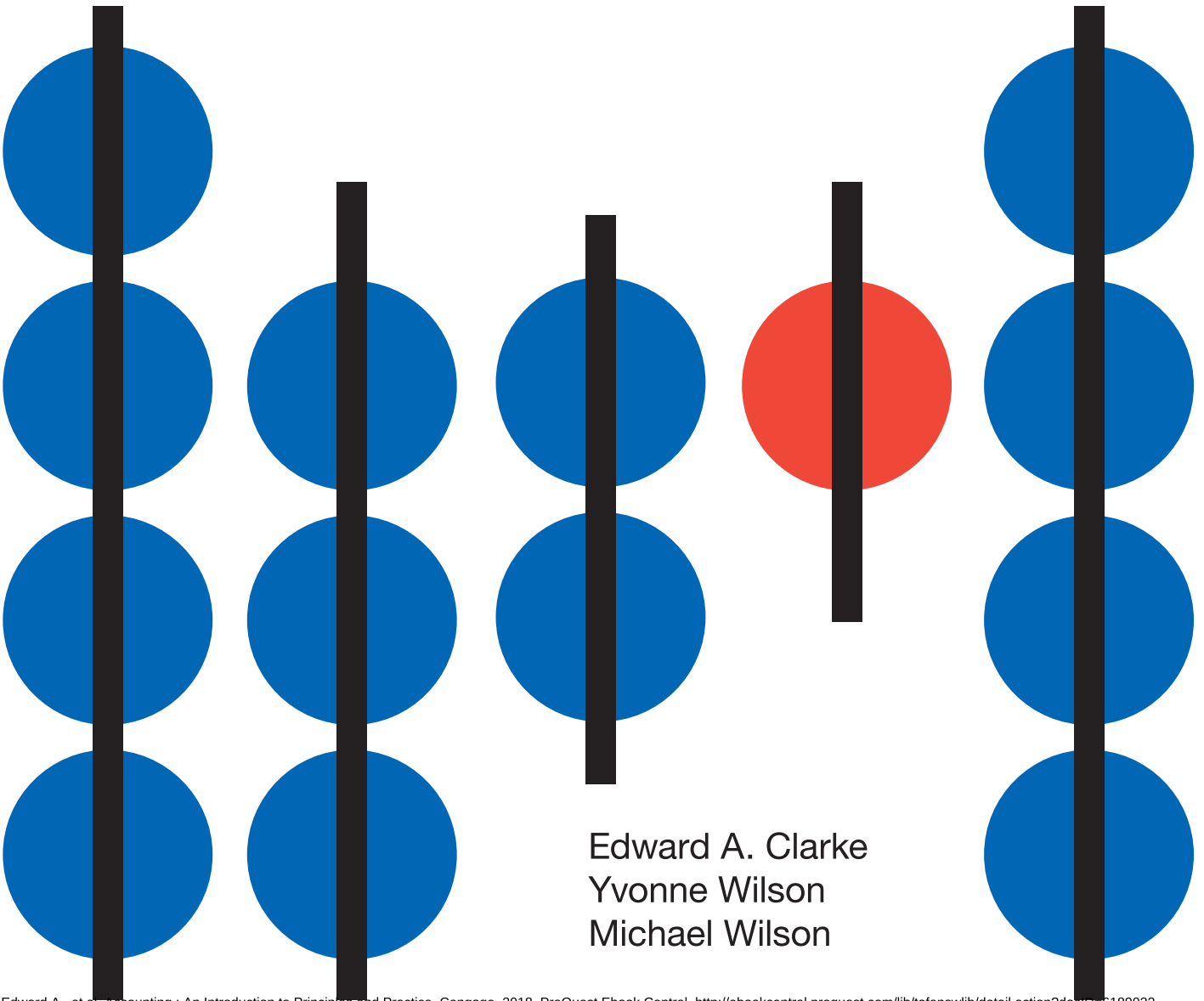


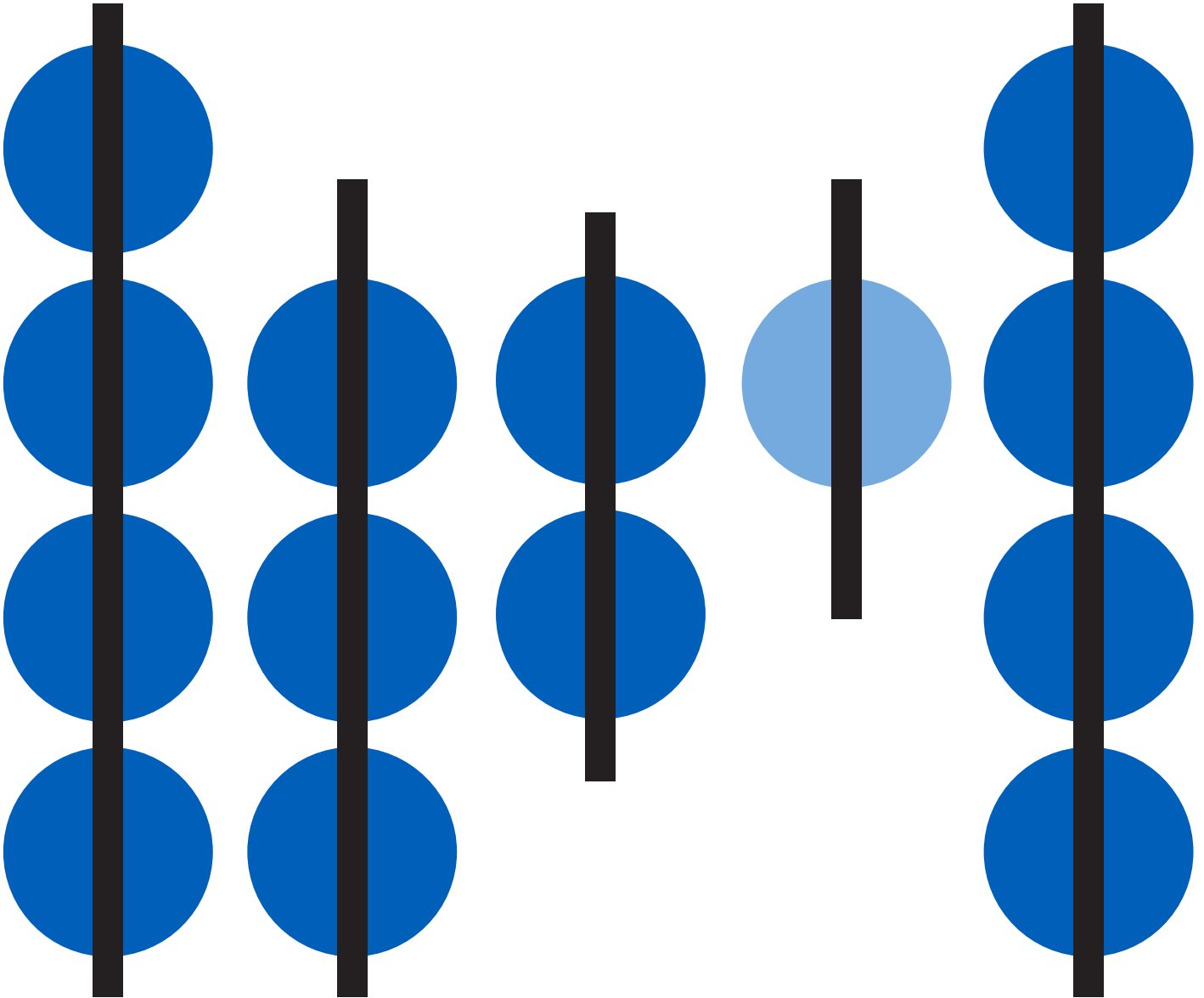
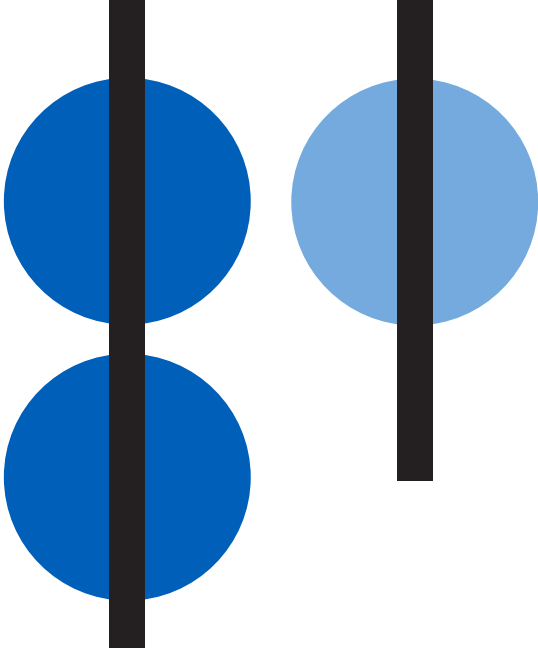
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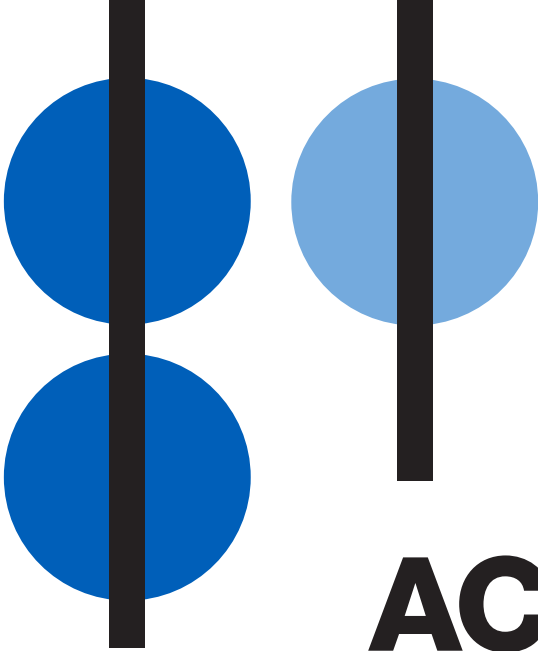
An Introduction to
Principles & Practice



Edward A. Clarke
Yvonne Wilson
Michael Wilson

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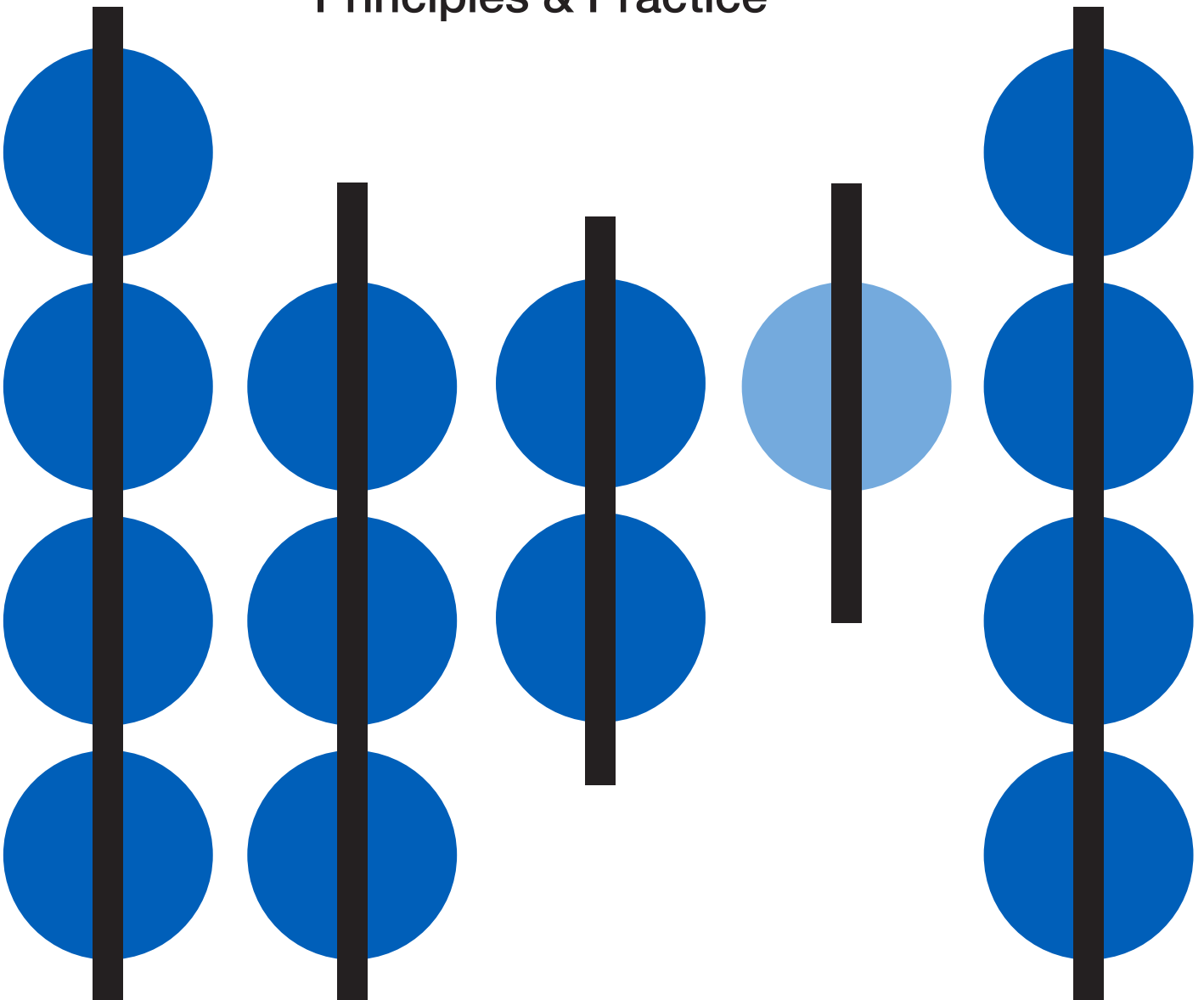




Edward A. Clarke
Yvonne Wilson
Michael Wilson

ACCOUNTING^{9E}

An Introduction to
Principles & Practice



Accounting: An Introduction to Principles and Practice
9th Edition
Edward A. Clarke
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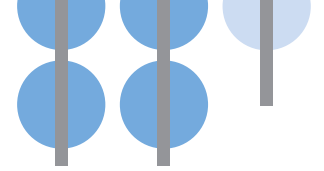
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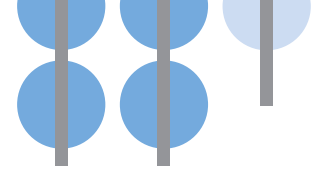
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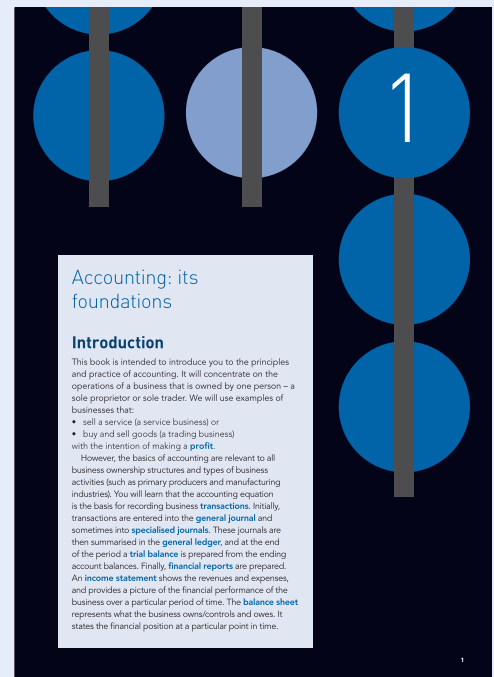
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Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of accounting, helping you to understand how the theory is applied in the real world.

CHAPTER-OPENING FEATURES

The introduction to each chapter provides a simple overview of the concepts the content covers and the specific accounting skills and knowledge you are required to achieve.



FEATURES WITHIN CHAPTERS

Important concepts that apply throughout a section are highlighted in the **Keep in mind** boxes.

Questions appear throughout the chapter to help you apply and test your understanding of the key topics as you go.

Worked **examples** demonstrate how to apply accounting principles in practice.

KEEP IN MIND

The users of a business's financial reports need information that is relevant and a faithful representation of the business's activities. The reports should have further qualitative characteristics: comparable, timely, verifiable and understandable.

QUESTION 3.3

You are required to complete the accounting equation formats shown in the Workbook where a business commenced with:

- assets of cash at bank \$12 000, motor vehicle \$25 000 and owner's equity \$37 000
- assets of cash at bank \$8000, machinery \$20 000 and office equipment \$10 000
- cash at bank \$5000, office equipment \$30 000, motor vehicle \$20 000 and inventory \$5000, and a liability of a loan \$10 000
- cash at bank, a liability of a loan from D Shark \$25 000 and owner's equity \$50 000.

Example 2: Stephanie's Fabrics and Materials – trading business and the general journal

- On 1 August 2022 Stephanie formally commenced business with \$5000 in the bank and an inventory of materials valued at \$1500.
- On 3 August 2022 Stephanie used her new debit card from the bank to purchase various bolts of material (various lengths of material rolled around a cardboard cylinder or rectangle) for \$880 (\$800 + \$80 GST). She purchased other material on credit from Gillian's Fabrics \$495 (\$450 + \$45 GST).

END-OF-CHAPTER FEATURES

At the end of each chapter you will find several tools to help you to review, practise and extend your knowledge of the key learning outcomes.

Revision questions reinforce and test your knowledge of the material covered in the chapter.

REVISION QUESTIONS

Confirm your understanding of this chapter by completing the following questions.

QUESTION 3.21

You are required to complete the figure in the Workbook for this question. Allocate the accounts into their account group including their sub-classification where necessary. Identify whether the account is normally debit [dr] or credit [cr] and allocate an account number as appropriate.

Accounts Payable	Electricity	Petty Cash
Accounts Receivable	Interest	Premises
Advertising	Interest Received	Rent Received
Bad Debt Expense	Inventory	Salaries
Bank Overdraft	Investment in Shares	Sales
Capital	Long-term Loan	Stationery
Cartage Inwards	Motor Vehicles	Telephone
Dividends Received	Office Equipment	Vehicle Expense

REVISION QUESTIONS

Confirm your understanding of this chapter by completing the following questions.

TIME LINE REMINDER

You are reminded that the time line is a tool to assist you in obtaining the correct answer to depreciation questions. It is not meant to be a work of art; it is your rough working. A time line solution will be given as part of the total solution for the following questions, but there will be no requirement given in the question. The depreciation worksheet is also a tool to help in depreciation calculations and the values are actually recorded in the relevant columns of the asset register.

QUESTION 13.42

On 15 September 2021, Bendigo Fabricating purchased for cash from Battenfeld Importers a BF767 Multi-Ripple metal folding machine for \$30 800 (\$28 000 + \$2800 GST). Delivery and installation costs were included in the price.

The new machine was commissioned on 1 October 2021. It is depreciated at 15% straight line, as past experience indicated that it should be operational for seven and a half years. The residual value was nil, as the amount was immaterial.

An upgraded larger feeding and extraction mechanism, BFM3.5, was obtained from Battenfeld Importers for \$8800 (\$8000 + \$800 GST) to enhance the capability of the BF767. It was delivered and installed as part of BF767. Depreciation is to remain at the same rate. Payment was made on the commissioning date of 1 February 2023.

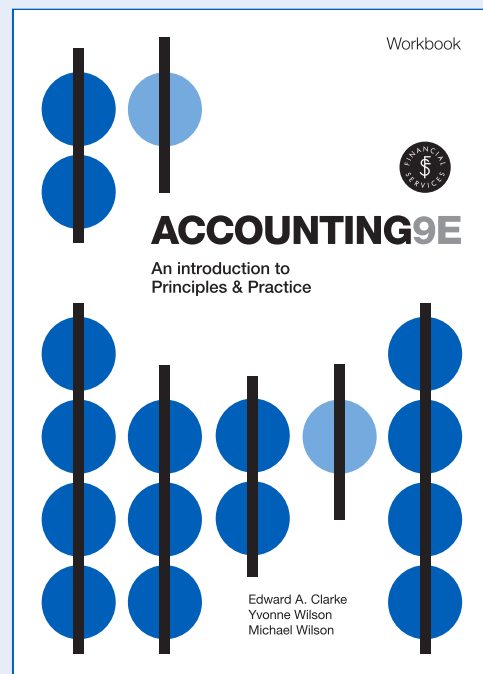
On 31 May 2025 the entire equipment was traded in for \$16 500 (\$15 000 + \$1500 GST) on a new digitised hydraulic multitasked folding machine from Battenfeld Importers.

Prepare an asset register record for the life of the machine (assume appropriate account and serial numbers).

WORKBOOK

The workbook for this new edition is structured to be used in combination with the student book, providing consistent and professionally presented solution templates for each question in the chapter.

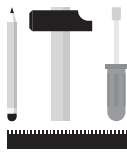
Microsoft Excel™ versions of the answer templates are available online for selected questions via CourseMate Express (see the Guide to the online resources — For students).



Guide to the online resources

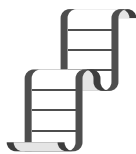
FOR THE INSTRUCTOR

Cengage is pleased to provide you with a selection of resources that will help you prepare your sessions and assessment plans. These teaching tools are accessible via cengage.com.au/instructors for Australia or cengage.co.nz/instructors for New Zealand.



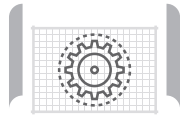
SOLUTIONS MANUAL

The **solutions manual** provides detailed solutions to every question in the text.



POWERPOINT™ PRESENTATIONS

Use the chapter-by-chapter **PowerPoint slides** to enhance your lecture presentations and handouts by reinforcing the key principles of your subject.



MAPPING GRID

The **intermediate mapping grid** is a simple tool that shows how the content of this book relates to the units of competency needed to complete FNS30317 – Certificate III in Accounts Administration and FNS40217 – Certificate IV in Accounting and Bookkeeping.



ARTWORK FROM THE TEXT

Add the **digital files** of graphs, tables, pictures and flow charts into your learning management system, use them in student handouts, or copy them into your lecture presentations.



ADDITIONAL QUESTIONS

Use **additional questions** in your assessment materials or assign them as homework or as an extension activity. Full answers are provided.



WEBLINKS

Use weblinks to research additional learning resources online and extend your students' understanding of complex topics

FOR THE STUDENT

New copies of the accompanying workbook come with an access code that gives you a 12-month subscription to the **CourseMate Express** website. Visit <http://login.cengagebrain.com> and log in using the access code card.

OR

Visit the *Accounting: An Introduction to Principles and Practice* student companion website. You will find:

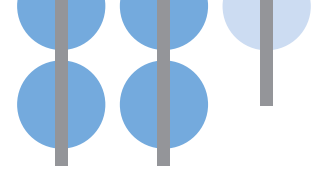
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Digital workbook templates

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PREFACE

When preparing for the first edition of this book from December 1989, technology and electronics were very different from today. At the time, many businesses used manual accounting systems. Computerised accounting systems were very basic and expensive.

In the intervening years, the business and accounting world has been ‘turned up-side down’ with computers and electronic processes that include cloud-based accounting software and storage facilities. Communication choices are considerable and have become inexpensive. Electronic devices including cards and phones may be used as means of payment. Cash money and cheques are being used less, as new technologies are developed and accepted. Technological developments continue to change payment systems at a rapid pace.

The ninth edition of this book includes some of these ongoing major developments in the way business is transacted.

This new edition includes the following features:

- The first chapter has been reduced in size and complexity to concentrate on the broad concepts of recording and reporting business transactions.
- A new second chapter incorporates the second half of chapter one in the 8th edition. It includes diagrams to demonstrate electronic forms of documentation and transfer of funds. The importance of thorough authorisation and checking procedures to verify the accuracy and authenticity of a transaction is also incorporated in diagrams and throughout the chapter.
- Further links are developed between manual accounting and computer accounting systems.
- The number of closing journals entries for end of year accounts has been reduced. Students should understand the principles behind the process but not be expected to complete excessive numbers of closing journal entries and general ledger postings.
- The emphasis on service industries has been enhanced throughout book. Service industry questions have been expanded, but financial reporting has been limited to basic income statements reporting to avoid undue complexity.
- Worksheets have been significantly upgraded as the need for having a ‘trading’ account has been incorporated into the profit and loss. This has reduced the worksheet process to an 8-column worksheet. The 6-column worksheet has been removed to place more emphasis on learning to prepare financial reports.
- The payroll chapter has been updated in line with current minimum wage rates. The 2017–18 income tax rates are used, being the most current at the time of updating the book.
- The exposition of the principles and methods is supplemented with clear, worked examples. This textbook is accompanied by CourseMate Express, a Cengage online platform that includes fully worked solutions to all even-numbered questions, and a soft copy of the workbook and additional templates in Excel format.

The ninth edition of *Accounting: An Introduction to Principles and Practice* supports compliance with the VET Quality Framework and the Financial Services Training Package (Release 3.0). It covers several core and elective units in the Accounting and Bookkeeping qualifications and skills sets. It is designed for use by students studying at TAFE and other tertiary education providers. It also continues to be very useful reading for university students studying introductory accounting.

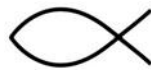
ACKNOWLEDGEMENTS

We – Yvonne, Michael and Ted – have appreciated the opportunity to combine our efforts in writing this ninth edition of your accounting book. It is our hope and trust that it will help you to understand and be able to apply the processes of accounting in your studies and career, in whichever direction it takes you.

Our thanks are due also to colleagues across Australia, and particularly in TAFE NSW, for feedback on the previous editions. We have noted your comments and hopefully have included some of the recommendations that you have made. We acknowledge and are grateful for the contribution you have made to this book. The invaluable contribution of Diane Fowler, the editor of the book, is also acknowledged by Ted, Yvonne and Michael. Diane's guidance and dedication throughout the process has been greatly appreciated.

Edward A. Clarke
Yvonne Wilson
Michael Wilson

To special friends:



Very special thanks continue to Peggy, Ted's friend, wife and confidante, who continues showing kindness, love and understanding as we journey together.

Thanks also go to all those friends who have contributed to our many wonderful life experiences down on the farm at Glenreagh.

Edward A. Clarke
Glenreagh NSW

Accounting: its foundations

Introduction

This book is intended to introduce you to the principles and practice of accounting. It will concentrate on the operations of a business that is owned by one person – a sole proprietor or sole trader. We will use examples of businesses that:

- sell a service (a service business) or
 - buy and sell goods (a trading business)
- with the intention of making a **profit**.

However, the basics of accounting are relevant to all business ownership structures and types of business activities (such as primary producers and manufacturing industries). You will learn that the accounting equation is the basis for recording business **transactions**. Initially, transactions are entered into the **general journal** and sometimes into **specialised journals**. These journals are then summarised in the **general ledger**, and at the end of the period a **trial balance** is prepared from the ending account balances. Finally, **financial reports** are prepared. An **income statement** shows the revenues and expenses, and provides a picture of the financial performance of the business over a particular period of time. The **balance sheet** represents what the business owns/controls and owes. It states the financial position at a particular point in time.

Introduction to business operations

It is usual for introductory accounting texts to demonstrate the principles of accounting through a sole trader ownership structure: that is, a business owned by one person who may employ other people. The examples we will examine include trading and service businesses that buy and sell goods and/or services.

SERVICING BUSINESS

A **servicing business** mainly sells its knowledge or skills at a profit. Examples of service businesses operated by sole proprietors may include vehicle maintenance and repair, building construction and renovations, repair, installation and restoration of electrical or electronic products. Businesses that provide professional services such as accounting, legal, veterinary, medical and dental practices as well as travel and accommodation may also be operated as sole proprietors.

TRADING BUSINESS

A **trading business** generally buys goods in large quantities (in bulk) and sells the products in smaller quantities, at a profit. Buyers purchase these goods for their individual or business use or consumption. A petrol station buys many thousands of litres of petrol and diesel at a bulk price and sells them to individual motorists, who drive in to fill up the tank of their car or truck. The petrol station does nothing to the petrol or diesel. A stationery shop buys paper, pens, pencils and many types of folders and sells the products or goods in smaller quantities. Other examples may include greengrocers and clothing retailers. 'Retailer' is another term used for businesses that buy and sell goods directly to the public.

COMBINED SERVICE AND TRADING BUSINESS

Some businesses may provide a combination of services and trade, such as a car dealership that sells cars, provides maintenance services on the cars it has sold, and also sells spare parts. As well as its core business of plumbing services, a plumber may also sell kitchen, laundry and bathroom fittings and provide installation services for these items.

Can you identify businesses in your area that operate as sole traders and are service providers, traders or both?

Departments or functions within a business

More complex businesses might have a number of departments or sections that are responsible for different functions, including the following:

- **purchases:** buying goods and/or services for the business
- **receiving:** accepting deliveries of goods that have been purchased by the business
- **warehouse:** holding or storing goods before sale or use by the business
- **sales:** selling goods to various customers
- **despatch:** sending or delivering out goods that have been sold to customers
- **accounting:** recording and reporting financial transactions related to the business
- **human resources (personnel) and payroll:** employing and paying employees for their services.

Some departments, such as receiving and warehouse, will often interact with each other. All departments, however, will interact with accounting as well as indirectly through accounting to each other (see figure 1.1).

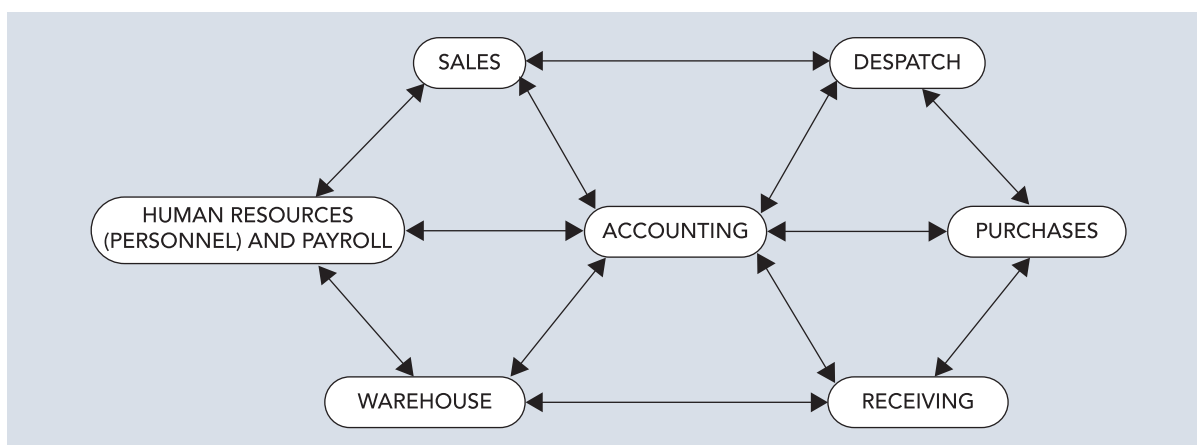


FIGURE 1.1 Interactions between departments or sections within a business

These interactions will occur no matter which industry group the business belongs to: primary, secondary, transport or service. More complex businesses generally operate through different ownership structures. Later in this chapter we will briefly look at different structures of business ownership, including sole traders, partnerships and companies.

Management

The objective of the owner or manager of a business (entity) is to plan, lead, organise and control the business to enable a reasonable return of profit on the investment put into the business by the owner.

Managers need to develop systems to provide them with the information they require to make decisions about a business. These systems are often referred to as the management information system, or MIS.

If the owner or manager plans to expand into a new area, they have to consider whether there is a market for the goods or services, whether the goods or services can be supplied and if there are trained human resources or personnel available in the business. Financial information can assist in the decision-making process. A money or dollar value needs to be placed on the cost or benefit of each option. It will help the owner to decide whether it is worth expanding in an area or whether to look for different alternatives.

Accounting

Accounting is the process of collecting, classifying, recording, reporting, analysing and interpreting financial data to meet the financial information requirements of the various interests, or users, concerned with the operation of a business both internally (within the business) and externally (outside of the business).

Accounting has evolved from a **single-entry record keeping system**, dating from around 4000 BCE and covering ownership of property and transactions between parties, to the **double-entry accrual accounting system** used by many businesses today. Basically, **accrual accounting** is the matching of revenue and expenses to the accounting period, usually one year. Although this book adopts the accrual accounting method, chapter 5 includes a brief introduction to the **cash accounting** method of recording.

A system for recording accounting information, commonly called an **accounting information system**, should be developed to provide relevant reports that faithfully represent the information to users. The reports should also be **comparable, verifiable, timely** and **understandable**.

An **accounting system** is a collection of processes, procedures and controls designed to collect, record, classify and summarise financial data for interpretation and management decision making.

Before the introduction of computers and appropriate software, businesses used a **manual accounting** system, keeping their financial records by hand. Some businesses may still use a manual accounting system.

Today many businesses use some form of **computerised accounting system** to maintain their financial records. Computers and **off-the-shelf** or **customised accounting software packages** are used to record, store and analyse financial data. In Australia, some commonly used off-the-shelf packages include MYOB, Reckon, QuickBooks and Xero.

Although this book focuses on setting up and maintaining a **manual accounting system**, the same principles are used in many computer accounting software packages. As data is input into the accounting package, most of the steps you would complete in a manual system are automatically processed. You would not be aware how the package is processing the data, but most accounting packages include reports that are similar to those manually produced. They can manipulate data and present information far quicker than manual systems.

Over time the accounting processes or systems of a business may need to change. As its operations and structure become more complex, different or more frequent information may need to be produced. Changes to legislation or accounting rules may also require changes in the way a business must report information to its users.

USERS OF ACCOUNTING INFORMATION

There are two user groups interested in the financial details of a business: **internal users** and **external users**.

- **Internal users:**
 - **owners and managers of the business**, who need to know the revenue, expenses and the resulting profit of the business so that decisions on the future for the business can be made. These users should have access to all available financial information or can require it to be prepared for them at any time.
- **External users:**
 - **other businesses**, such as suppliers, who are owed monies by the business (also known as **creditors**, or **accounts payable**); these may be concerned if the business is making insufficient profit (or even a loss), in which case they may not be paid the amount that is owed to them
 - **government departments**, including the Australian Taxation Office, which must ensure that the correct taxes are paid by the business
 - **lenders**, who are concerned that the funds lent to the business together with interest will be repaid in full and on time
 - **employees**, who are interested in the long-term financial viability of the business and its ability to pay leave entitlements when they fall due.

External users generally only have access to financial reports or financial statements that are prepared periodically and contain limited financial details about the business. Some external users, such as government departments, may require more detailed information that is not available to other external users.

Basic accounting terms

Assets

An **asset** is a resource controlled by the entity (business) from which future economic benefits are expected.¹ Therefore, an asset is an item of value to the business, which can be used in its operations and can be expressed as a dollar value.

There are two classifications of assets: current assets and non-current assets.

CURRENT ASSETS

Current assets are cash or other assets of the business that are expected to be used, consumed or converted into cash within the next 12 months. Examples of current assets are:

- **cash at bank**; that is, **funds** that are held by a bank but owned and used by the business to buy and sell goods and services. The words ‘cash’ and ‘bank’ also mean the same as ‘**cash at bank**’
- **inventory**; that is, all of the goods that a business has for sale. The words ‘stock’ and ‘stock on hand’ also mean the same as ‘**inventory**’. Service businesses that hold large amounts of materials for use in providing their services may use the term ‘**supplies**’ for these current assets
- **accounts receivable**; that is, all the amounts owed by customers who have bought goods or services from the business with the agreement that they will remit or pay the funds owing for that sale within the next month or two. The word ‘**debtors**’ means the same as ‘**accounts receivable**’.

NON-CURRENT ASSETS

Non-current assets are assets the business expects to hold for more than 12 months; that is, they will not be consumed or converted into cash within the next 12 months. Examples of non-current assets include:

- **land** – the area of earth, ground, soil or terrain that a business controls and uses in the business
- **buildings** – structures usually built on land controlled by the business and used in its operations
- **machinery or machines** – equipment used by a business to make goods or products for sale as inventory, stock or goods
- **motor vehicles** – cars, utilities, trucks, forklift trucks and motorbikes. Trucks bring inventory and goods from suppliers into the business, or deliver inventory to customers. Cars are used by salespeople to visit customers or by other employees while carrying out their work responsibilities
- **office equipment** – equipment used in the office or administration area. It includes such assets as tables, desks, chairs, cupboards, shelving, filing cabinets, photocopiers, fax machines and telephone systems
- **computers** – these may form an integrated information and communication system between all areas of the business
- **investments** – other long-term assets that the business has acquired. These may include shares and debentures in a company, government bonds and other financial instruments.

Liabilities

A **liability** is a present obligation of the entity (business) that is expected to result in an outflow of resources. Therefore, a liability is an obligation of the business that it must eventually discharge or repay. Liabilities are what the business owes outside or external to the business.

There are two classifications of liabilities: current liabilities and non-current liabilities.

CURRENT LIABILITIES

A **current liability** is an obligation that the business is required to satisfy or pay within the next 12 months. An example of a current liability is:

- **accounts payable**; that is, all the amounts owed by the business to suppliers from whom it has purchased goods or services, with the expectation that it will remit the funds owing for that purchase within the next month or two. Accounts payable include amounts owing to suppliers for inventory or stock purchased for resale, as well as amounts owing for expenses incurred or acquired by the business, such as electricity, telephone, postage and stationery. The word ‘creditors’ means the same as ‘accounts payable’.

NON-CURRENT LIABILITIES

Non-current liabilities are obligations that the business is required to satisfy or pay after or beyond 12 months. Examples of non-current liabilities include:

- **loan** from a lending institution or other source; there is a requirement to repay the amount that has been received from the loan, but this is expected to occur beyond or after 12 months
- **mortgage**: this is a special type of security for a loan, usually for a bank or other lending institution. The funds are only given if the business and/or persons guaranteeing the loan assigns the title or right to specific land (real estate) as security that the loan will be repaid. A mortgage allows the lender (mortgagee) to sell the borrower’s land (real estate) if they default on the loan. This puts the lender, often a bank, in a better position than most other creditors.

Owner’s equity

Owner’s equity is what the owner has put into or invested in the business. It shows what the business owes to the owner. The total can be calculated by deducting liabilities from assets. The words ‘proprietorship’ or ‘equity’ mean the same as ‘owner’s equity’. Examples of owner’s equity are:

- **capital**, which shows the amount and details of what has been invested by the owner in the business. Any profit made by the business is added to this capital amount. Any loss incurred by the business is deducted from the capital amount
- **drawings**, which includes amounts of cash taken out of the business by the owner as well as the value of any inventory taken by the owner that the business had originally purchased to sell to its customers.

Revenue

Revenue arises in the course of the ordinary activities of an entity. Therefore, revenue is the earnings, proceeds or takings from the operations of a business. Examples of revenue are:

- **sales**, which includes the total amount or price obtained by the business when it sells its inventory or goods. This is the main revenue source for a business selling inventory or goods
- **fees**, which includes the total amount or price obtained by the business when it sells its services. This is the main revenue source for a business selling services
- **commission received**, which is revenue received from selling someone else’s inventory, goods or property. It is not usually the main revenue source
- **interest received**, which is revenue received from investments that the business has made with available funds. This may include interest-bearing deposits with a bank or other borrowing institution. It is not usually the main revenue source
- **rent received**, which is revenue received from renting to a third party a part or all of a building that the business controls but does not use. It is not usually the main revenue source.

Expense

We shall examine **expenses** that arise in the course of the ordinary activities of the entity (business). Expenses usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.

For our purposes, 'cost' means the same as 'expense'. Examples of expense are:

- **cost of sales (services or goods)**, which is the cost of the service that has been provided or goods that have been sold by the business
- **wages or salaries**, which are paid to the people who work for the business; they are employees of the business
- **rent expense**, which is the amount paid to another business for the right to use an area of land and/or building to store inventory and carry out the activities of the business
- **postage expense**, which includes the cost of sending and receiving items through the mail – that is, Australia Post
- **stationery expense**, which includes the cost of pens, pencils, markers, paper and pre-printed forms used by the business
- **depreciation**, which is an allocated expense spread over the estimated useful life of a non-current asset.

If the total revenue is greater than the total expenses then the business has made a profit that is added to owner's equity.

$$\text{Revenue } \$10\,000 - \text{Expense } \$8\,000 = \text{Profit } \$2\,000$$

$$\text{Owner's Equity } \$50\,000 + \text{Profit } \$2\,000 = \text{new Owner's Equity } \$52\,000$$

If the total revenue is less than the total expenses then the business has made a loss; this reduces the owner's equity.

$$\text{Revenue } \$10\,000 - \text{Expense } \$11\,000 = \text{Loss } \$1\,000$$

$$\text{Owner's Equity } \$50\,000 - \text{Loss } \$1\,000 = \text{new Owner's Equity } \$49\,000$$

Financial statements

Financial statements are particular reports that are prepared for users and provide information about the business's assets, liabilities, owner's equity, revenues and expenses. We will develop two financial statements in this book:

- **statement of financial position** or **balance sheet**, which shows the account balances of all assets, liabilities and owner's equity at the end of the accounting period
- **statement of profit or loss and other comprehensive income** or **income statement**, which shows the account balances of all revenues and expenses that determine the profit or loss made for the period.

QUESTION 1.1

From the following clues relating to the topic matters covered above, complete the crossword in figure 1.2.

Across

- 2 It can be an asset or a liability that still exists after 12 months.
- 5 An obligation that the business is required to satisfy or pay within the next 12 months (2 words).
- 8 The type of accounting system used today by businesses.
- 10 If total sales revenue is greater than total expense then a occurs.
- 11 Part of the accounting process is the i of financial data.
- 12 Accounting information is prepared for them.
- 15 Part of the accounting process is the a of financial data.
- 16 The users of accounting information have very limited access to accounting information.
- 17 The earnings made from the operation of the business.
- 18 Accounting is not a science or an art but an ongoing

Down

- 1 Cash is this (2 words).
- 3 It is what the owner has put into or invested in the business (2 words).
- 4 Other businesses that are owed debts are called it (2 words).
- 6 This group of users of accounting information usually has full access to accounting data.
- 7 Accounting exists to provide this to the business.
- 9 Part of the accounting process is the c of financial data.
- 13 It is incurred or spent in making sales or running the business.
- 14 Items of value used by the business in its operations.

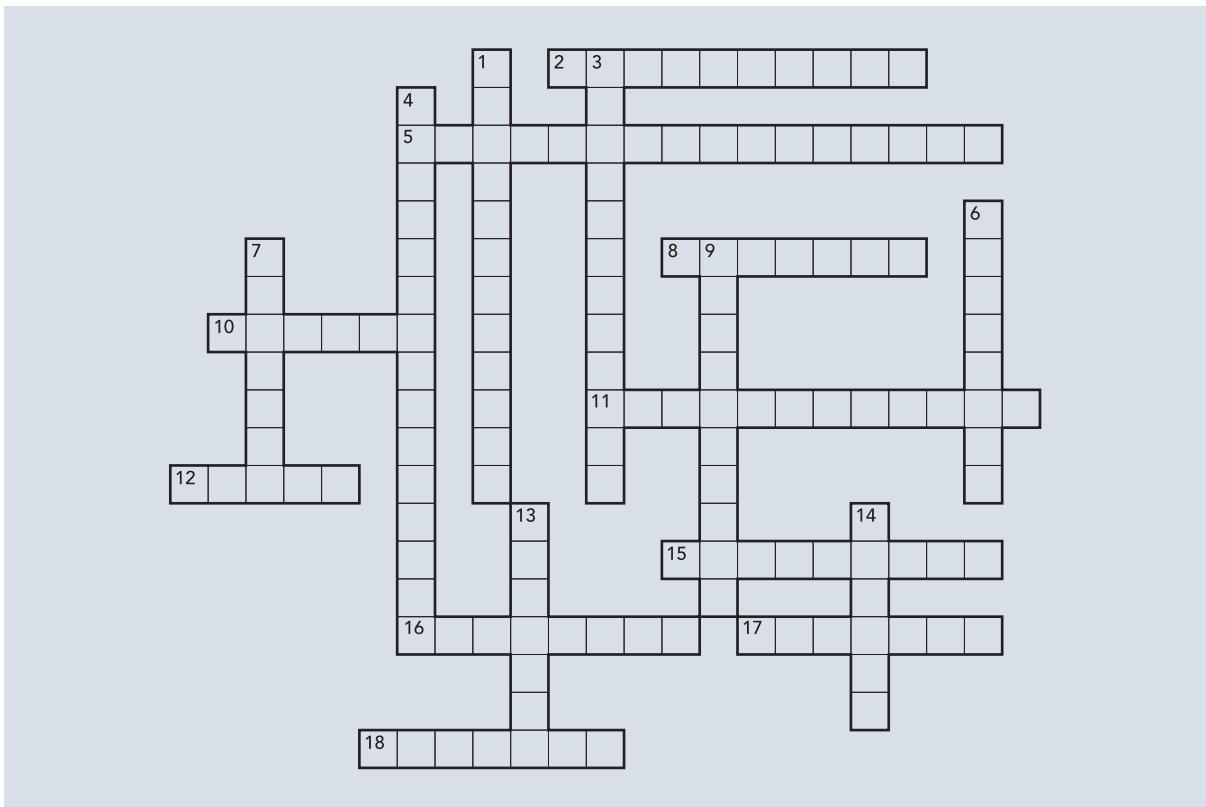


FIGURE 1.2 Crossword for question 1.1

QUESTION 1.2

From the following clues relating to examples used above for assets, liabilities, owner's equity, revenue and expenses, complete the crossword in figure 1.3.

Across

- 2 The business owes them for purchases of goods and services not yet paid.
- 5 A current asset summarising details of what amount is owed to the business and by whom.
- 6 The printed word you are reading this from is on it and it is included in this expense.
- 10 This non-current asset is used in the administration area (2 words).
- 11 A current asset that shows details of who and how much is owed by customers to the business (2 words).
- 14 An expense for using the mail system.
- 15 The business has this current asset to sell (3 words).
- 16 Amounts of cash and inventory taken by the owner.
- 17 This non-current liability provides funds to the business that must be repaid.
- 19 The business uses this non-current asset to make goods or products for sale.
- 20 These non-current assets are sometimes referred to as work stations.
- 21 A business selling goods calls the goods this, and it's a current asset.

Down

- 1 This type of loan requires collateral or security and is a non-current liability.
- 3 The bank has this current asset but the business owns it.
- 4 If you don't like flying, this non-current asset is very good to keep your feet on.
- 7 A current liability that shows details of who and how much is owed to suppliers by the business (2 words).
- 8 This current asset is used to pay for goods and services (3 words).
- 9 Cars, utilities, trucks and forklifts are this non-current asset.
- 12 This owner's equity shows what the business is worth and any profit adds to it.
- 13 A structure that the business may construct and use for its operations; a non-current asset.
- 18 The same meaning as inventory.

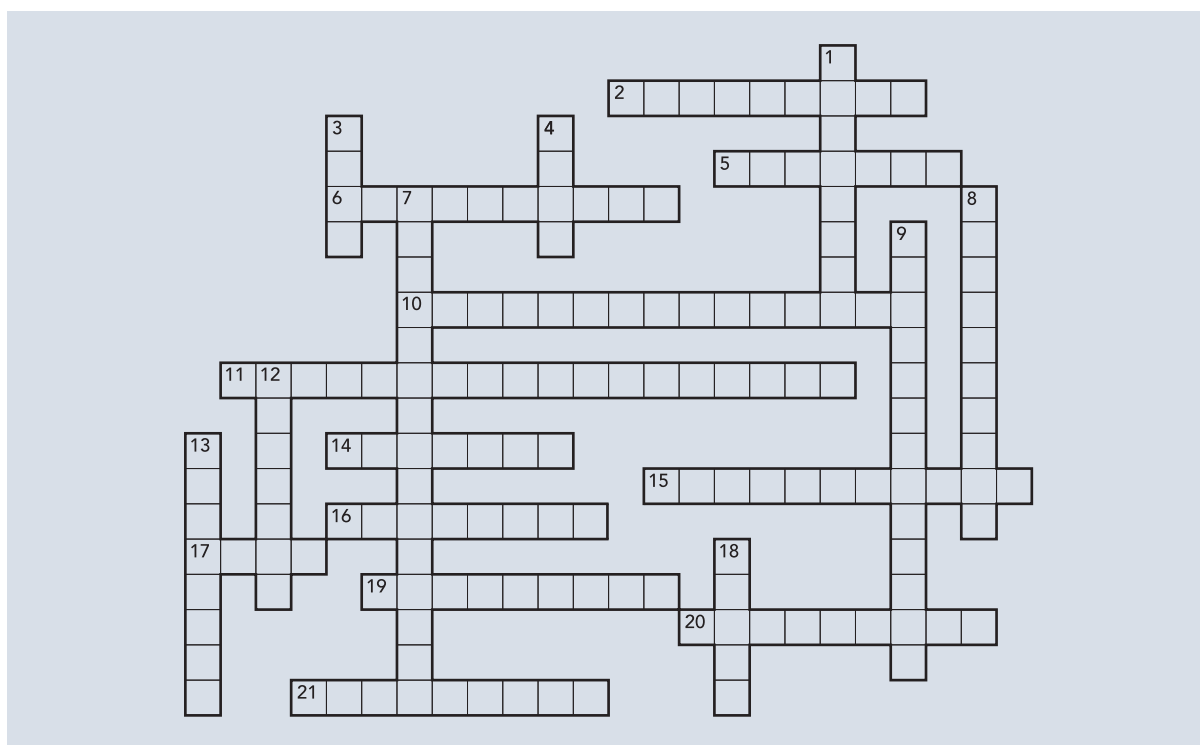


FIGURE 1.3 Crossword for question 1.2

Types of business ownership, their advantages and disadvantages

Sole trader

A business that is carried on by a **sole trader** is owned by one person, who also usually runs and manages the business. There may or may not be people working in the business; these are referred to as employees of the business and the owner is the employer. This is the simplest form of ownership and numerically the most common.

The sole trader receives all profits and is legally required to bear and satisfy all losses personally. In other words, the sole trader has **unlimited liability** to repay amounts owing, or debts, of the business.

The total amount of cash and other assets brought into the business by the sole trader is the capital that the business owes to the owner; it is called the owner's equity. Over time, the owner's equity will be increased by profits made by the business, and reduced by losses made by the business and drawings (cash or goods) from the business.

The sole trader is free to run the business as they think best and is not answerable to a boss. Although such a business is inexpensive and easy to set up and run, additional finance may be difficult to obtain. The business name, if different from the owner's own name, must be registered with the Australian Securities and Investments Commission (ASIC). A business bank account would normally be set up.

Partnership

A business that is carried on by a **partnership** can generally be owned by between two and 20 people. A partnership is a relationship between two or more persons with a view to profit. The partners usually run and manage the business. However, there may be a silent partner who does not take any part in the running of the business even though they have contributed capital to the partnership.

The amount of the capital that each partner brings to the partnership and the proportion in which the profits and losses are to be split among the partners is agreed between them and usually written in the partnership agreement. If a matter is not covered by the partnership agreement, then the position as set out in the Partnership Act of the state or territory in which the business is registered applies.

Partnerships do not have any special legal, accounting or recording requirements. A partnership is not a taxable entity. Profits and losses are allocated to each partner according to their entitlements in the partnership. It is important the accounts correctly record income and losses for the partners' individual tax returns. The partners share in the profits of the partnership. However, they also must share in the losses and can each be held personally liable for the debts of the partnership. There is unlimited liability on the partners to repay the debts of the partnership. Partners are jointly and severally liable for debts. This means that, if necessary, creditors can enforce their full debt against the personal assets of any partner who can afford to pay.

The partners are able to use their individual skills and specialise in areas for the overall benefit of the partnership and therefore should be able to earn more collectively than would be possible if they operated individually as sole traders.

It is easy and inexpensive to set up a partnership. The business name should be registered and a separate bank account must be used for the partnership.

Corporation

The most common type of **corporation** or **company** is one that is limited by shares. The shareholders hold shares in the company and therefore own it. Shareholders have limited liability; that is, their obligation is limited to the amount, if any, unpaid on their shares. Beyond this, the shareholder is not required to contribute to satisfying the debts of the company. The company has a separate legal identity. It can sue and be sued, but the shareholders (the owners) cannot be sued by creditors. The name of a company limited by shares must end with 'Limited' or its abbreviation 'Ltd'. There are approximately 2.5 million companies that are registered in Australia.

The *Corporations Act 2001* (Cwlth) indicates that companies are either proprietary or public companies.

PROPRIETARY COMPANY

A proprietary company is a company limited by shares and is sometimes referred to as a private company. The *Corporate Law Economic Reform Program Act 1999* (Cwlth), which became effective early in 2000, changed a number of the areas covering these types of companies. Since the Act came into force, a proprietary company need only have one member and one director, but must have no more than 50 non-employee shareholders and the transferability of shares is restricted. The word 'Proprietary' or its abbreviation 'Pty' must appear in the company name; for example, ABC Pty Ltd. A proprietary company can be either a small or a large proprietary company.

To be defined as a small proprietary company, the rules of ASIC require that the company must satisfy at least two of the following conditions for a financial year:

- the consolidated revenue of the company and any entities it controls is less than \$25 million
- the value of the consolidated gross assets of the company and any entities it controls is less than \$12.5 million at the end of the financial year
- the company and any entities it controls have fewer than 50 employees at the end of the financial year.

To be defined as a large proprietary company, a company must satisfy at least two of the following conditions for a financial year:

- the consolidated revenue of the company and any entities it controls is \$25 million or more
- the value of the consolidated gross assets of the company and any entities it controls is \$12.5 million or more at the end of the financial year
- the company and any entities it controls have 50 or more employees at the end of the financial year.

Large proprietary companies must prepare and lodge a financial report and a directors' report for each financial year. The accounts must be audited unless ASIC grants relief.

PUBLIC COMPANY

The *Corporations Act 2001*, Part 1.2 – Interpretation Div. 1 s. 9. defines a public company as any company other than a proprietary company; it is a company limited by shares. Many – although not all – public companies are listed on the Australian Securities Exchange (ASX). A public company is able to ask the public for funds and its shares are readily transferable. It must have at least one member and at least three directors, of which two must ordinarily reside in Australia.

A board of directors, which is elected by and acts on behalf of the shareholders, manages the company. However, the board of directors recommends to the shareholders how much of the profit the company should retain and how much should be paid to shareholders as a dividend (a return on their investment in the company). Public companies are regulated by the Corporations Act, and they can be expensive to establish. There are around 2400 that are listed and traded on the ASX.

QUESTION 1.3

From the following clues relating to topic matters covered for the different types of businesses, complete the crossword in figure 1.4.

Across

- 5 The liability of a sole trader and the partners in a partnership is
- 6 They usually run and manage the partnership.
- 8 How much capital is contributed and how profits are shared among partners is usually written in the partnership
- 9 A partner does not take part in the running of the partnership.
- 12 The company is owned by them.
- 13 A is owned by between two and 20 people.
- 14 A business owned by one person is a (2 words).
- 15 The last word in a company's name is

Down

- 1 This Act regulates companies.
- 2 The abbreviation for limited.
- 3 They manage the company on behalf of the shareholders.
- 4 The abbreviation for proprietary.
- 7 The liability of a shareholder is limited to the amount, if any, unpaid on their
- 10 A company owned by between one and 50 people is a limited company.
- 11 If a sole trader operates a business using other than their own name as the business name, then the name of that business must be
- 13 This type of company is listed on the Australian Securities Exchange.

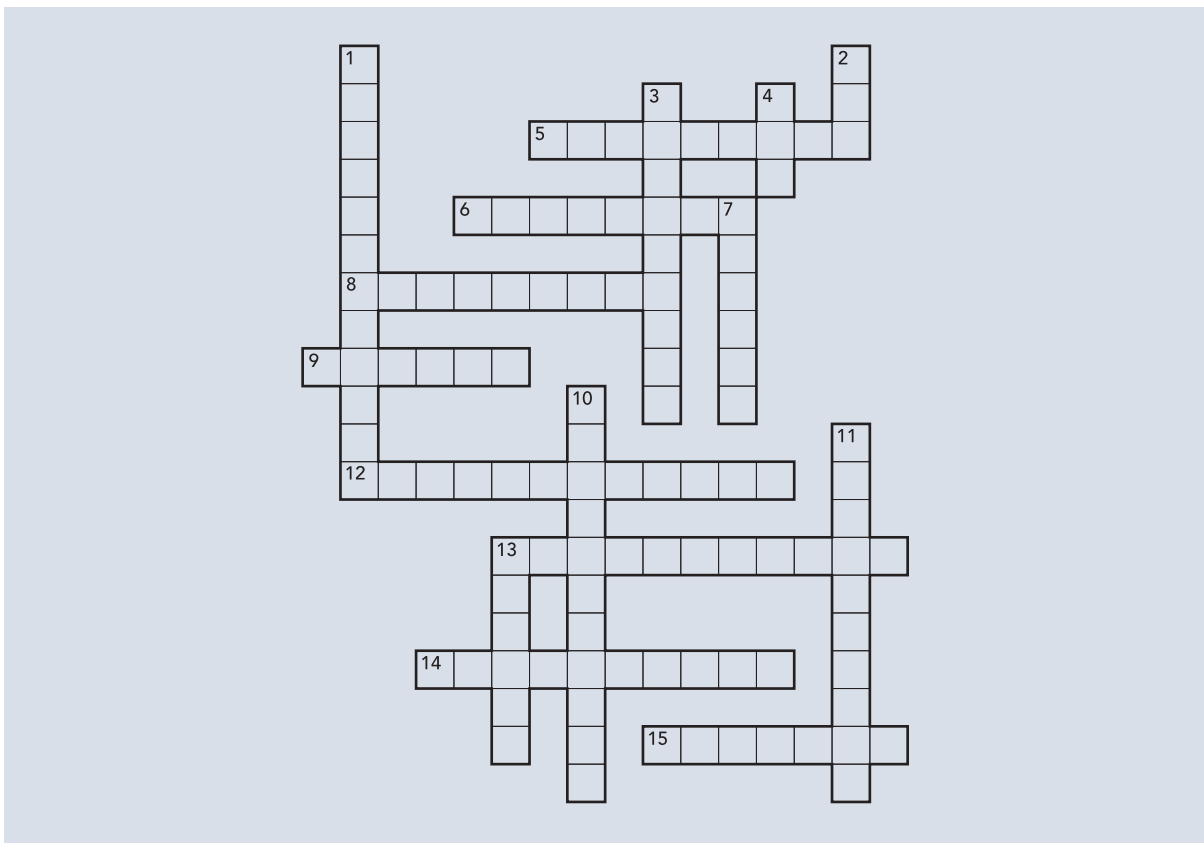


FIGURE 1.4 Crossword for question 1.3

Accounting assumptions: conventions and doctrines

The accounting process creates a common language that enables communication within and between different businesses, no matter which language is spoken or what the ethnic background. Accounting is used by all businesses.

The accounting language is guided by basic accounting concepts, ideas or thoughts. There are 10 concepts listed on pages 13–15 that are often referred to as **conventions** or **doctrines**.

- Conventions are general agreements in accounting, which especially relate to standards or procedures.
- Doctrines or principles are fundamental or general truths upon which other truths depend.

Conventions

ACCOUNTING ENTITY CONVENTION

The accounting or financial information of the business is always treated as a separate unit or body from the owner's personal financial information.

The business exists separately from the owner; this is known as the **accounting entity convention**.

For example, the owner has a business, which includes a warehouse and trucks used in the business, and these are both recorded (or shown) in the books of the business. However, the house where the owner lives and the boat that is used on the weekend are personal property and are not shown (or recorded) in the books of the business. Also, the bank account of the business must be kept separate from any personal or private bank accounts.

In accounting, the owner is treated as separate from the business. In a court of law, however, the non-business assets of a sole trader are not likely to be treated as separate from the business, if creditors have not been paid. Legal separation occurs when a business is incorporated into a company that is owned by shareholders. Running a business within a company structure offers a level of protection for personal assets such as the family home.

ACCOUNTING PERIOD CONVENTION

The life of a business is divided into periods of equal lengths for reporting purposes. This is known as the **accounting period convention**. Accounting or financial reports are prepared for a specific time period to enable two things: to assess the results of buying and selling goods or services, and to meaningfully compare the results for the period with expected or past period results. In Australia many businesses use a **financial year** (or fiscal year) from 1 July to 30 June of the next year. Shorter accounting periods may be used depending upon the needs of the user.

The goods and services tax (**GST**) started in Australia on 1 July 2000. A business that has an annual turnover (revenue or sales) of less than \$75 000 is not required to register for GST but may choose to do so. The GST is introduced in chapter 4 and is relevant throughout the book. Most small and medium businesses registered for the GST are required to complete and submit a Business Activity Statement (**BAS**) every three months. This is known as submitting on a quarterly basis. A business with an annual GST turnover of \$20 million or more must submit its electronic BAS on a monthly basis.

Businesses must also prepare financial reports showing their profit or loss on an annual (yearly) basis to the Australian Taxation Office for final assessment of taxation. The specific time period is usually the financial year from 1 July to 30 June.

Regardless of the size of a business or its GST registration obligations, it is wise for all businesses to prepare regular reports. Certain monthly, quarterly or six-monthly reports are useful as they provide

management with information on the finances of the business. They allow comparisons to be made and corrective action taken where necessary. A loss of \$10 000 revealed in an annual financial report might have been avoided if monthly reports had been prepared. Early corrective action could have been taken to change the loss for the year into a profit.

GOING CONCERN (OR CONTINUITY OF ACTIVITY) CONVENTION

Financial reports or statements are prepared on the assumption that the life of the business will continue indefinitely. A business is regarded as a **going concern** as long as it can pay its liabilities when they have to be paid and the intention of the owner is not to cease business but to carry on with that business.

A business is started because the owner expects it to be successful and to earn adequate profits. Even when the owner wants to retire, there may be an expectation that the business will be sold and will carry on indefinitely into the future.

MONETARY CONVENTION

All financial business transactions or events are recorded in Australian dollars and cents.

If a monetary value cannot be given to a transaction, then it cannot be recorded in the books of the business and cannot be included in an accounting financial statement or report. This is known as the **monetary convention**.

The sale of 1000 goods or items for \$5.00 each is recorded as sales of \$5000. The 1000 units are not shown, only the monetary value of those units.

HISTORICAL COST (OR HISTORICAL RECORD) CONVENTION

The actual amount that a business receives or pays is the amount that is recorded or written in the accounting books or records of that business. Non-current assets are recorded at their cost. This is known as the **historical cost convention**.

This convention assumes that the buying capacity of a dollar is the same in the past as it is at present. However, this is not the case, as the purchasing power of a dollar is reduced over time by inflation.

For instance, land that was purchased by a business 15 years ago for \$8000 was recorded at its original cost and would still be in the accounting records today at \$8000. This is the case even though the land might be worth \$80 000 if it was sold now. This can lead to apparent distortions of the worth of a business when only historical cost accounting records are used to record items purchased in the past. Certain non-current assets may be revalued to 'fair value'. This is a topic studied in more advanced financial accounting and will not be covered in this book.

In another example, a delivery truck that was advertised for \$35 000 is purchased at a special sale price of \$31 500. The delivery truck is recorded in the books of the business at its cost of \$31 500 and not at the advertised price.

Despite the valuation problem caused by inflation and the recording of items at their original cost to the business, the historical cost convention remains the most commonly used method of reporting the financial statements of businesses.

There are alternatives to historical cost accounting but these generate considerable debate and go beyond our scope of study.

RECOGNITION OF LAW CONVENTION

The preparation of statements and reports must follow relevant laws. Taxation law includes specific recording and reporting requirements to comply with GST and income tax purposes.

The *Corporations Act 2001* requires companies that are reporting entities to comply with Australian Accounting Standards.

Doctrines

DOCTRINE OF CONSISTENCY

The accounting principles used to prepare financial statements should be applied in the same way for each accounting period, irrespective of whether the period is a month or a year.

If a business is not consistent in its reporting methods from one period to another, then differences may appear to have occurred that in fact did not happen. More seriously, a change in valuation or reporting may cover up a problem that the business is having. The valuation of inventory or stock needs to be consistent, as it has a direct result on the profit of the business. If there is any change in consistency, then the change should be disclosed.

DOCTRINE OF DISCLOSURE

The accounting reports should contain information that ensures that the users understand the financial position of the business.

A loss should not be included with other figures if it has the effect of hiding or misleading an event of significance. A profit on the sale of a truck should not be included with the diesel and other running costs of the truck, as they are two different events. The cost or expense of running a truck and the profit on the sale of a truck should be shown as separate figures.

The owner and other users who rely on the financial reports expect that full disclosure has taken place.

DOCTRINE OF MATERIALITY

The significance, importance or materiality of an amount depends on both the size of a business and the importance of the item being considered.

A shortage of \$100 from inventory or stock held in a warehouse where the total cost was \$250 000 may not be considered material or significant and very little effort may be made to try to find it. However, \$1000 missing from \$2500 that was to be deposited in the bank is material. It would result in a significantly detailed investigation as to how and why the funds went missing and what was required to prevent such an event happening again.

The accounting reports often reflect the doctrine of materiality, where a large business may report in hundreds, thousands or millions of dollars, whereas a small business may report in dollars.

DOCTRINE OF CONSERVATISM

When there is a choice or uncertainty in the results to be reported, the preference is to understate the profit results rather than to overstate them; the more conservative approach should be taken.

Generally, an expense in running the business should be included as an expense of the business when it is first anticipated. However, revenue would normally be included when it has been received, or when there is strong probability that it will be received when it is due.

However, this should not lead to a distortion (or misunderstanding) of the financial reports, as there should be a full disclosure of why the conservative alternative has been taken.