Topic 1 - Double Entry Accounting System

Cash vs. Accrual Accounting

- **Cash** accounting: records income and expense **at the time the cash is received or paid** ⟶ **Cash profit = cash inflows - cash outflows**
- **Accrual** accounting: records income and expenses **at the time they occur**, not necessarily when he cash is received or paid → **profit (for current period) = income - expenses**
    - Levels of accrual accounting:
        i. Cash transactions (cash already exchanged)
        ii. Credit transactions (promises) - cash to be exchanged
        iii. Estimates and future expectations over the short-term (months)
        iv. Estimates and future expectations over the long-term (years)
        v. Narrative and other disclosure in addition to accounting numbers

5 Account Types

1. Asset: a **resource controlled by the entity** as a **result of past events** and from which **future economic benefits** are expected to flow to the entity (e.g. cash, accounts receivable, inventory, etc.)
    - Recognition criteria:
        1. It is **probable** that any future economic benefits associated with the item will flow to the entity
        2. The item has a cost/value that can be **measured reliably**
2. Liability: a **present obligation** of the entity arising **from past events**, the settlement of which is expected to result in an **outflow** from the entity of resources embodying **economic benefits** (e.g. accounts payable, provisions, tax liabilities, etc.)
    - Recognition criteria:
        1. It is **probable** that any future economic benefits associated with the item will flow from the entity
        2. The item has a cost/value that can be **measured reliably**
3. Equity: **residual interest** in assets less liabilities, including: **share capital, retained profits** (accumulated profits - accumulated dividends) and **reserves**
4. Income (revenue and gains): **increases in economic benefits** during the accounting period in the form of **inflows or enhancements of assets or decreases of liabilities** that **result from increases in equity**, **other than** those relating to **contributions from equity participants**
    - Revenue: the **gross inflow of economic benefits** during the period arising in the course of ordinary activities of an equity when those **inflows result in increase in equity, other than** increases relating to **contributions from equity participants**
    - Gains: other items that meet the definition of income, but not revenue (e.g. gain on sale) → part of non-current assets
    - Recognition criteria:
        1. An **increase** in **future economic benefits** has arisen
        2. The increase can be **measured reliably**

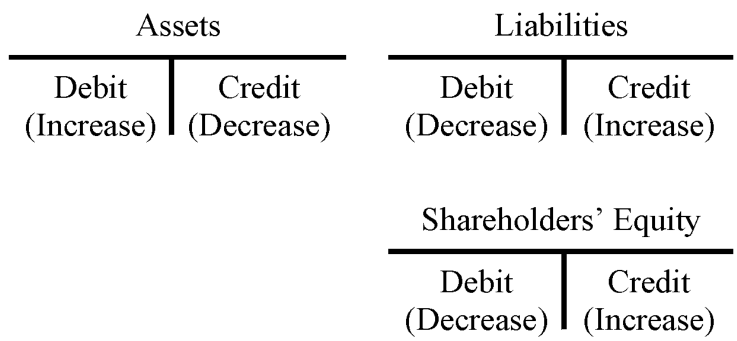
5. Expenses (includes losses): **decreases in economic benefits** during the accounting period in the form of **outflows or depletions of assets or incurrence of liabilities** that **result in decreases in equity, other than** those relating to **distributions to equity participants**
    - Losses: other items that meet the depletion of an expense, but is not an ordinary transaction (e.g. revaluing assets)
    - Recognition criteria:
        3. An **decrease** in **future economic benefits** has arisen
        4. The increase can be **measured reliably**

The Accounting Cycle

1. **Source documents and transactions**
    - Transaction analysis: an examination of each business transaction with the aim of understanding its effect on the accounting equation (must always remain equal regardless of transaction type). In order for a transaction to qualify (in financial accounting), an event must have **all 5** of the following:
        1. **Three fundamental and legal characteristics:**
            - The event must involve an exchange of goods, money or other items of economic value
            - The exchange must have happened in the past
            - The exchange must have been between the entity being accounted for and someone else (external)
        2. **Supplementary characteristics:**
            - Evidence: there must be documentation of what has occurred
            - $: must be measurable in a currency unit
        3. Transactions must be **linked to the legal and economic concept** of exchange (i.e. contracts)
        4. They constitute a large part of the underlying rationale for the **historical cost basis** of accounting, which is firmly based on the transaction
        5. The characteristics of the transaction provide the basis on which the **records can be verified (audited)**
2. **General Journal**
    - Every transaction has two effects: one credit and one debit entry → **the sum of credit (CR) balances must = the sum of debit (DR) balances**
    - Debits are recorded as positive and credits as negative (**add debits, subtract credits)**

Type of Account	Increases Result In:	Decreases Result In:
Assets (A)	DR	CR
Liabilities (L)	CR	DR
Equity (E)	CR	DR
Share capital (E)	CR	DR
Retained profits (E)	CR	DR
Revenue (R)	CR	DR
Expenses (Exp)	DR	CR

3. **<u>Post to Ledger Accounts</u>**
    - Ledger accounts (T-accounts): summaries of the recorded transactions and grouped into accounts



4. **<u>Trial Balance</u>**
    - List of all general accounts and their balances shown as either DR or CR balances
    - Hints on finding errors:
        - **Divide by 2 and look for account with that balance.** Likely the amount is **posted to the wrong side** of the account
        - If the **difference is divisible by 9,** the it is likely **a transposition error** (e.g. 21 instead of 12)

Appendix

BALANCE SHEET

<u>Assets</u> $ **Current Assets** Cash Accounts Receivable ... etc. **Total Current Assets** **Non-Current Assets** Equipment ... etc. **Total Non-Current Assets** **Total Assets (current + non-current)**	<u>Liabilities</u> $ **Current Liabilities** Loan Accounts Payable ... etc. **Total Current Assets** **Non-Current Assets** ... etc. **Total Non-Current Assets** **Total Liabilities (current + non-current)** <u>Equity</u> $ Share capital **Total Equity** **Total Liabilities & Equity**

INCOME STATEMENT

<u>Revenue</u>	<u>$</u>	<u>$</u>
Sales		x,xxx
COGS		
Operating Inventory	x,xxx	
(add) Purchases	x,xxx	
(less) Closing Inventory	x,xxx	
(less) COGS		x,xxx
Gross Profit		
(add) other operating revenue		
Total Revenue		
<u>(Less) Other Operating Expenses</u>		
Selling & Distribution Expense		
Advertising		
... etc.		
General & Administrative Expenses		
Depreciation		
Rent Expense		
... etc.		
Total Expenses		
<u>Net Profit</u> (revenue - expenses)		

Topic 2 - Accounting Cycle Completed

Accounting Cycle Continued

5. **<u>Adjusting Journal Entries</u>**
    - Adjusting entries never involve cash
    - Purpose of adjusting entries is to adjust revenues and expenses (and the related asset and liability accounts) to:
        - Record revenue in the period in which it is "earned"
        - Record expenses in the period in which they have been "incurred"
    - 2 main categories of adjusting entries:
    1. **Deferrals (prepayments):** to recognise revenue (resource inflow) or expense (resource outflow) <u>after</u> cash inflow
        - **Prepaid expenses** (e.g. rent paid in advance) are initially recorded as an asset → arises when expenditure has been made, but there is still value in the future
            - As an asset is consumed in the process of earning revenue, the portion of the cost "used up" is written off in each period as an expense
            - Adjusting entry: the amount of the adjusting entry represents the **portion of the prepaid asset consumed in the current period**

              DR Expense

              CR Prepaid Asset
        - **Unearned Revenue** (e.g. subscription fees paid in advance): initially recorded as a liability
            - Occurs when the company has received payment for goods/services that are yet to be provided, so the company is not entitled to recognise the revenue at the time the cash was received
            - Adjusting entry: the amount of the adjusting entry represents the **actual or estimated amount of the expense that has been incurred but not recorded**

              DR Unearned Revenue

              CR Revenue
    2. **Accruals (unrecorded transactions):** to recognise revenue (resource inflow) or <u>before</u> cash in/outflow
        - **Accrued expenses** (e.g. wages owed but not yet paid): arise when expenses were incurred but not yet paid in cash during a period → payment will occur in a future accounting period
            - **Is a current liability**
            - Adjusting entry: the amount the adjusting entry represents the **actual or estimated amount of the expense that has been incurred but not recorded**

              DR Expenses

              CR Payables (Accrued Expenses)

- **Accrued revenues** (e.g. interest earned but not yet received): the company has earned the revenue but cash will not be received until following accounting period
    - **Accrued interest is a current asset**
    - Adjusting entry: the amount of the adjusting entry represents **actual or estimated amount of the revenue that has been earned but not recorded**

6. <u>**Closing Journal Entries**</u>
    - **Temporary accounts** include: revenue/gain accounts, expense/loss accounts and dividends/drawings accounts → these accounts **must be closed** (reduced to a **zero balance**) at the **end of the accounting period**
    - Permanent accounts (assets/liabilities/equity) are not closed → balance carried to the next accounting period
    - The process:
        1. A new temporary account (Profit & Loss Summary) is created
        2. The balance in each **revenue/gain** account is transferred (i.e. closed) to the P&L Summary account
           DR Revenue
           CR P&L Summary
        3. The balance in each **expense/loss** account is closed to the P&L Summary account
           DR P&L Summary
           CR Expenses
        4. The **net balance** (total revenue - total expenses) in the P&L Summary account is closed to the retained profits account

Profit:	**Loss:**
DR P&L Summary	**DR Retained Profits**
CR Retained Profits	**CR P&L Summary**

        5. The balance of the Dividends account is closed to the Retained Profits → for the sole trader, the Drawings account is closed to the capital account
           DR Retained Profits
           CR Dividends

7. <u>**Post-Closing Trial Balance**</u>
    - Once closing entries have been posted, closing **trial balance should show zero balances for the temporary accounts** → only permanent accounts are shown

8. <u>**Financial Statements**</u>
    - Once adjusting entries have been prepared and posted, an adjusted trial balance can be drawn up → basis for preparing the financial statement

Expense & Contra Accounts

- Contra accounts: used mainly with asset accounts → used as a "negative" asset account for a related account. They include:
    - Property, Plant and Equipment (land does not depreciate) → **Accumulated Depreciation**

- Accounts Receivable → **Allowance for Doubtful Debts**
- Inventory → **Allowance for Obsolescence**

- Contra assets are useful for:
  - Showing remaining economic benefits of an asset
  - Ascertain level of doubtful debts (and changes therein), collection policies and problems
  - Show's level of slow-moving stock, out of date stock, efficiency of stock management

Accumulated Depreciation

- Depreciation: the allocation of the cost of a non-current asset to expense over the life of an asset to recognise the consumption of the asset over time
- Depreciation Expense (income statement) shows this year's depreciation allocation only
  - Formula: (cost - residual value)/useful life in years
- Accumulated Depreciation (balance sheet) shows all depreciation shown to date
  - Carrying amount formula: asset - accumulated depreciation
- **Journal entries:**
  DR Depreciation Expense
  CR Accumulated Depreciation

Allowance for Doubtful Debts

- The risk of extending credit to customers that won't pay. Two main methods are used to account for bad debts:
  1. **Direct write-off method:** directly write off an account (receivable) when the company determines an account to be uncollectible → no "provision" or "allowance" account is used
     - **Journal entries:**
       DR Bad Debts Expense
       CR Accounts Receivable
     - Assumes no previous allowance has been made and hence no expense was previously recorded
  2. **The allowance method** - under this method:
     - Receivables are valued at the lower of the cost and net realisable value (NRV) → this is reflected in Allowance for Doubtful Debts
       - NRV: the amount expected to be collected
     - **Journal Entries:**
       Potential:
       DR Bad Debt Expense
       CR Allowance for Doubtful Debts
       Uncollectable:
       DR Allowance for Doubtful Debts
       CR Accounts Receivable