PIPSO
Pacific Islands Private Sector Organisation

January 1

ACCOUNTING CONCEPTS

2014

This Module takes participants on a short journey through some basic bookkeeping. It asks why we keep accounts, the principles we apply in accounting & considers the documents that begin the process. We look at the components of the accounting equation, assets, liabilities, equity, expenses & revenues. Finally, we look at the basic rules of double entry bookkeeping.

MODULE 2.1

ACCOUNTING CONCEPTS (MODULE 2.1)

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Contents

PURPOSE

This Module presents an introduction to basic bookkeeping. It is not designed to give participants a working knowledge of bookkeeping or accounting, merely an appreciation of what a bookkeeper does. They should get some basic insight into bookkeeping only, sufficient to understand the income statement & balance sheet introduced in more detail in the next several modules in Level 2.

This Module introduces accounting disciplines previously assumed & undisclosed. It is important to appreciate that accounting adopts a disciplined approach to financial reporting in order to produce meaningful reports for owners & managers of businesses.

We stop short of an introduction to accrual accounting, which is explored later in Level 2, Module 5, Accrual Reporting.

By the time the Module is completed participants should have a clearpicture of the links between the following:

a. Source documents
b. The accounting framework
c. A chart of accounts
d. The accounting equation
e. Rules of double entry (used to record information)
f. Accounts
g. Financial reports

The Module presents information &allows participants the opportunity to learn by undertaking several activities.

The accounting equation is fully expanded.

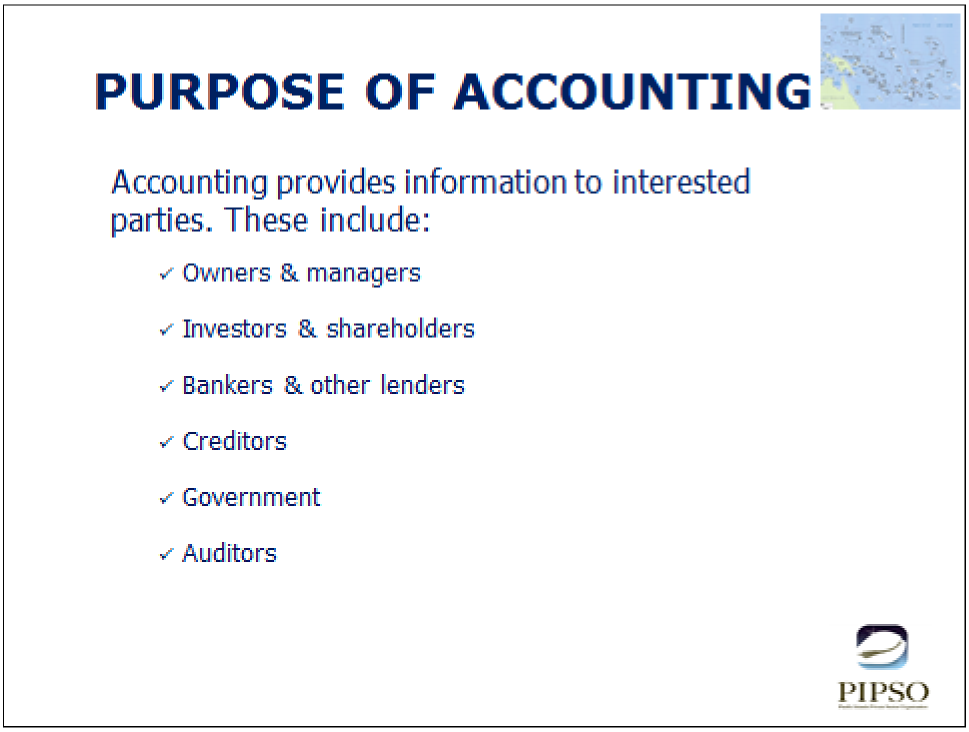
The principles of accounting & rules of bookkeeping are introduced & demonstrated by examples While the transactions recorded grow in complexity, the method used to record them remains the same as presented in this Module.

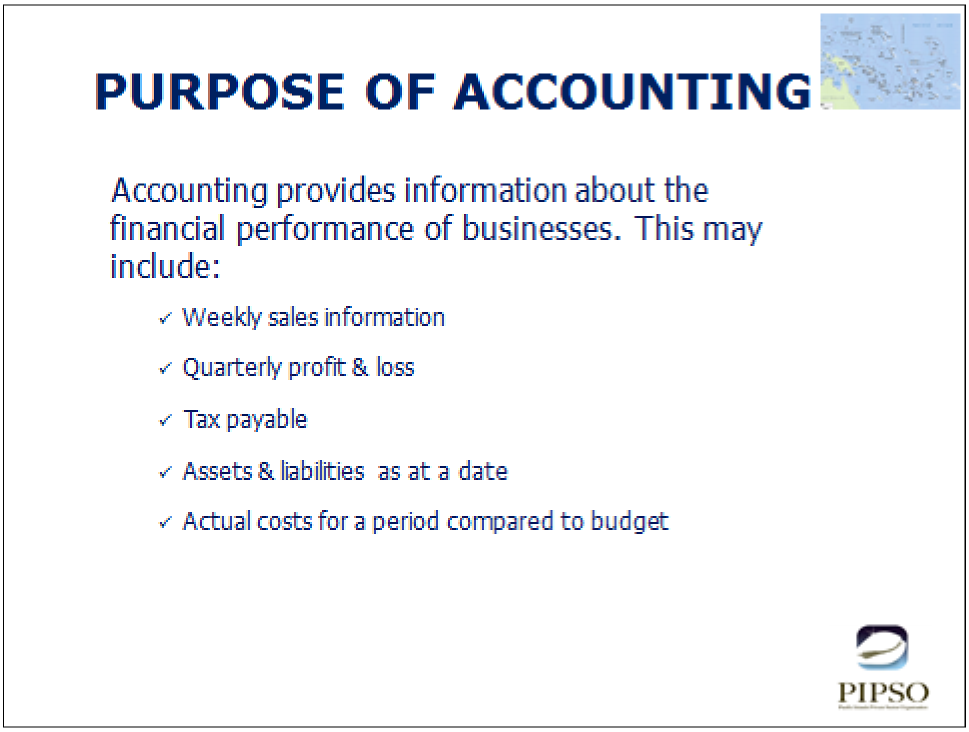
On completion of this Module participants should have a very basic understanding of double entry bookkeeping. This is a foundation stone to later Modules which expand the accounting concepts touched on here. The intention is for participants to gain an appreciation of what accounting does for them, not for them to become accountants.

PURPOSE OF ACCOUNTING

The purpose of accounting is primarily to provide owners & managers of businesses with financial information relevant to their needs. Secondary to these needs it also provides information to other external parties who have an interest in equity in the business, i.e. investors, whether current shareholdersor potential new ones. This is particularly relevant to larger businesses where ownership, management & control lie in different hands.

There are a range of other external parties that have an ongoing interest in the business.These parties are interested in &, require & rely on, financial information to protect amounts owingby the business (lenders & creditors) or determine the extent of their revenues from the business (government) or legal obligations in relation to the business (auditor).





The above list is illustrative only. Information provided should match the needs of the user for whom it is prepared.

The needs of the user will determine:

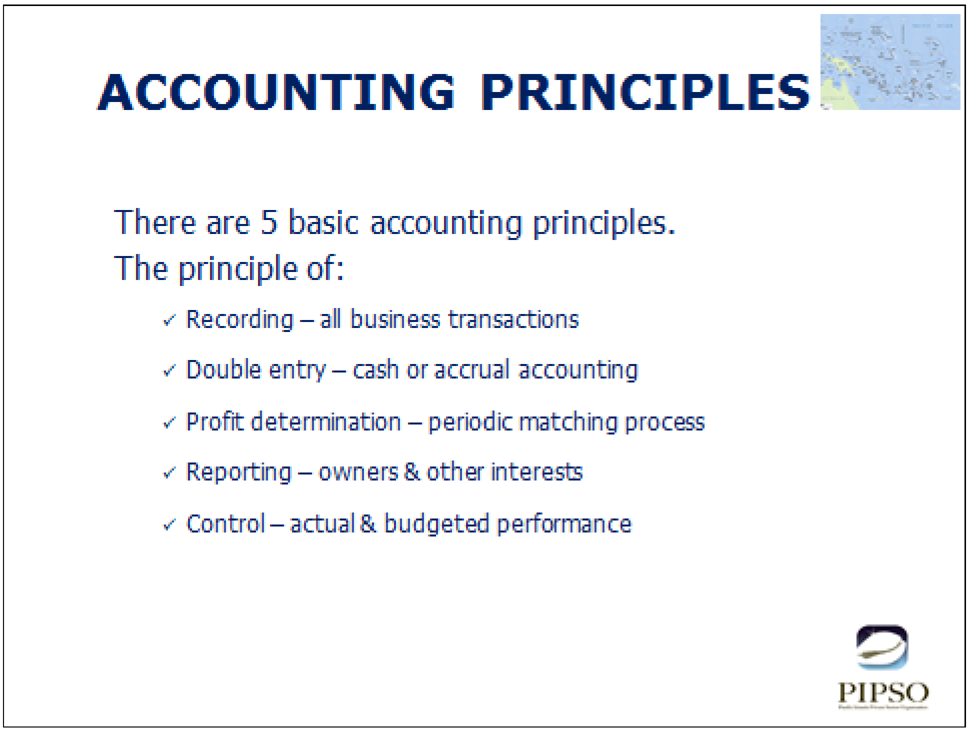
- Timing of receipt of information
- Level of detail of the information
- Frequency of reports received
- Nature of accounting information required, e.g. taxes, sales, production or asset & cash management

IMPORTANT: For owners &internal management, information needs to be timely.

For external parties the need varies depending on their particular interest.

The methods introduced here provide information which is ultimately used for performance measurement in a range of ways to meet the need of each of the interest groups listed above. Later Level 2 & Level 3 Modules will reveal some of the measures used by investors, owners & management.

ACCOUNTING PRINCIPLES



In essence, the 5 principles listed in the slide are:

Recording

All business, not private, transactions must be captured, recorded & included in the business records & reports, from source documents to financial statements.

Double entry

There are two accounting methods, cash & accrual accounting, that require the use of a double entry system. Applying either of these two accounting methods, requiresthat all financial transactions have two sides, often where one side records a transaction with an external party & the other internally. We will explore this in more detail later in this Module.

Profit determination

One of the primary reasons to record financial transactions is to identify if a business has made a profit or loss & how much. This is done periodically over time with the periods being the same, usually 12 months, so that the information provided can be measured in a systematic way.

Reporting

Financial information generated by the periodic measurement is intended to be shared with relevant interested parties, including owners, management, lenders etc. (as per prior slide). The breadth of the audience will depend on the ownership structure of the business, with a publicly listed company being subjected to the highest level of required reporting while a sole trader may incur the least onerous level of requiredreporting.

Control

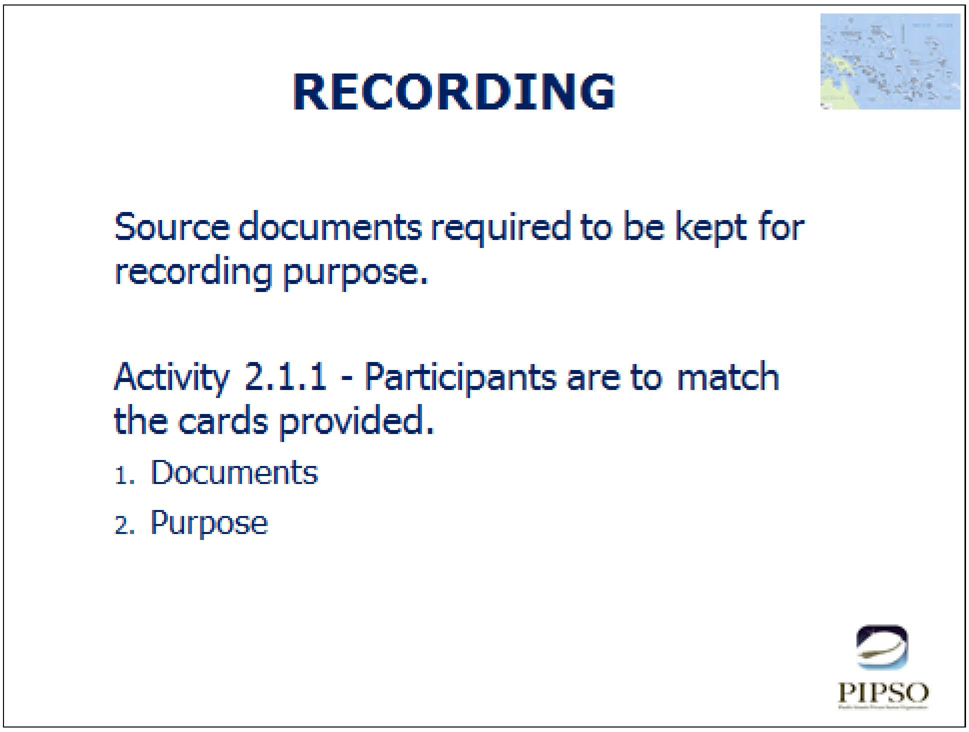
Control occurs in several ways, but in this context we are talking about use for budgeting control purposes. Actual financial results can be matched against the budgeted or forecast results as a measure of performance & control. Variances may indicate a need to take action to limit escalation of costs or expand sales revenues.

RECORDING TRANSATIONS

Records must be kept of all business transactions. These documents are the ones revealed & discussed in Level 1, Module 1.1, Business Structure & Record Keeping. Do you remember them?

IMPORTANT: Records may be manual (hard copy) or electronic (soft copy).Records must be stored safely & retained for tax &other internal & external reporting purposes.

Before moving on, it is timely to briefly look back on our types of financial transactions & the source documents required in order to record them. This we will now do using the following exercise to match documents & the purpose for each.



For those doing this exercise online, match the letters with the numbers in the two following lists.

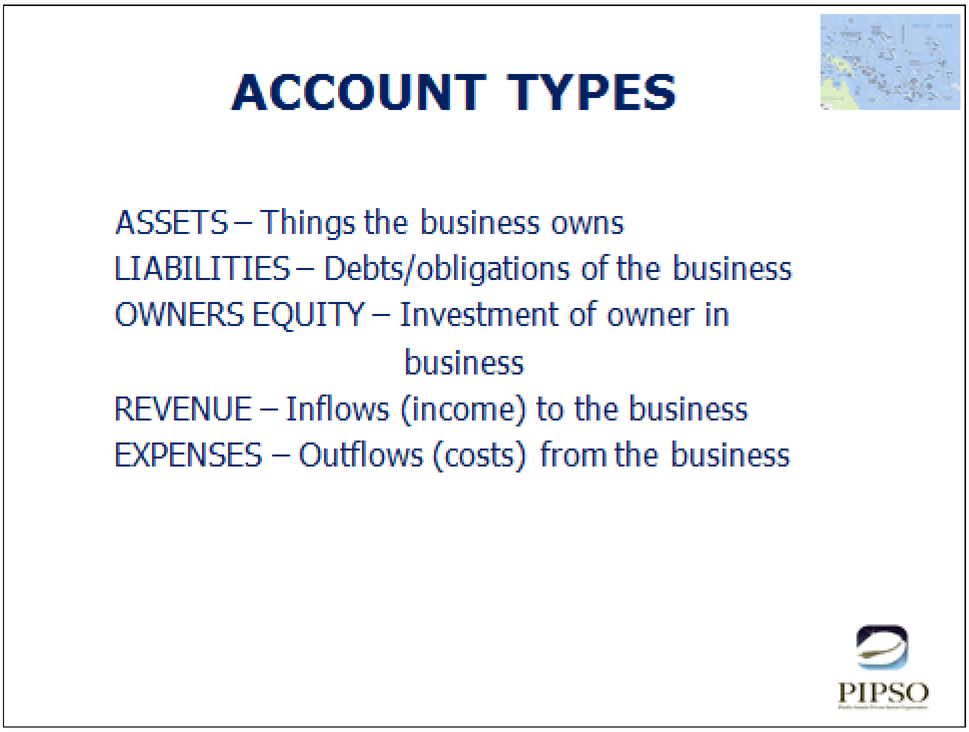
Activity 2.1.1

Documents to keep for recording purposes include:

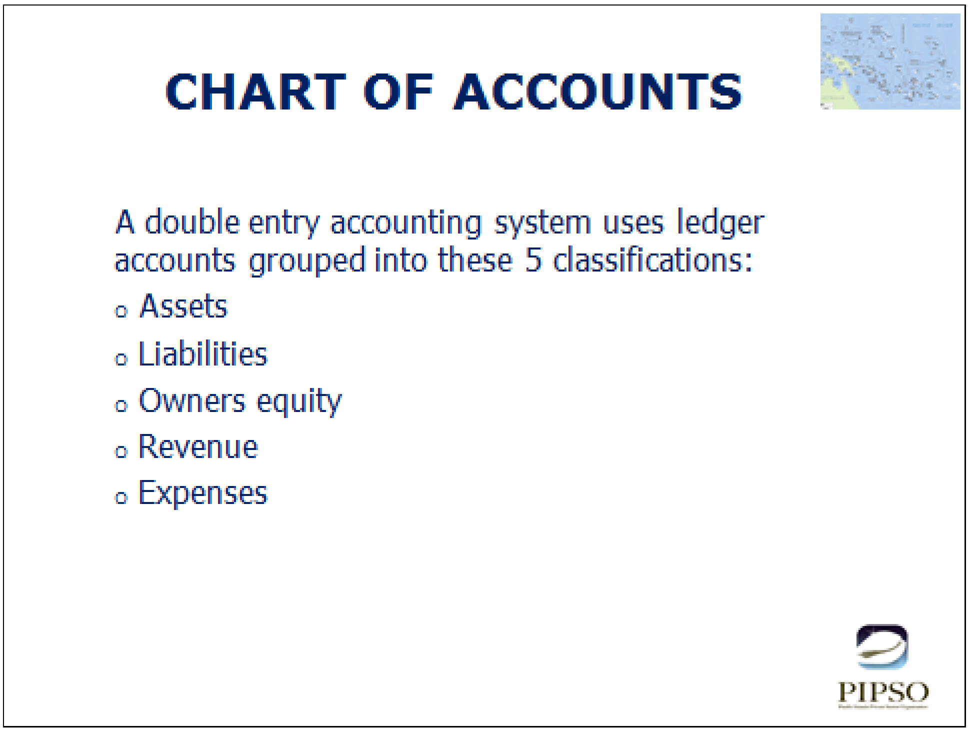
	DOCUMENT
A	ASSET REGISTER
B	BANK STATEMENTS
C	DEBTORS/INVOICES
D	EXPENSES
E	INVENTORY
F	SALES RECEIPTS
G	TAX RETURNS
H	WRITTEN CONTRACTS

	WHAT DOCUMENT RECORDS
1	Assets, purchased & sold – amount & date
2	Deposits, payments, loans, fees & interest
3	Insurance, leases, suppliers and loans etc.
4	Purchases & stock on hand
5	VAT & other periodic taxes collected & paid
6	Wages, travel, power & other bills
7	When & from whom you receive payments
8	Who owes you, how much & when

CHART OF ACCOUNTS



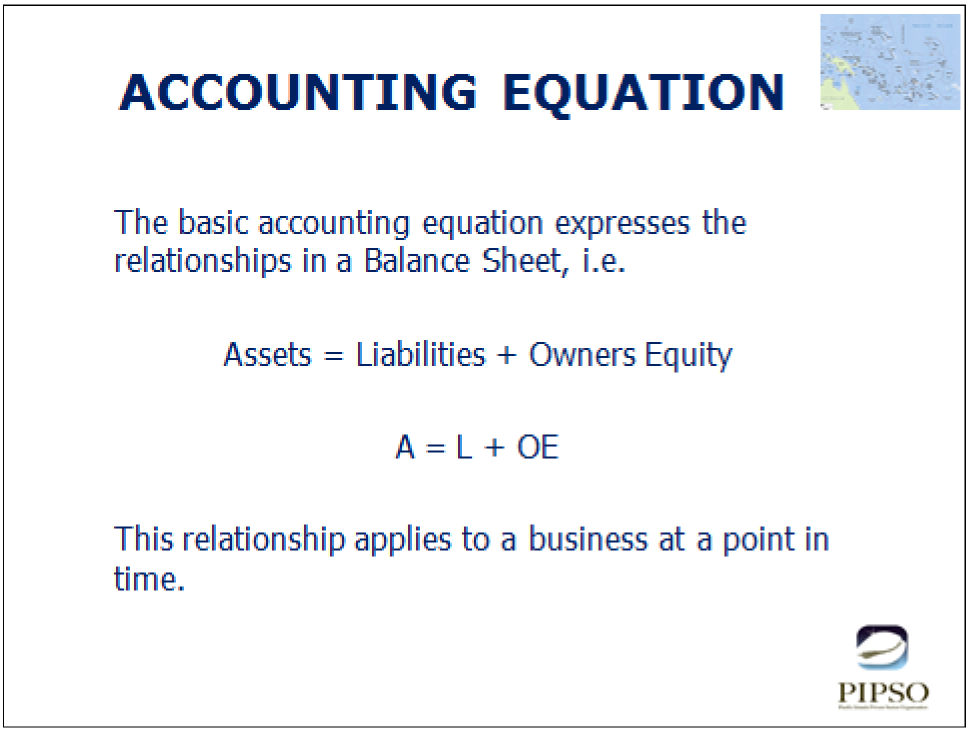
A chart of accounts is a list of **all** the accounts used by a business to record its financial activities. The list is grouped into the general classifications used in presenting the financial statements.



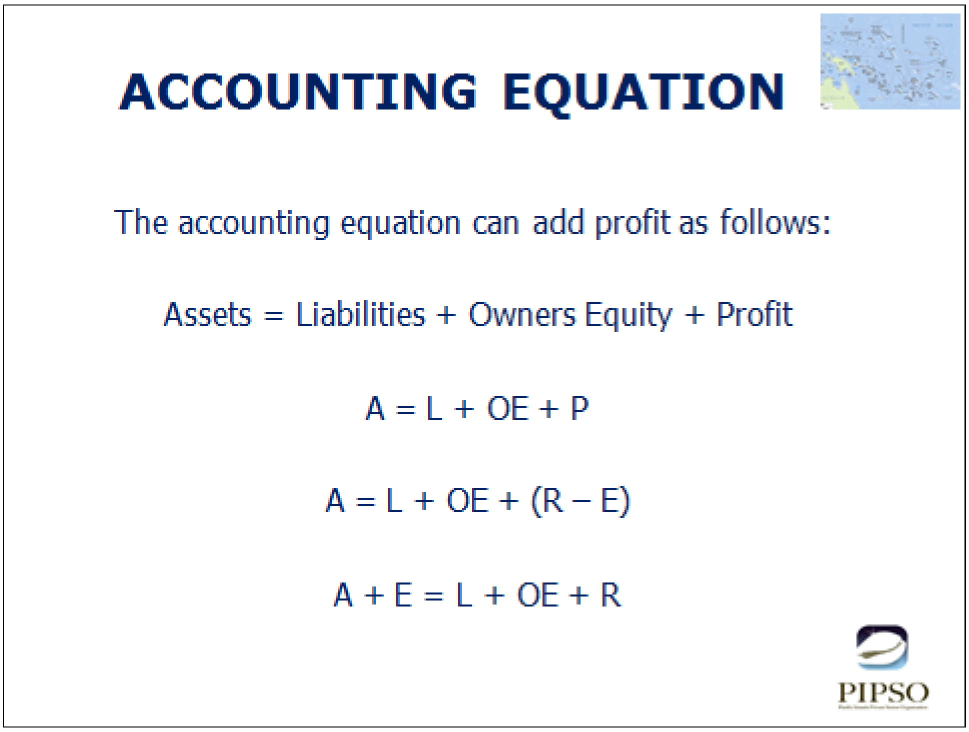
Each individual asset, liability, equity, revenue & expense will have its own ledger account. These are combined under the 5 headings in either the Balance Sheet or Income Statement as per the slide:

Assets
Liabilities
Owners Equity/ Equity/ Proprietorship
Revenues
Expenses

ACCOUNTING EQUATION



The accounting equation in its simplest from was introduced in Level 1, Module 1.2, Assets, Liabilities & Equity.



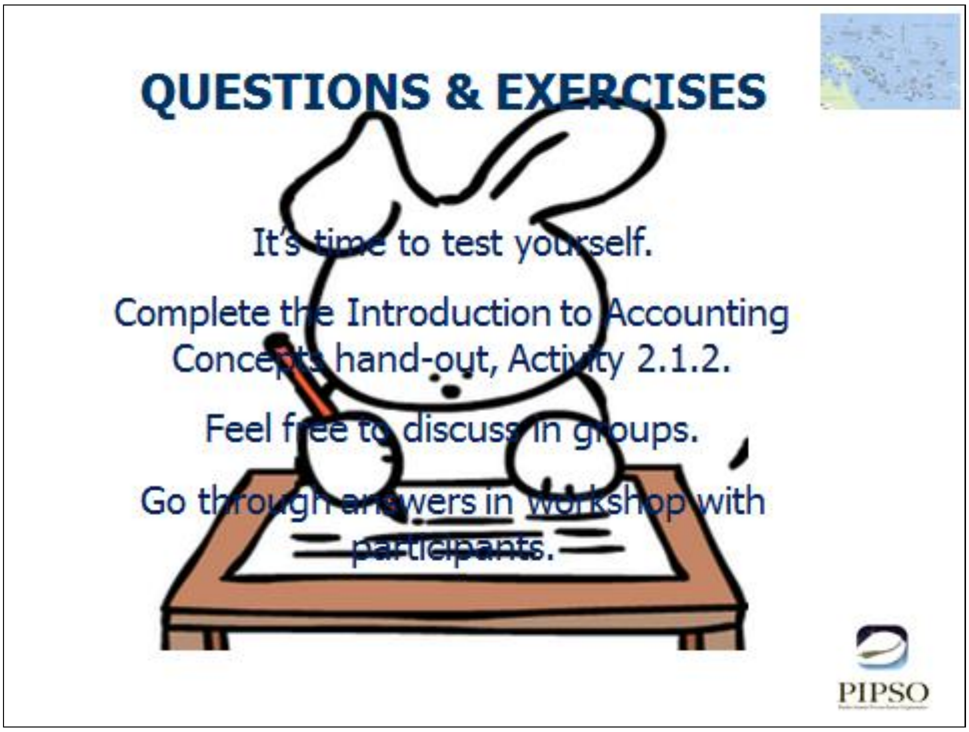
The simple form of the accounting equation is now expanded to include the components of profit (or loss), i.e. revenues & expenses.

If the five components of the accounting equation are regrouped as per the final equation in the slid, we are in a position to consider the natural side of accounts within the chart of accounts. They are either naturally DEBIT or CREDIT accounts.

Before we look in more depth at the rules of double entry, this is a good time to revise the material we have covered.It is very important that a participant has a sound understanding of the principles described so far, before moving on.

The activity on accounting principles that follows is designed to draw out any misconceptions or issues that participants have with regard to material presented thus far.

The exercises are true/false, short answer & multiple choice only. They are designed to test understanding of the basic concepts.



Activity 2.1.2

Accounting Principles

Section A: True or False

1. Accounts Receivable is classified as an asset.
2. Revenue and expense items have no bearings on the Balance Sheet.
3. The double entry system requires that a transaction be recorded as a debit and a credit entry.
4. A balance sheet is the only financial report that provides information for a business.

Section B: Examples of Transactions

Provide an example of a transaction that

I. increases an asset and increases a liability

II. increase an expense and decrease an asset

III. increase a revenue and increase an asset

IV. decrease an asset and increase an asset

Section C: Multiple Choice

Question 1

The extended accounting equation can be stated as

a. Assets = Liabilities –Expenses + Revenue – Owner's Equity
b. Revenue + Expenses = Assets + Liabilities – Owner's Equity
c. Assets + Expenses = Liabilities + Owner's Equity + Revenue
d. Revenue - Expense + Assets = Owner's Equity + Liabilities

Question 2

If asset increase by $22,000 and liabilities increase by 5,000 then Owner's Equity

a) increase by 22,000
b) decrease by 17,000
c) increase by 27,000
d) increase by 17,000

Question 3

If Owner's Equity increases by $33,500 and Liabilities increase by 1,500 then Assets would

a) decrease by 35,000
b) increase by 35,000
c) decrease by 32,000
d) increase by 32,000

Question 4

The balance of inventories on hand at the end of a year is

a) an expense
b) an asset
c) a revenue
d) a liability

Question 5

If a debtor pays their account at the end of the month:

a) assets increase & liabilities increase by the same amount
b) assets decrease & liabilities decrease by the same amount
c) assets increase & liabilities decrease by the same amount
d) there is no change in asset or liabilities

Question 6

If the owner pays out of personal funds for a harvester to be used only in the business:

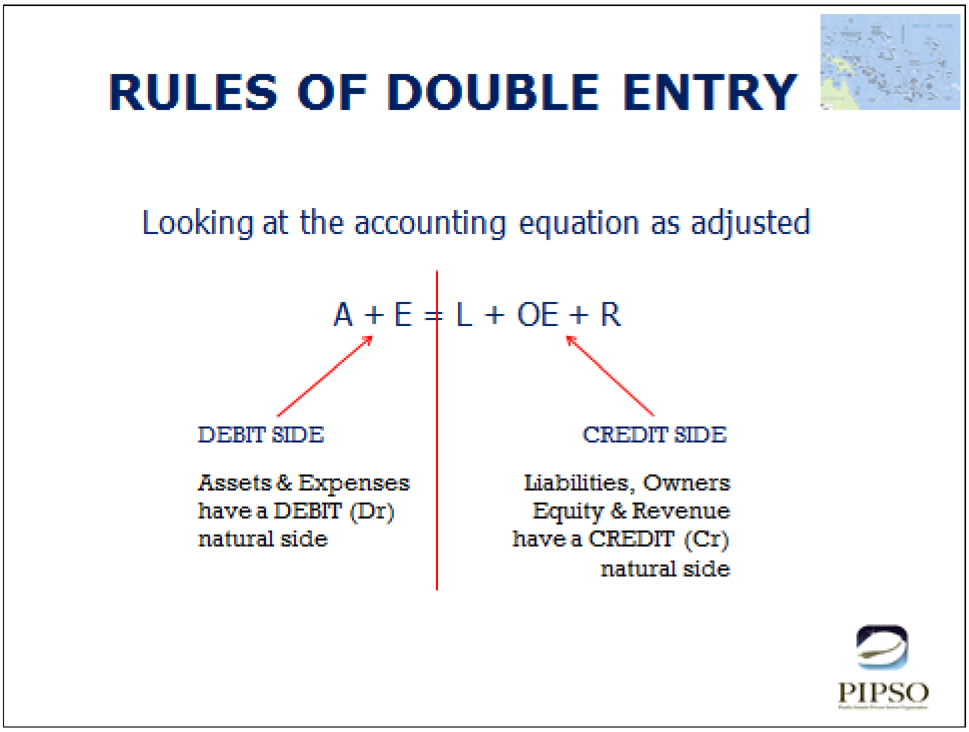
a) assets increase & liabilities increase by the same amount
b) assets decrease & liabilities decrease by the same amount
c) assets increase & owner's equity increases decrease by the same amount
d) assets decrease & owner's equity decreases by the same amount

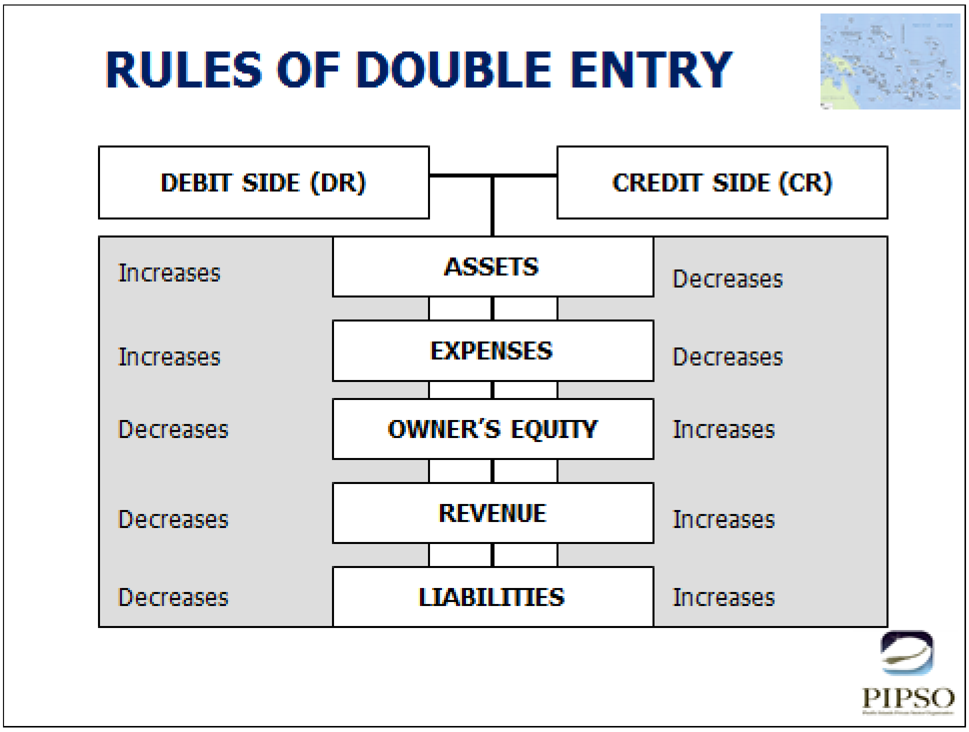
Question 7

If the business buys a computer on 30 day's credit:

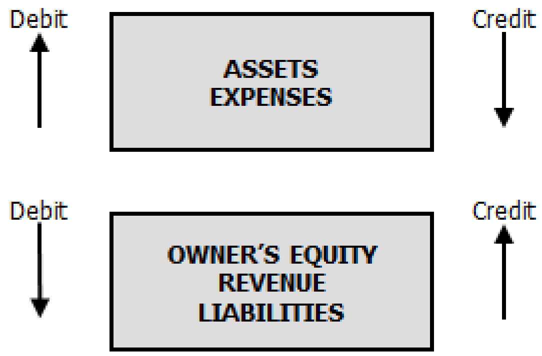
a) assets increase & liabilities increase by the same amount
b) assets decrease & liabilities decrease by the same amount
c) assets increase & liabilities decrease by the same amount
d) there is no change in asset or liabilities

RULES OF DOUBLE ENTRY





RULES OF DOUBLE ENTRY



RULES OF DOUBLE ENTRY

ASSETS	Debit = Increase	Credit = Decrease
EXPENSES	Debit = Increase	Credit = Decrease
OWNERS EQUITY	Debit = Decrease	Credit = Increase
REVENUE	Debit = Decrease	Credit = Increase
EXPENSES	Debit = Decrease	Credit = Increase

TRANSACTION EXAMPLES

Having gone thru the rules of double entry, the next series of slides provides illustrations of how the rules are applied in practice. Each shows a basic transaction applying the rules as stated.

The examples below cover:

1. A purchase of an asset for cash
2. Payment of an expense from an overdraft
3. A credit sale
    a. The sale on credit
    b. Payment by the debtor

Example 1

- Joe's Fishing Company purchases a computer from ABC Computers with a purchase price of $500.
- The computer was purchased using cash
- In order to record this in the General Ledger:

ACCOUNT	DETAILS	DEBIT	CREDIT
Asset	Computer	$500	
Asset	Cash		$500

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EXAMPLE 2

- Joe's Fishing Company pays staff wages for the month of January.
- The total staff salary cost is $750 and is paid using the business overdraft facility
- In order to record this in the General Ledger:

ACCOUNT	DETAILS	DEBIT	CREDIT
Expense	Wages	$750	
Liability	Overdraft		$750

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If the payment was made out of a Cash at Bank account, would it be any different? No, not really. It would still be a credit to the Cash at Bank account, rather than an Overdraft account.

EXAMPLE 3 (a)

- Joe's Fishing Company sells 15 fishing rods to A Customer for $150.
- The customer receives 30 days credit for the fishing rods
- In order to record this in the General Ledger:

ACCOUNT	DETAILS	DEBIT	CREDIT
Asset	Debtors	$150	
Revenue	Sales		$150

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EXAMPLE 3 (b)

- Joe's Fishing Company sold 15 fishing rods to A Customer for $150 on credit 30 days ago.
- Today Joe's Fishing Company receives a cheque in the mail from A Customer.
- In order to record this in the General Ledger:

ACCOUNT	DETAILS	DEBIT	CREDIT
Asset	Cash	$150	
Asset	Debtors		$150

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NOTE FOR FACILITATOR

Show on the white or black board what would the last two entries look like if the sale included VAT or GST of 15%?

ACCOUNT	DETAILS	DEBIT	CREDIT
Asset	Debtors	$150	
Revenue	Sales		$130.43
Liability	VAT Payable		$$19.57
Asset	Cash	$150	
Asset	Debtors		$150

FINANCIAL STATEMENTS

FINANCIAL STATEMENTS

Tane has been operating a new business for 12 months.

Activity 2.1.3 – After viewing the financial reports, participants are to answer the 5 questions.

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This is a relatively simple exercise in recognising the main components of an income statement & balance sheet.

ACTIVITY 2.1.3

Tane commenced a new business, Best Baker Ever, as a sole trader 12 months ago.

He borrowed $30,000 from his bank at the time based on his business plan. Repayment of the loan was agreed to be $6,000 annually on 31 December each year. Tane made the first repayment on 31 December 2013. He used his private residence as security for the loan.

The financial statements for the new business as at 31 December 2013 were as follows:

Income Statement of Best Baker Ever for the 12 months ended 31 December 2013

	$	$	$
Sales			100,000
Less Cost of Production			
Inventories		5,000	
Labour		31,000	
Purchases		24,000	
Cost of Goods Produced		60,000	
Less Inventories		4,500	55,500
Gross Profit			44,500
Less Other Expenses			
Depreciation delivery vehicle		7,000	
Advertising		5,000	
Admin costs		4,000	
Depreciation kitchen equipment		1,500	
Amortisation of establishment expenses		1,200	
Insurance		4,500	
Interest on loan		3,600	26,800
Net Profit			17,700

Balance Sheet of Best Baker Ever at 31 December 2013

	$	$	$
<u>Current Assets</u>			
Bank		32,785	
Inventories		4,500	
Accounts Receivable		12,550	
Prepaid Expenses		6,950	56,785
<u>Non- Current Assets</u>			
Motor Vehicle	44,405		
Accumulated depreciation of motor vehicle	7,000	37,405	
Kitchen equipment	16,900		
Accumulated depreciation of kitchen equipment	1,500	15,400	52,805
<u>Intangibles</u>			
Establishment expenses		12,000	
Accumulated amortisation of establishment expenses		1,200	10,800
Total Assets			109,590
<u>Current Liabilities</u>			
Accounts payable	11,150		
GST payable	3,750		
Accrued expenses	2,990	17,890	
<u>Non-Current Liabilities</u>			
Bank loan	24,000	24,000	
Total Liabilities			41,890
Net Assets			67,700
<u>Owner's Equity</u>			
Capital			50,000
Plus Net Profit			17,700
Owners Equity			67,700

Questions

What is Tane's:

1 Total assets at 31 Dec 2013?
2 Net assets at 31 Dec 2013?
3 Revenues for the year to Dec 2013?
4 Profit for the year to Dec 2013?
5 Owners equity at 1 Jan 2013?
6 What is the interest rate on the business loan?

This slide ends the Module.

ANSWERS TO ACTIVITIES

Activity 2.1.1

Documents to keep for recording purposes include:

DOCUMENT	WHAT DOCUMENT RECORDS
BANK STATEMENTS	Deposits, payments, loans, fees & interest
SALES RECEIPTS	When& from whom you receive payments
DEBTORS/INVOICES	Who owes you, how much & when
INVENTORY	Purchases & stock on hand
EXPENSES	Wages, travel, power & other bills
ASSET REGISTER	Assets, purchased & sold – amount & date
TAX RETURNS	VAT & other periodic taxes collected & paid
WRITTEN CONTRACTS	Insurance, leases, suppliers and loans etc.

Activity 2.1.2

Accounting Principles

Section A : True or False

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8. A balance sheet is the only financial report that provides information for a business. F

Section B: Examples of Transactions

Provide an example of a transaction that

V. increases an asset and increases a liability

Examples: Buying an asset on credit e.g. purchasing a motor vehicle credit or borrowing money to buy an asset

VI. increase an expense and decrease an asset

Example: Paying for any expense e.g. paying rent or stationery

VII. increase a revenue and increase an asset

Example: Selling goods in the normal course of business on credit or for cash

VIII. decrease an asset and increase an asset

Example: purchasing an asset for cash or on credit or a debtor paying account

Section C: Multiple Choice

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The extended accounting equation can be stated as

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ACTIVITY 2.1.3

Questions &Answers

What is Tane's:

1	Total assets at 31 Dec 2013?	109,590	
2	Net assets at 31 Dec 2013?	67,700	
3	Revenues for the year to Dec 2013?	100,000	
4	Profit for the year to Dec 2013?	17,700	
5	Owners equity at 1 Jan 2013?	50,000	
6	What is the interest rate on the business loan?	12.0%	(= $3,600 / $30,000)%