1 cash-flow determination from two year's balance sheets, change in equity , and a detailed income statement

Using a divide-and-conquer technique, it may be possible to determine a cash flow statement from knowing a beginning balance sheet, an ending balance sheet, a change in equity statement, and a detailed income statement. Even if there is not enough detail to calculate exactly, it helps to correlate that the statements are consistent.

The first division is to divide cash flow into operating, investing and financing activities. Cash flow from :-

- operating activities - this can be seen by calculating changes in the *current assets* and *current liabilities*, and from operating income and expenses in the income statement. Payment of interest on borrowings is regarded as an operating activity, as interest is a current liability arising out of a non-current liability.
- investing activities - these deal with changes in *non-current assets* , such as property and equipment, and investment of cash , such as shares, foreign currency, government bonds - and return on investment such as dividends from invested other entities and gains from sale of non-current assets , which can be seen in the investing income part of the income statement.
- financing activities - cash may be generated from creation of company shares, and used in buybacks of company shares, payment of dividends on company shares, borrowing cash, and repayment of cash, and these can be seen in *changes in non-current liabilities*, and in *changes in equity* in the change-in-equity statement. e.g. Repayment of a long-term debt from retained profits is a outgoing cashflow; dividends is a form of drawings and is a equity distribution cash flow; issuing discounts is regarded as a finance expense, but there is no cash flow.

Why separate current and non-current, and separate non-current asset cash flow from non-current liability cash flow ? Separating current from non-current helps to see if there is enough easily accessible cash for day-to-day operations : separating long-term assets from long-term liabilities may help to predict longer term cash flow problems. However, cash flow statements are more useful when seen in the entire series: for instance, the first cash flow statement of the company may show a large incoming cash flow from borrowing in the financial section; then subsequent cash flow statements show the company purchasing non-current assets with outgoing cash flow; not knowing about the first borrowing cash flow makes the company look good.

3.18 GAAP

Generally Accepted Accounting Principles (GAAP) refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as accounting standards. GAAP includes the standards, conventions, and rules accountants follow in recording and summarizing, and in the preparation of financial statements

3.19 IFRS

International Financial Reporting Standards (IFRS).

International Financial Reporting Standards (IFRS) are Standards, Interpretations and the Framework Full text of the Framework adopted by the International Accounting Standards Board (IASB). [1]

United States

Financial Accounting Standards Board (FASB) [2]

Generally Accepted Accounting Principals (GAAP) [3]

U.S. Securities and Exchange Commission (SEC)

International

International Accounting Standards Board (IASB) [4]

International Financial Reporting Standards (IFRS) [5]

International Accounting Standards Committee (IASC)

Description	International	United States
Organization	IASB	FASB
Name of Standards	IFRS	GAAP
Oversight	IASC	SEC

1. http://en.wikipedia.org/wiki/Ifrs
2. FASB
3. GAAP
4. IASB
5. IFRS

Description	International	United States
Oversight Type	Private	Public

3.19.1 References

1. http://en.wikipedia.org/wiki/Ifrs
2. FASB
3. GAAP
4. IASB
5. IFRS

3.19.2 Also See

International Accounting Standards Board (2007): *International Financial Reporting Standards 2007 (including International Accounting Standards (IAS(tm)) and Interpretations as at 1 January 2007)*, LexisNexis, ISBN 1-4224-1813-8

Original texts of IAS/IFRS, SIC and IFRIC adopted by the Commission of the European Communities and published in Official Journal of the European Union http://ec.europa.eu/internal_market/accounting/ias_en.htm#adopted-commission

3.19.3 External Links

IFRS for SMEs (http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/EXTCENFINREPREF/0,,contentMDK:22577649~pagePK:64168445~piPK:64168309~theSitePK:4152118,00.html)

Why many Financial Services are adopting to IFRS - Deloitte | An Overview of International Financial Reporting Standards (IFRS) (http://www2.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/capital-markets/2c557501a5b91210VgnVCM200000bb42f00aRCRD.html)

Accounting Standards (http://www.icaew.com/en/library/subject-gateways/accounting-standards)

3.20 Cost Flow Assumptions

- Cost flow assumptions affect the more important Income Statement and less important Balance Sheet
- Assume that the most recent cost is most relevant cost

3.20.1 Specific Identification

- Keeps track of the cost of each, specific good sold

3.20.1.1 The Good

- Perfect matching of costs of goods to goods sold

3.20.1.2 The Bad

- Often impossible or too costly
- Allows manipulation by management

3.20.2 FIFO

- First-In-First-Out
- Assigns first costs incurred to COGS (Cost of Goods Sold) on the Income Statement

3.20.2.1 The Good

- Disallows manipulation by management
- Cost flow agrees with ideal, physical flow of goods
    - Counter-Argument – Agreement of cost flow and ideal, physical flow of goods is not important

3.20.2.2 The Bad

- Uses the least relevant cost for the Income Statement

- Underestimates or overestimates cost of goods sold if prices are rising or falling, respectively

3.20.3 LIFO

- Last-In-First-Out
- Assigns last costs incurred to COGS on the Income Statement

3.20.3.1 The Good

- Disallows manipulation by management
- Uses the most relevant cost for the Income Statement

3.20.3.2 The Bad

- Underestimates or overestimates cost of goods sold if prices are falling or rising, respectively
- Cost flow disagrees with ideal, physical flow of goods
  - Counter-Argument – Agreement of cost flow and ideal, physical flow of goods is not important

3.20.4 Weighted Average

- Assigns average cost incurred to COGS on the Income Statement

3.20.4.1 The Good

- Disallows manipulation by management
- Better estimation of the cost of goods sold than FIFO or LIFO if prices are rising or falling

3.20.4.2 The Bad

- Tends to ignore extreme costs of inventory
- There is no theoretical reasoning for using this method

3.20.5 Notes

- LIFO and Weighted Average cost flow assumptions may yield different end inventories and COGS in a perpetual inventory system than in a periodic inventory system due to the timing of the calculations. In the perpetual system, some of the oldest units calculated in the periodic units-on-hand ending inventory may get expended during a near inventory exhausting individual sale, in the LIFO system; in the weighted average system, in the perpetual system, each sale moves the weighted average, so it is a moving weighted average for each sale, whereas in the periodic system, it is only the weighted average of the cost the beginning inventory, the sum cost of all the purchases, less then cost of the inventory , divided by the sum of the beginning units and the total units purchased.

3.21 Bookkeeping

3.21.1 Basic Bookkeeping

An introduction to bookkeeping for community non-profit organizations.

3.21.1.1 Quick Start

The purpose of this section is to introduce core concept: "always leave a papertrail", and give easy tips for a person who is immediately assuming financial duties, but hasn't yet read the rest of this document. Mention multi-signature bank accounts and other good habits?

So you've volunteered to be a treasurer for a community organization. Good for you! Now what? It can take time to take over from your predecessor and/or setup accounting practises for a new organization. In the mean time, your organization still needs to move forward. But here are some simple guidelines that will immediately help:

- get for receipts for everything. Write on the receipts memos of what it was for and who paid it (and if they need to be reimbursed)
- avoid cash, prefer cheques.
- if you have to accept cash, have two people count the money and sign a statement to the effect: "On this day, at this event, we counted $money in the cashbox. There was $float at the start of the event, so we collected $net total. (Person) is going to deposit $deposit in our bank account."

When in doubt, ask yourself: "if someone else looked at my records, would they understand how the money was spent?"

3.21.1.2 Paper Trails

The purpose of this section is to introduce a simple single-entry accounting system, building on the previous section. Do this by showing ready-to-use examples of photocopiable forms, or showing how to use spreadsheets or chequebooks to track (and annotate) bank accounts. If possible, try and sneak in terminology and techniques from double-entry accounting.

3.21.2 Cheque Book

(Using a cheque book to track and anotate bank account activities.)

3.21.3 Event Cash Flow Sheets

(one 8.5x11 sheet of paper to record cash collection--e.g. from ticket sales. Have a chart to help cash counting, then a form for folk to sign off on the results. Organization-specific stuff would also be handy: e.g. new members.)

3.21.3.1 Next Steps

The purpose of this section is to introduce double-entry accounting, building on the previous section. Show how to do this using low-tech supplies (eg. a dollar-store notebook). Lots of examples. Suggest spreadsheets.

(ideas: introduce "cash flow sheets" to replace the signed statements described above. Talk about banking. How to record transactions. Generally how to set up a simple bookkeeping system.. possibly including low-tech examples.)

3.22 Financial Ratios

financial ratios help us for better understanding of business' previous and future financial position and it s operating result, specially when we have tow year or more

financial statement of a business. also, these ratios help us find critical items in auditing because there are relations between the financial statement items. For example suppose that in a company in second year sale, accounts payable and inventory were decreased in the other hand accounts receivable and expenses were increased a simple analysis with financial ratios can tell us what happened and will happen for company. some answers can be: 1- the operational activities have decreased . 2- the company has lost the market. 3- the sale prices has decreased 4- inventory has damaged and ... if we have the numbers we can better find out the cause financial ratios dividend in to : 1- liquidity ratios 2- leverage ratios 3- activity ratios 4- profitability ratios

3.23 GST

GST may be set at 10% of GST applicable sales and business related purchases.

Some governments make certain goods and services **GST-free** in order to help disadvantaged tax payers, or people who can't work due to poor health, lack of education, poverty resulting in suboptimal personal development and further relative poverty. Examples include fresh vegetables , bread, milk , meat, infant formula, eggs, cooking oil , child care services, government funded medical services.

GST collections is a liability account to accrue GST on sales, and GST outlays is a current asset account to accrue GST on purchases

GST is an accrued current liability when a GST applicable sale, whether cash or credit ,is made. The creditor is the government taxation service. The liability account might be called GST collections. It is credited whenever cash in bank or accounts receivable is debited against a sale/revenue income account credit, and the total credits equals debits.

The moment a purchase is made, and an asset or expense is debited, a GST outlays current asset account is also debited; the total of the debits are made *against* the equivalent credit in cash in bank , or in accounts payable.

Sale and purchase returns are simply reversals. If cash was handed over which included GST, it is handed back and the relevant GST account reversed (GST collections debited for sales returns, GST outlays credited for purchase returns).

Discounts are like partial reversals : if 2% of the sales is the discount offered for meeting early payment terms, then the cash received as a debit to cash in bank is offset the discounted amount and one tenth of the discounted amount, the discount amount debited to the discount allowed finance expense account, and the one tenth discount amount debited against the GST collections liability account, reversing one tenth of 2% of the GST that was owed by the original sale. (The rest of the credit is against accounts receivable as usual for accrual sale, or against revenue income account if direct cash sale).

In the allowance method for bad debts for accounts receivable, GST collections is reversed for the bad debt when the bad debt is realised i.e. when the accounts receivable is credited for the bad debt and the GST on the bad debt, and the bad debts allowance contra-asset account is debited (some jurisdictions might call bad debts a probable liability account and hence a provision).

Non-current asset acquisitions may be for a group of assets, and GST outlay is usually calculated on the net fair value of the assets given up, but may include deductions on asset value by acquired liabilities , as well. i.e. GST outlays debited 10% of (fair value of acquired assets - fair value of acquired liabilities).

Chapter 4 Glossary and Appendices

4.1 Glossary

Asset

Anything with probable future economic benefit that is obtained or controlled by a company and is the result of a past transaction.

Asset accountant items

Pretty Cash: This is an account of small amount cash used in operation. in a format of Date, Account Number, HB (handbook) No., Particular usage, item amount, signature, total amount, C/F balance.

Cr

The abbreviation for Credit.

COGS

The abbreviation for Cost of goods sold

Depreciation

The process of spreading the cost of acquiring a fixed asset over its useful economic life.

Double Entry

is the principle of accounting which requires that every transaction has two effects one of which is a debit and the other of which is a credit of the same amount.

Dr

The abbreviation for Debit.

FIFO (First IN First OUT)

The inventory system leave new inventory in stock until the old ones sold by legal terms.

Fixed Asset

An asset acquired by a business where there was no intention to make money from immediately reselling the asset. e.g A Van used by a plumbing firm.

Liability

Probable future sacrifice of economic benefits, or the entity owes somebody something.

Prepayment

A Prepayment is a type of asset arising from the fact that the business has alreasy been invoiced for the right to all or part of a service in a future period e.g. rent for next year, paid this year.

Stock

Stock is the set of those assets held by the business intended for resale in their current form or in a modified form. Stock includes raw materials, components, work in progress and finished goods.

UEL

The abbreviation for useful economic life.

Useful economic life (UEL)

The useful economic life of a fixed asset is the time period for which the asset is likely to be useful in generating profit for a company (or meeting the aims of a charity).

WIP

WIP is the abbreviation for Work in Progress

Work in Progress (WIP)

Work in progress is the set of assets held by a business which are part way through some process after which they can be resold. Once completed the articles will cease to be WIP and become finished goods.

4.2 Professional Bodies

The following **professional bodies** represent and regulate accountants in their respective countries:

4.2.1 United Kingdom

- Association of Chartered Certified Accountants (ACCA)
- Institute of Chartered Accountants in England & Wales (ICAEW)
- Institute of Chartered Accountants of Scotland (ICAS)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Chartered Institute of Management Accountants (CIMA)
- Association of Accounting Technicians (AAT)
- Institute of Financial Accountants (IFA)
- Certified Public Accountants (CPA) Professional (CPA-PRO) (http://cpapro.eu/)
- Association of Certified Public Accountants (CPA)
- Institute of Professional Accountants (IPA)
- Institute of Cost & Executive Accountants (ICEA)
- Association of International Accountants (AIA)

- The Association of International Certified Practising Accountants (THEAICPA) (http://www.cpapro.pk/)

4.2.2 United States

- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- American Institute of Certified Public Accountants (AICPA)
- Institute of Management Accountants (IMA)
- Association of Certified Project Accountants (ACPA)

4.2.3 Australia

- The Institute of Chartered Accountants in Australia (ICAA)
- CPA Australia
- Institute of Public Accountants, Australia (IPA)

4.2.4 Canada

- The Candian Institute of Chartered Accountants (CICA)
- Certified General Accountants Association of Canada (CGA)
- Certified Management Accountants of Canada (CMA)

4.2.5 Republic of Ireland

- The Institute of Chartered Accountants in Ireland (ICAI)

4.2.6 New Zealand

- New Zealand Institute of Chartered Accountants (NZICA)

4.2.7 Malta

- The Malta Institute of Accountants (MIA)

4.2.8 India

- The Institute of Chartered Accountants of India – CA
- The Institute of Cost Accountants of India – CMA
- The Institute of Company Secretaries of India - CS

4.2.9 Malaysia

- Malaysian Institute of Accountants (MIA)
- The Malaysian Institute of Certified Public Accountants (MICPA)

4.2.10 Pakistan

- The Society of Accounting Education (SOAE)
- The Association of International Certified Public Accountants (THE-AICPA) (http://www.cpapro.pk/)
- The Institute of Cost & Management Accountants of Pakistan (ICMAP)
- The Institute of Chartered Accountants of Pakistan (ICAP)
- Pakistan Institute of Public Finance and Accountancy (PIPFA)
- Institute of Professional Accountants of Pakistan (IPA)
- Institute of Certified Global Management Accountants of Pakistan (ICGMA, Pakistan) (http://www.icgma.net)
- Institute of Certified Commercial Professional Accountants & Internal Auditors (ICCPAIA)

4.3 Notes to Authors

This is the place to write notes which are only useful to authors and not readers of this book. It is best to put everything here rather than clutter up the contents page for the book.

4.3.1 Contributors

Contributors include:

- John Cross (https://en.wikibooks.org/wiki/User:John_Cross)
- Benjamin Kok

4.4 Templates

{{currencychoice}} allows people to create a version of an accountancy text in a different currency with a single edit.

4.4.1 Journal templates

Simple bookkeeping journal

{{bookkeeping journal| name = General | page = 1 }}

An empty journal just takes the journal name and page number

Date	Description	Post Ref.	Dr	Cr

```
{{bookkeeping journal
| name = General
| page = 1
| entry =
{{bookkeeping entry| date = 2006<br/>Feb | day = 15 | description = Accounts Payable | dr = 100 }}
{{bookkeeping entry| description = Stock | cr = 80 }}
{{bookkeeping entry| description = Stationery | cr = 20 }}
}}
```

Fig. 4.1: General Journal - Page 1

A journal with entries takes the journal name, page number and the entries. All fields of a bookkeeping entry are optional. cr is short for credit account and dr is short for debit account.

This is the result:

Date		Description	Post Ref.	Dr	Cr
2010 Feb	15	Accounts Payable		100	
		Stock			80
		Stationery			20

Fig. 4.2: General Journal - Page 1

The templates are:

- bookkeeping journal - basically the table with the column headers and captain *Name* Journal - Page *n*.
- bookkeeping entry - passed as the parameter to bookkeeping journal, any number of them can be passed. Takes date, day, description, post, dr and cr. All parameters are optional and leave an empty column when not set. "dr" and "cr" are short for debit and credit entry respectively.

4.5 Quick Reference

text and cases 9th edition by anthony,reece,hertenstein Alfredson, Lero, Picker,Loftus, Clark. Apply International Accounting Standards, 2nd Edition, Wiley IAS 7 16 etc. all IAS standards

4.5.1 Accounting Ratios

4.5.1.1 Profit-Based Ratios

x	*Gross Profit*	*Operating Profit (PBIT)*	*Net Profit*	*Profit After Tax*
$\frac{100\%}{Sales}$	*Gross Profit Margin %*	*Operating Profit Margin %*	*Net Profit Margin %*	
$\frac{100\%}{Equity + Debt}$		*ROCE %*		
$\frac{100\%}{Equity}$				*Return on Equity %*
$\frac{1}{Debt}$		*Interest Cover*		
$\frac{1}{No.of Ordinary Shares}$				*Earnings per Share*

The table shows how to calculate the ratios by multiplying the row and column headings together. e.g.

Gross Profit Margin % =

$$\frac{Gross\ Profit \times 100\%}{Sales}$$

Earnings per Share =

$$\frac{Profit\ after\ Tax}{No.\ of\ Ordinary\ Shares}$$

4.5.1.2 Also

Sales = Turnover

Equity = Ordinary Share Capital + Reserves

Debt = Long Term Liabilities = Non-Current Liabilities

Capital Employed = Equity + Debt

Asset Turnover = Sales / (Fixed Assets + Net Current Assets)

Fixed Assets + Net Current Assets = Equity + Debt (Accounting Equation)

ROCE = Operating Profit Margin x Asset Turnover

Chapter 5 Other pages

5.1 Cost Accounting

Cost accounting is the branch of accounting which involves the recording, classifying, summarizing and allocating the expenditure in order to determine the cost of product or service and report same to the management.

Chapter 6 Resources

6.1 BOOKS

- Principles of Accounting (http://www.principlesofaccounting.com/) free online text book - but not Public Domain or available under a Creative Commons license, so don't COPY them here
- Accounting 7e (http://www.johnwiley.com.au/highered/engine.jsp?page=titleinfo&all$isbn13=9781742465869) - introductory Australian accounting textbook. ***Link Broken***
- Accounting I and II (http://www.textbooksfree.org/Financial%20Accounting%20Book.htm) - Concise review with practice set and quizzes.

6.2 SOFTWARE

Comparison of Famous Accounting Software (https://en.wikipedia.org/wiki/Comparison_of_accounting_software)

- List of free-of-charge Finance& Accounting software for real business world (http://www.freebyte.com/office/#accounting)
- MIT Sloan School of management Open courseware (http://ocw.mit.edu/courses/sloan-school-of-management/)
- A website for learning Financial Accounting (http://www.financial-accounting.us/)
- Accounting For Management (http://www.accountingformanagement.org/)