

ACCOUNTING AND BOOKKEEPING PRINCIPLES AND PRACTICE

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CHAPTER 1

INTRODUCTION

LEARNING OUTCOME

To gain background to accounting and bookkeeping principles and practice.

SAMPLE PAGES

CHAPTER CONTENTS

- A brief history of bookkeeping
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KEY TERMS

The key terms introduced in this chapter include the following:

- **Accounting entity**—a business having a separate identity from its owner.
- **Accounting equation**—Assets less Liabilities equals Equity.
- **Accrual concept of accounting**—transactions are accounted for at the time they are earned or incurred rather than when payment has been made.
- **Assets**—items owned by a business (for example, motor vehicles and trading stock).
- **Australian Accounting Standards**—specific accounting policies concerning a particular topic or industry related to businesses that are 'Reporting entities'.

- **Balance date**—the final date of the accounting period (for example 30 June)
- **Balance Sheet**—a statement of what a business owns: its assets; what the business owes: its liabilities; with the difference between assets and liabilities being the Equity of the owner in the business.
- **Capital**—part of the Equity, which is the owner’s investment in the business.
- **Chart of Accounts**—an index to all ledger accounts.
- **Double entry system**—where a transaction provides both a debit and a credit entry.
- **Drawings**—amounts of cash or inventories drawn out of the business by the owner. This is a reduction in Equity.
- **Equity**—the total investment in the business by the owner represented by assets less liabilities.
- **Expenses**—costs incurred in operating a business.
- **Legal entity**—the business is legally able to buy, sell and own property in its own name.
- **Liabilities**—items owed by a business to other parties (for example loans to a bank).
- **Reporting entity**—an organisation required by law to report its financial activities (for example, company reports to shareholders).
- **Reporting period**—the period covering a financial report. A full financial year is the period 1 July to 30 June.
- **Revenue**—the earnings of a business, mainly from sales of trading stock or fees for services.
- **Rules of double entry**—the double effect of each transaction on the five groups of accounts.
- **Sole trader**—a business owned by a single person.

Alternative terms

There are alternate terms in accounting to describe the same item. Some to be familiar with at this stage are:

Name used in this text	Also known as
Inventories	Trading stock or goods
Debtors	Accounts receivable
Creditors	Accounts payable
Revenue	Income

SAMPLE PAGES

A brief history of bookkeeping

As soon as records could be documented, thousands of years ago, wealth and taxes were recorded. Early writing on papyrus or stone showed the amount that tenants of wealthy landholders paid as taxes for living on the owner's land. Governments issued taxes and recorded receipt of the taxes and payments made for expenditure.

Bookkeeping is based on principles set in a text written in excess of five hundred years ago.

The double entry system of bookkeeping was first used by the merchants in Venice, Italy. A friar, Luca Pacioli, published a mathematics book in 1494. One chapter referred to the double entry system used by the merchants. He stated that for 'every credit there must be a corresponding debit' and also mentioned the merchants' use of journals, ledger accounts and a trial balance. Also stated was the separation of the five groups of accounts used today: the assets, liabilities, income, expense and capital accounts.

The text also referred to the 'cash' and 'accrual' methods of accounting.

Pacioli stated that a successful merchant needed three basic but important things to operate a business diligently:

1. a surplus cash fund and the availability of credit
2. the ability to arrange business transactions in debits and credits in an orderly way
3. to have the services of a 'sharp' bookkeeper.

Double entry bookkeeping was so simple that it was immediately adopted by businesses of that time and this strengthened the position of bookkeepers as important financial contributors to the industry. The principles of double entry bookkeeping continue today.

The nature of accounting

Our economic environment is one where the production and distribution of goods and services is primarily left to individuals or to a group of people. It is based on the principle that these entrepreneurs can own property and conduct their business with the view of making a profit from their efforts.

There are some exceptions to this. Institutions such as churches, hospitals, clubs, libraries, charities and some government enterprises operate to provide benefits to the community at large, rather than for the profit motive. However, all businesses need a system of planning and maintaining information about their financial affairs.

Definition of accounting

Accounting can be defined as providing *information* about *business organisations* to *interested parties*.

Information

The information supplied by an entity depends on the type of business and the needs of the interested parties, but it would include sales figures for the day, week or year; an analysis of the cost of manufacture of an item; a statement of profits for a given period; comparisons of actual with budgeted figures; a statement of what the business owns (its assets); and a statement of what the business owes (its liabilities).

Business organisations

Examples of business ownership include:

- *A sole trader (a single proprietor)*—ownership is vested in one party only. The sole trader is liable under law and is responsible for all of the business debts and usually has complete control of the business activities.
- *Partnerships*—two or more owners carrying on a business. The partners are responsible for the business debts in a ratio stated in the partnership agreement and with a legal position similar to that of a sole trader. Ownership of the business is shared. Each state has a Partnership Act. Examples of partnerships are lawyers, accountants, doctors and dentists.
- *Limited liability companies*—these are created by law and are regarded as separate entities from the persons who contribute the capital (the shareholders) or the persons who control the enterprise (the directors). There is limited liability for the business debts. Shareholders elect directors to act on their behalf in the conduct of the company. The *Corporations Law* states the information that must be supplied to shareholders and authorises the use of standards in accounting.
- *Co-operatives*—these are groups of people with similar interests and the members may be entitled to cheaper goods and services provided by the co-operative.
- *Clubs and societies*—generally the motive is not for profit, but to improve the facilities of the club or society, for the benefit of members.
- *Government, semi-government, local government and statutory authorities*—these entities provide services and some goods; however, there has been a tendency since the late 1990s away from government to private ownership (for example, share issues for larger former government organisations such as Telstra, the Commonwealth Bank and Qantas).

Interested parties

Those parties interested in the performance of a business include:

- owners, managers and shareholders for business performance and calculation of profit or loss
- tax authorities to assess the tax liability of the business
- investors to assess the business for investment potential
- auditors to ensure that internal controls are working effectively and to prepare audit reports where appropriate
- creditors to ensure that a line of credit is justified
- bankers to ensure that the business is a sound proposition for loans.

Try Exercise 1.1

Types of businesses

There are three main types of businesses:

- *Trading*—these businesses sell products and can be either wholesale or retail. A wholesaler operates between the manufacturer and the retailer. Retail businesses sell products to customers (for example, household goods, clothes, food and computers).
- *Service industries*—these businesses provide services to customers and include plumbers, electricians, dentists and doctors.

- **Manufacturing**—these businesses convert material and labour into finished products that are then sold to trading businesses.

Note

This book is mainly concerned with the activities of a sole trader buying and selling and goods or providing services.

Basic accounting principles

There are five basic accounting principles. These are outlined below:

1. *Principle of double entry*—each transaction is entered twice in the books of accounts. For every debit there must be a corresponding credit.
2. *Principle of recording*—all accounting entries emanate from a source document. This is the authority for entry into journals (and to the general and subsidiary ledgers).
3. *Principle of profit determination*—the life of a business is divided into time periods. Revenue and expenses from those periods can be matched to determine whether a profit or loss has been obtained.
4. *Principle of reporting*—accounting information is to be conveyed to a person without accounting knowledge in a clear, logical and understandable form. Examples are the Revenue Statement and the Balance Sheet.
5. *Principle of control*—accountants and bookkeepers must be constantly alert to ensure that the accounting practices minimise the chances of error and fraud.

Accounting entity

The accounting entity principle regards the business as a *separate accounting entity* from the owner.

If Jimmy Jones started a clothing retail store by investing \$20 000 cash into a bank account in the business name and bringing in \$8000 in value of clothing inventories for resale, this is viewed as involving both the business Jones' Clothing Store and Jimmy Jones personally. The business now has \$20 000 cash and \$8000 in value of inventories that it now owns.

An amount of \$28 000 is owed *by the business* to Jimmy Jones in a special account called 'Capital' (part of Equity) which comprises the difference between the assets and liabilities of the business.

This example will be further considered in the section on the Accounting Equation later in the chapter.

Legal entity

If the business is owned by a sole trader or by a partnership, even though the accounting concept is separated, the owner and the business are viewed as the same legal entity and, as such, are legally responsible for the debts of the business.

Reporting entity

Reporting entities are generally large businesses such as public companies, superannuation funds and government organisations that need to report their activities to a wide group of people; for example, to shareholders, to superannuation contributors and to the government. Australian Accounting Standards apply to these businesses.

Reporting period and the balance date

For taxation purposes the accounting year in Australia and the reporting period is a 12-month period from 1 July to 30 June. The balance date in this instance is 30 June each year.

In practice, businesses divide their accounting year into 12 monthly periods or 13 four-week periods. This is so that items such as cash flows and profits or losses can be ascertained and reviewed on a regular basis.

TUTORIAL

A

Accounting reports are to be prepared for the month of March. What are the dates for the accounting period and the balance date?

Accrual concept of accounting

Revenue and expense recognition

Accounting operates on the accrual concept where revenue is recognised *when it is earned* and expenses recognised *as they are incurred*, that is before cash is received or paid out.

Revenue

Revenue items are the earnings of a business such as proceeds from sales of trading stock, fees for services, interest received and rent received. Revenue is an inflow to the business and it is recognised and accounted for as soon as it is earned. For example, a sale of trading stock on credit will be entered into the accounts before the actual cash is received from the debtor. Other inflows may be straight cash transactions, such as rent or commission received.

Expenses

Expenses are the outflows of a business, such as the purchase of trading stock on credit. Expenses are recognised and accounted for as soon as they are incurred. Some expense items will be entered into the accounts before the actual cash is paid by the business to the creditor or the supplier. Other outflows are straight cash transactions, such as the payment of salaries, advertising, insurance and cash purchases of inventories.

Goods are sold on 30 April and paid for on 31 May. On what date is the revenue recognised?

B TUTORIAL

Operating cycle

A satisfactory cash flow is the lifeblood of any business. Items of trading stock (inventories) need to be purchased and converted into sales to generate cash flows (or the sale of services in a service business such as television repairs).

The process of the operating cycle is shown in Figure 1.1.

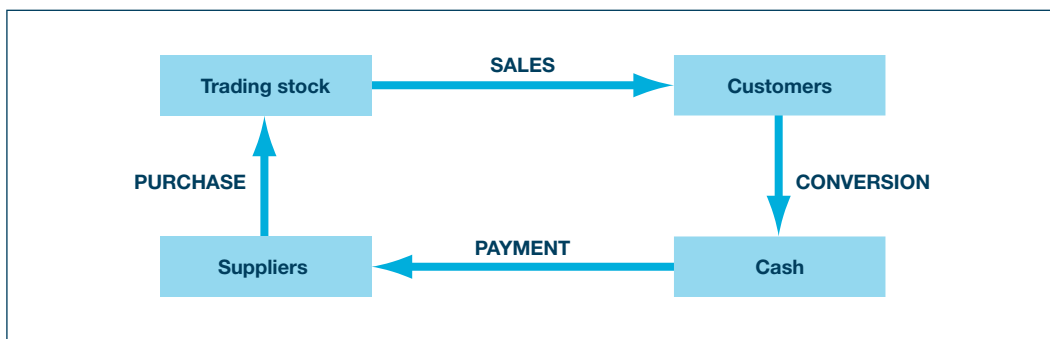


Figure 1.1 Process of the operating cycle

Five groups of accounts

It is very important to be able to distinguish between the five groups of accounts: Assets, Expenses, Equity, Revenue and Liabilities. An understanding of these groups leads into the essential learning tool, the 'rules of double entry', covered in Chapters 3, 4 and 5.

Definitions

- *Assets* are items of value owned/controlled by a business; examples are cash, inventories, buildings and motor vehicles.
- *Liabilities* are amounts owed to people or to organisations outside of the business; examples are amounts owed to Creditors control for purchases, or to a bank for a loan, overdraft or mortgage.
- *Equity* is represented by the business's assets less its liabilities (or the amount that the business owes to the owner). Equity is the amount originally invested in a business plus extra cash introduced, plus profits and less losses and drawings of cash or inventories from the business by the owner.
- *Revenue* items are the earnings of a business; examples are income from sales of trading stock, interest, commission, rent and discount received.
- *Expenses* are outflows from a business; examples are payment for wages or salaries, purchases of trading stock, payments for advertising, freight, motor vehicles expenses and discount allowed.

Note that the acquisition of some items may include more than one of the five groups. As an example, when a motor vehicle (an asset) is purchased for the business there is a capital cost, the price of the vehicle, and some associated costs that are needed to make the vehicle operational. These costs, such as registration fees and insurance, are expenses as they are recurring items.

Service costs for that vehicle would also be recorded as an expense of maintaining the asset. Another example is the purchase of a computer (an asset) but acquisition of additional software, depending on the value, may be an expense. Repairs to computer hardware equipment are an expense.

Inventories

Inventories are also known as trading stock or goods. Using the physical inventory system where stocktakes are usually performed annually, accounting for inventories can be simplified as follows:

- Opening inventories is the balance at the start of a financial year.
- Purchase of inventories for cash or on credit is an *Expense*.
- Sales of inventories for cash or on credit bring in *Revenue*.
- Closing inventories is the balance at the end of the year, which may have been determined by a stocktake at balance date; for example, 30 June.
- The value of inventories on hand, for example, trading stock in the shop for sale, at any time during a financial year is an *Asset*.

The asset value at the close of one financial year is the opening inventory figure for the next accounting year.

Illustration 1.1

Each of the following items is entered into the appropriate column of the five groups of accounts:

Inventories	Debtors control	Bank overdrawn
Machinery	Creditors control	Motor vehicles
Purchases of inventories	Rent paid	Discount revenue
Sales of inventories	Bank interest paid	Insurance
Capital	Bank interest revenue	Manager's salary
Net profit	Mortgage loan	Advertising
Sales salaries	Factory buildings	Furniture

Assets	Liabilities	Equity	Revenue	Expenses
Inventories	Creditors control	Capital	Sales	Purchases
Machinery	Mortgage loan	Net profit*	Bank interest revenue	Sales salaries
Debtors control	Bank overdrawn		Discount revenue	Rent paid
Factory buildings				Bank interest paid
Motor vehicles				Insurance
Furniture				Manager's salary
				Advertising

* Net profit for a small business is transferred to the owner's accounts.

Chart of Accounts

A Chart of Accounts is an index to the accounts in the general and subsidiary ledgers.

Ledger accounts are classified into the five groups of accounts. A Chart of Accounts is an index to place these five groups into an order, to assist in locating ledger accounts, which allows for the accounts to be easily accessed. Ledger accounts are covered from Chapter 5 onwards.

Illustration 1.2

1. Trading businesses

A Chart of Accounts for a trading business could have accounts organised into groups of 100, as shown below.

1–100	Assets	101–200	Liabilities
1	Cash at bank	101	Bank overdraft
2	Petty cash	102	Loan by mortgage
3	Debtors control	103	Creditors control
4	Plant and machinery	104	Income tax payable
5	Motor vehicles	105	Deductions suspense
6	Buildings	106	Accrued expenses
7	Inventories	107	Revenue in advance
8	Furniture and equipment	108	Credit cards
9	Prepaid expenses		
10	Accrued revenue		
201–300	Expenses	301–400	Revenue
201	Purchases	301	Sales
202	Purchases returns	302	Sales returns
203	Discount allowed	303	Discount revenue
204	Rent paid	304	Rent revenue
205	Commission paid	305	Commission revenue
206	Sales salaries	306	Interest revenue
207	Manager's salary		
208	Office salaries	401–500	Equity
209	Cleaning wages	401	Capital
210	Electricity	402	Net profit
211	Postage	403	Drawings
212	Advertising		
213	Bad debts	501–600	Goods and services tax (GST)*
214	Doubtful debts	501	GST input tax credits
215	Depreciation motor vehicles	502	GST collected
216	Motor vehicle expenses	503	GST clearing

* GST is explained in Chapter 2.

Posting to some of the ledger accounts in this group will be shown in Chapter 5.

continued ►

◀ *continued***Subsidiary ledgers***

	Debtors		Creditors
3.01	B. Black	103.01	A. Apple
3.02	W. White	103.02	B. Banana
3.03	G. Green	103.03	M. Melon
3.04	B. Blue	103.04	P. Pear

* These accounts are subsidiaries of accounts 3 and 103, above, and represent individual debtors and creditors, whose balances are reconciled in total with the control accounts. This topic is covered in Chapter 6.

2. Service industries

Businesses supplying services, such as plumbers, dentists, doctors, electricians, motor mechanics and white goods appliance services, would have a similar Chart of Accounts. The differences would be that material and supplies are in place of purchases, and fees are received instead of sales.

3. Computer accounting packages

Accessing a computer accounting package will reveal a very detailed Chart of Accounts, which can be very extensive.

Some accounts might have sub-categories; for example, 108 credit cards could be further divided as 108.01 Diners club, 108.02 Visa and 108.03 MasterCard.

For a garden centre, account 301 Sales, may be further broken down to 301.01 sales of flowers, 301.02 sales of plants, 301.03 sales of fertilisers, 301.04 sale of pots, 301.05 sale of hardware and 301.06 sale of giftware.

TUTORIAL**C**

In a large department store, for 100 employees, that sells women's wear, men's wear and electrical appliances, there is only one account for salaries and wages.

List or discuss the separate type of salaries and wages accounts that would be required for a Chart of Accounts for this store.

Accounting equation

Earlier it was stated that the accounting entity concept regards the business as a separate accounting entity from its owner. The formula for the Accounting Equation extends this concept.

The Accounting Equation is: *Assets* – *Liabilities* = *Equity*. In an abbreviated form this is $A - L = EQ$.

By simple transposition the Accounting Equation can also be shown as:

1. $Assets = Liabilities + Equity$ ($A = L + EQ$)
2. $Assets - Equity = Liabilities$ ($A - EQ = L$).

Try Exercise
1.4 to 1.7

Illustration 1.3

1. Jimmy Jones, who was introduced earlier, started a clothing retail business with \$20 000 cash and inventories for sale of \$8000. At that stage:

$$A\ 28\ 000 = EQ\ 28\ 000$$

continued ▶

◀ *continued*

2. If the next step was to purchase a computer from Computer Supplies for \$3000 payable in 30 days, then assets are increased and a new liability has been created:
 $A\ 31\ 000 - L\ 3000 = EQ\ 28\ 000$ (The amount of Equity is unchanged from step 1).
3. Shop fittings were purchased for \$2000 cash. Overall, there is no change to the accounting equation as one minus asset, cash, has been replaced by another asset, shop fittings:
 $A\ 31\ 000 - L\ 3000 = EQ\ 28\ 000$
4. Jones pays half of the amount owing to Computer Supplies by a business cheque = Assets \$1500 less cash and L \$1500 less liability owed by the business. The result of this is:
 $A\ 29\ 500 - L\ 1500 = EQ\ 28\ 000$
5. The owner wishes to draw out \$1000 from the business to pay a personal account: = A \$1000 less cash and EQ \$1000 less owed by the business to the owner.
 The final Accounting Equation is $A\ 28\ 500 - L\ 1500 = EQ\ 27\ 000$

Illustration 1.4

From Illustration 1.3, the final Accounting Equation can be shown as a simple form of a Balance Sheet:

Balance Sheet of Jimmy Jones' Clothing Store as at

Assets	\$	\$
Cash	15 500*	
Inventories	8 000	
Computer	3 000	
Shop fittings	<u>2 000</u>	28 500
/less Liabilities		
Creditor—Computer Supplies		<u>1 500</u>
		<u>27 000</u>
= Equity		
Capital	28 000	
/less Drawings	<u>1 000</u>	<u>27 000</u>

* Total cash paid out is \$4500:

- \$2000 shop fittings + half payment to Computer Supplies \$1500 + drawings \$1000
- Final cash balance \$20 000 less \$4500 = \$15 500.

The bookkeeper's main concern is that he or she must consider all transactions from the point of view of the business, rather than that of the owner.

Illustration 1.5

The accounting equation always applies no matter what business transactions occur. This analysis of a few transactions shows the effect on the Accounting Equation.

Transaction	Effect on the business	Effect on the Accounting Equation
Bought motor vehicle on credit	Asset (motor vehicle) increased Liability (creditor) increased	$A (+) - L (+) = EQ$
Paid off the bank loan account in cash	Asset (cash) decreased Liability (loan) decreased	$A (-) - L (-) = EQ$

continued ▶

◀ *continued*

Transaction	Effect on the business	Effect on the Accounting Equation
Owner paid in extra capital	Asset (cash) increased Equity increased	$A (+) - L = EQ (+)$
Owner withdrew cash from the business	Asset (cash) decreased Equity decreased	$A (-) - L = EQ (-)$
Owner paid some creditors from own private cash funds	Equity increased Liability (creditor) decreased	$A - L (-) = EQ (+)$
Bought plant for cash	Asset (plant) increased Asset (cash) decreased	No change $A (+) = A (-)$
Arranged bank overdraft to pay off part of Equity	Liability (bank) increased Equity decreased	$A - L (+) = EQ (-)$

TUTORIAL**D**

Equity of the owner is \$10 000 and assets are twice as much as liabilities. What is the value of the assets?

Effect of profit

The profit factor will not be considered in detail until later in this book, but at this stage a simple introduction is shown in the next Illustration.

Illustration 1.6

Refer back to Illustration 1.4:

- The entire inventories of \$8000 at cost, are sold at a 50% mark-up on cost, the selling price is \$12 000 and the full amount received as cash. This represents a profit of \$4000 and in the absence of any other expenses, this amount will be transferred to the owner.
- This means that the amended final Accounting Equation of $A \$28\,500 - L 1500 = EQ 27\,000$, as shown in Illustration 1.3, is changed.
- The Assets of \$28 500 are now minus the inventories cost of \$8000 but there is an extra \$12 000 in cash = \$32 500 amended assets, less the Liabilities still owed of \$1500 = Equity opening balance \$27 000 + profit \$4000 = \$31 000.
In summary, the amended Accounting Equation is $A 32\,500 - L 1500 = EQ 31\,000$.

Note

This Illustration is only used to show the effect of profit. In practice any net profit or loss from total revenue less total expenses will be transferred to the owner at the end of an accounting period or financial year, rather than after each individual transaction.

Extended Accounting Equation to include revenue and expenses

Once a business commences it will start earning revenue, primarily from the sale of trading stock or services, and incur expenses, for the purpose of earning revenue, such as purchases of trading stock, rent and salaries. Expenses relate to the cost of earning revenue in the running of a business and are not used for acquiring assets.

When revenue is matched with expenses a profit or loss occurs. Profit calculation is covered in detail later in this book.

These items can now be added to the Accounting Equation as:

$$A - L = EQ + R - E$$

Illustration 1.7

- Just before the end of a financial year a business Accounting Equation shows:
A \$200 000 – L \$75 000 = EQ \$125 000
 - During the year the business has earned cash revenue of \$150 000 with cash expenses of \$80 000. The difference represents a profit of \$70 000. Liabilities are unchanged.
 - In the absence of any owner's drawings, the revised equation will be:
A \$200 000 + excess cash of \$70 000 = A \$270 000 – L \$75 000 = EQ \$195 000.
- In this simplified example, Assets have increased by \$70 000 cash and Equity increased by the same amount for the profit.

Equity (before any profits) is \$20 000, Liabilities \$5000 and net profit \$2000. What is the value of the business assets?

E TUTORIAL

The Balance Sheet

The Balance Sheet contains a business's assets minus the liabilities, to equal the amount invested in the business by the owner, known as the owner's Equity.

This Balance Sheet is prepared as at a particular date (for example, 30 June) and it could be different if prepared at the close of business on the next day (for example, on 1 July, a motor vehicle could have been bought for cash, thus changing the asset distribution).

Illustration 1.8

B. Nana, a greengrocer, has the following assets and liabilities as at 30 June. They are shown in a Balance Sheet and the final Equity balance is calculated, based on the Accounting Equation $A - L = EQ$.

	\$		\$
Shop fittings	18 000	Bank overdraft	10 000
Delivery vehicle	28 000	Refrigeration equipment	7 000
Debtors control	4 400	Inventories for sale	8 600
Creditors control	6 000		

continued ►

◀ *continued***Balance Sheet for B. Nana as at 30 June**

Account	\$	\$
Assets		
Shop fittings	18 000	
Delivery vehicle	28 000	
Debtors control	4 400	
Refrigeration equipment	7 000	
Inventories	<u>8 600</u>	66 000
less Liabilities		
Creditors control	6 000	
Bank overdraft	<u>10 000</u>	<u>16 000</u>
equals Equity		<u>50 000</u>

$$A \$66\,000 - L \$16\,000 = EQ \$50\,000$$

The concepts of a Balance Sheet are only briefly introduced at this stage. More detailed information is contained in Chapter 15.

Discounts

Discounts are mentioned in the Exercises. They are associated with the payment of creditors' accounts by the business, or the receipt of monies from debtors owed to the business.

To aid cash flow, which is very important for the continuation of a business, it is useful to offer an amount of discount, say, 2.5% on an account balance owing for payment of that amount within, say, seven days rather than waiting the usual 30 to 40 days for payment.

When received or paid, the discount amount is deducted from the balance owing before the payment is made or cash received.

- 'Discount allowed' is for receipts from debtors (who owe money to us) and is an expense to the business.
- 'Discount revenue' is from creditors (to whom we owe money) for early payment and earns income for a business.

These discounts are not related to a discount on the normal retail selling price of an item during a store 'sale'.

Accrual concept references

As mentioned earlier bookkeeping and accounting refer to the process of reporting on and interpreting the results of business transactions.

The accrual basis assumes that transactions are accounted for at the time they are earned (for example revenue for sales), *or when they are incurred* (for example expense of purchasing trading stock), rather when the cash is received or paid.

The sales of trading stock on credit, for example, are counted as revenue at the time of the sale, even though the account may not be paid until 30 or more days later.

Chapter 3 introduces the 'credit' journals, and in Chapter 6, sales and purchases on credit are included in subsidiary ledgers. In Chapter 14, General journal entries are used to account for 'balance day adjustments'.

Accounting Standards

The purpose of a Standard is to:

1. prescribe concepts that guide the selection, application and disclosure of accounting policies
2. require specific disclosure to be made in relation to the accounting policies adopted in preparing and presenting financial reports.

Accounting Standards promulgate specific accounting policies concerning a particular topic or industry. Existing Standards are regularly updated and new ones formulated. Accounting Standards increase the value of information shown in financial statements by:

- improving the quality and uniformity of reporting
- standardising accounting practice
- compelling members of the accounting profession to apply them
- having an avenue to cope with the changing accounting environment
- adding to and consolidating accepted conventions and doctrines.

These Standards, enforced by the *Corporations Law*, generally apply to reporting entities, for example, companies that are required by law to prepare general purpose financial reports. This does not apply to the one-owner business, which we are considering in this book, although the principles of Accounting Standards are expected to be incorporated in the accounting for all businesses.

Australian Standards based on International Accounting Standards were adopted in Australia from financial years beginning on or after 1 January 2005. For a full list of Australian Accounting Standards visit the website www.aasb.com.au or insert 'Australian Accounting Standards Board' in your search engine.

Accounting reports for internal and external use

The accounting system for a sole trader must give an assurance to managers that it can supply sufficient information to allow them to perform their tasks to the optimum benefit of the organisation.

Some of the internal reports include:

- sales figures for the day, week, month and year
- analyses of expenses in different classifications
- budgets for expected results
- reports on variations from the budget
- ratio and ratio analysis
- statements of cash flows
- profit and loss analysis
- stocktakes and controls over stock
- branch reports

- production reports and reviews
- asset registers and controls
- reviews of Debtors and Creditors balances.

Financial statements

The 'Income Statement', also known as the 'Revenue Statement', is a summary of inventory, revenue and expenses accounts but is not shown in debit/credit form. It is a summary of results over a period of time (for example 1 July to 30 June). The Statement is presented in this book in a 'down the page' format that is easy to read for anyone without accounting knowledge. Expenses are classified in a way that facilitates comparison of results from current or earlier accounting periods.

The 'Balance Sheet' is a statement of all assets and liabilities held by a business as at a specified date (for example 30 June). This statement also shows the amount owed to the owner and is in the form of the accounting equation (covered earlier): Assets less Liabilities equals Equity and can be classified between 'current' (under 12 months) and non-current items (in excess of 12 months).

Both Financial Statements are used internally within a business (for example for a sole trader) and externally for the Australian Taxation Office, by banks if loans are required and by suppliers extending credit to the business.

Financial Statements are covered in Chapter 15.

For companies, both statements would also be used for reports to shareholders and other interested parties.

Design of an accounting system

Accounting reports are prepared for internal purposes as a management tool to aid decision making and for external purposes to disclose to interested parties the financial affairs of the business. So the design must cater for a wide variety of needs.

The system must be able to comply with government requirements, such as those for the Australian Taxation Office and WorkCover, and must be presented in a way that shows the business financial position for the information of outsiders, such as banks and creditors, as well as for the needs of management.

Stages in the design for both a manual or computerised accounting system include:

1. collecting input information, including source documents
2. recording transactions in journals, ledgers and extracting a Trial Balance
3. producing financial reports and statements
4. producing information for use internally to better control and optimise the business potential
5. storing of information for future reference; for example, for auditing purposes, the Australian Taxation Office requires data to be available for the past five years, and also for comparing results with previous accounting periods.

The main factors to be considered in the design of an accounting system are:

- what the business does
- the type of product or service given

- the location—whether the business is all in one place or has branches
- whether the business is a sole trader, partnership, club or company
- the information required by the owner or owners
- the information required by outsiders (for example, banks, accountants, auditors)
- the type of information processing (manual or computer)
- the effect of the law (for example taxation and the *Corporations Law*).

Internal controls

Built into the design is the need for internal controls to be inherent in the accounting system. Examples are:

- prescribing accounting procedures in writing, including control over documents so that staff have a clear understanding of the procedures
- a clear allocation of staff responsibilities
- control by two staff over the receipts and banking of monies, the issuing of cheques or bank transfers
- controls in place to safeguard the most negotiable of assets—cash—including controls over calculations and payments of salaries, wages and petty cash
- a system to safeguard the valuable assets of a business, including trading stock
- rotation of staff, so that tasks can be shared and separated
- internal checks made on a regular basis by responsible staff to ensure that the internal controls are operating satisfactorily.

The internal controls over cash are considered in Chapter 9.

Identify and discuss, from your own practical knowledge, the possible benefits to be derived from computerising an existing manual accounting system.

F TUTORIAL

Flowchart of accounting transactions into accounting records

The flowchart shown in Figure 1.2 shows the outline of information that will be considered, with practical examples, in Chapters 3 to 7 of this book.

SAMPLE PAGES

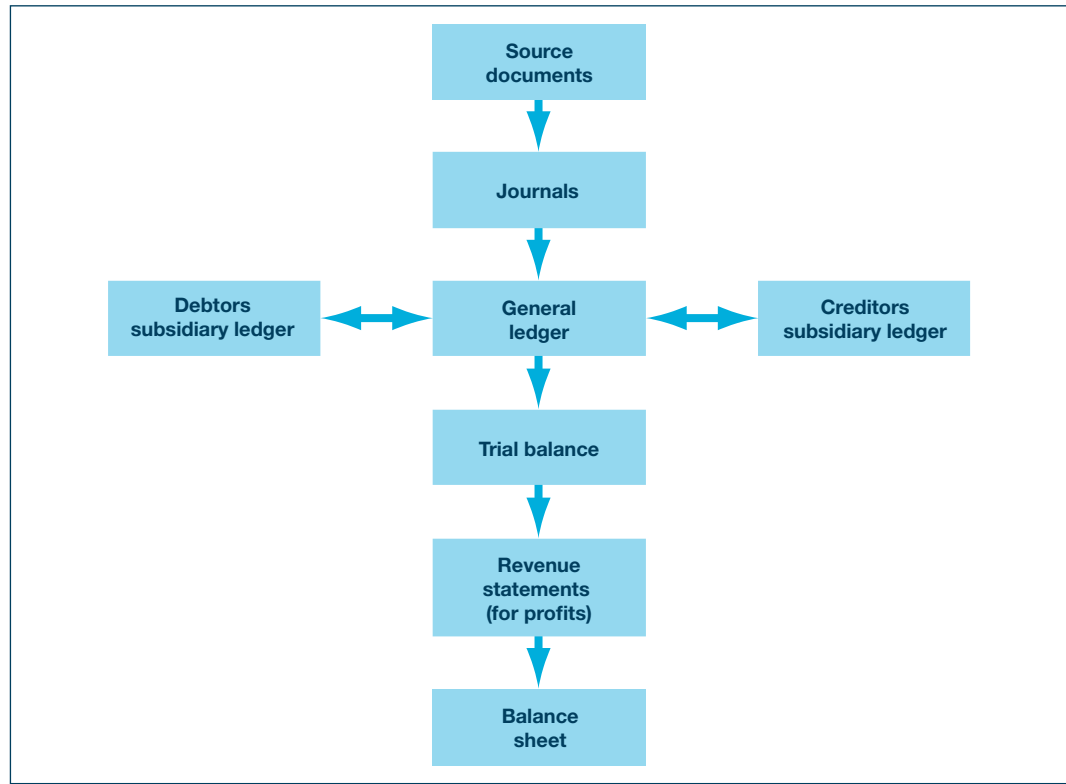


Figure 1.2 Flowchart of transactions into accounting records

Finish with the Multiple choice questions and Exercises 1.8 to 1.10

ANSWERS • TUTORIALS

- A** The accounting period is 1 to 31 March and the balance date is 31 March.
- B** The revenue is recognised on 30 April under the accrual system of bookkeeping.
- C** There would need to be separate salaries accounts for at least the groups of women's wear, men's wear, the electrical section and for the administrative and management salaries. Then costs could be allocated direct to the different areas of the business.
- D** Assets of \$20 000 – Liabilities of \$10 000 = Equity of \$10 000.
- E** Revenue less expenses = a \$2000 profit added to Equity. Assets \$27 000 – Liabilities of \$5000 = Equity of \$22 000.
- F** Benefits for a business could include: quick access to information; standardised following of an accounting package; cost savings; better availability of information to help staff with decision making; ability to link to the bank record, facilitating bank reconciliations; easier comparison of previous years' data to assist budgeting, sales analyses and automatic preparation of BAS for tax instalments and GST payable to the Australian Taxation Office.

TEST YOUR LEARNING

Insert your answers into the workbook.

✓ Multiple choice questions

- 1** Olive started a business with cash of \$30 000. She purchased inventories on credit for \$15 000 and for cash \$5000. She purchased a computer with a bank loan for \$4000.
What is the value of her Equity at this time?
- (a) \$25 000
(b) \$30 000
(c) \$45 000
(d) \$50 000
- 2** Janette wants to find what portion of the business that she owns. Her asset and liability accounts show: Cash \$1000, Motor vehicle \$25 000, Plant \$3000, loan to the business by a bank \$20 000, Inventories \$10 000, Debtors \$5000 and Creditors \$2000. The Equity of the owner is:
- (a) \$20 000
(b) \$22 000
(c) \$24 000
(d) \$26 000
- 3** Assets totalled \$15 000, Liabilities \$2000 and Equity \$13 000. Inventories were purchased for \$10 000 on credit. An asset was sold for \$5000 cash and the owner drew \$500 cash out of the business. The Accounting Equation is:
- (a) $\$25\,000 - L\ 10\,000 = EQ\ 15\,000$
(b) $\$20\,000 - L\ 10\,000 = EQ\ 10\,000$
(c) $\$19\,500 - L\ 12\,000 = EQ\ 7500$
(d) $\$24\,500 - L\ 12\,000 = EQ\ 12\,500$
- 4** A listing of all ledger accounts in a numbering or alpha numerical system is called a:
- (a) Numerical index
(b) Chart of Accounts
(c) Title index
(d) Balance index
- 5** Jim purchases TV sets as inventories from Egbert, payable in seven days. Using the rules of double entry, which is correct?
- (a) Assets increased— Liabilities increased
(b) Expenses increased—Liabilities decreased
(c) Assets decreased— Liabilities increased
(d) Expenses increased—Liabilities increased
- 6** Assets total \$20 000 and Equity is 40% of assets. The liabilities are:
- (a) \$6800
(b) \$7000
(c) \$12 000
(d) \$23 800
- 7** Interest paid by a business on a bank loan is:
- (a) An asset
(b) An expense
(c) A liability
(d) Revenue
- 8** An asset, plant, was sold on credit for \$5000. What is the effect on the Accounting Equation? The value of assets is:
- (a) Increased
(b) Decreased
(c) Unchanged
(d) None of the above
- 9** When the owner contributes more money to the business, the Equity is:
- (a) Increased
(b) Decreased
(c) Unchanged
(d) None of the above
- 10** Complete the following sentence. An owner, as a sole trader, is distinct in accounting terms from the business, but both are viewed as having the same entity.
- (a) Reporting
(b) Legal
(c) Ownership
(d) Accounting

E Exercises

Exercise 1.1

State three advantages and three disadvantages of being a sole trader compared with a partnership of two or more persons.

Exercise 1.2

For a sole trader, briefly explain the difference between a business being an accounting entity and a legal entity.

Exercise 1.3

Explain the accrual concept of accounting.

Exercise 1.4

- (a) Jan Smith has \$5000 worth of assets but owes \$3000. Write the value of her Equity in the workbook.
 (b) Peter Prune has a balance of Equity of \$6000, with assets totalling \$15000. How much are his liabilities?
 (c) Hattie Hen has an Equity balance of \$1000 but she owes \$6000. What is the value of her assets?

Exercise 1.5

In the table in the workbook, insert in the right-hand column A for asset, L for liability, R for revenue, E for expenses and EQ for Equity.

Exercise 1.6

Insert 'A' or 'L', for the items in the workbook for C. Crumb, the baker, and advise him of the extent of his Equity in the business.

Exercise 1.7

Part A: Enter into one of the five headings shown in the workbook, each of the following items:

Discount allowed	S. String, a creditor
sales of trading stock	bank interest paid
manufacturing plant	commission revenue
capital investment by the owner	discount revenue
insurance	bank interest revenue
motor vehicle	bank overdraft
motor vehicle expenses	rent paid
rates and taxes	mortgage loan
stationery expenses	freight charges
A. Archer and B. Bow, both debtors	advertising
purchases of trading stock	cash in the change float
furniture	a five-year loan from the bank
drawings by the owner	

Part B: Prepare a Chart of Accounts using the above information starting each group at Assets 101, Liabilities 201, Expenses 301, Revenue 401 and Equity 501.

Exercise 1.8

Part A: Complete the table in the workbook for the Accounting Equation.

Part B: Prepare a Balance Sheet from the information in Part A after completing the last transaction.

Exercise 1.9

The Accounting Equation at the start is Assets \$30 000 – Liabilities \$15 000 = Equity \$15 000.

Using the abbreviation $A - L = EQ$, show in the workbook the amended Accounting Equation and the cash balance after each transaction.

Exercise 1.10

Arrange the following items into a Balance Sheet in the workbook and show separately the final Accounting Equation.

Account	Amount (\$)
Cash on hand	500
Bank overdraft	11 000
Inventories	20 000
Plant and machinery	25 000
Debtors	14 000
Mortgage loan	30 000
Computer system	7 500
Creditors	9 000
Motor vehicle	23 000
Office furniture	5 000