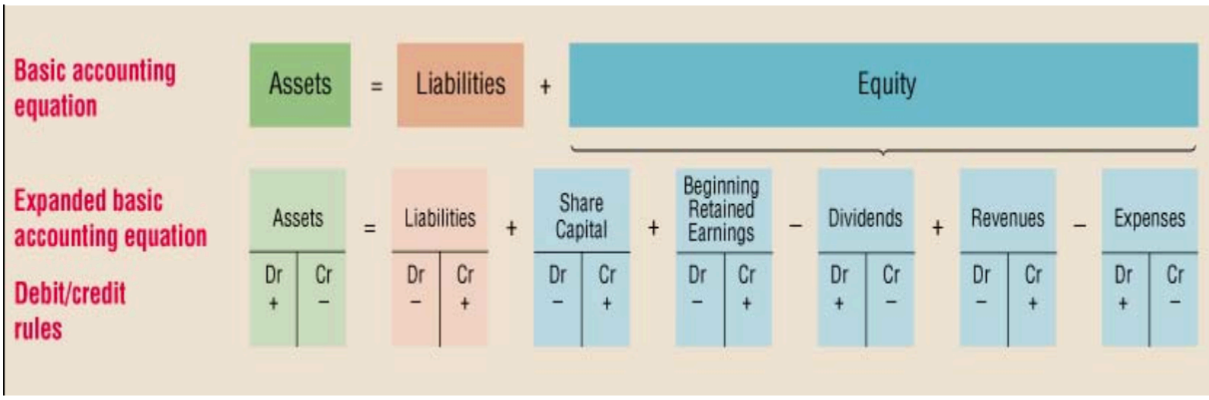
GAAP Concepts and Principles

Principle	Description
Accounting Period Concept	Time accounting data is collected and financial statements are prepared. **WHY?** Divided into artificial periods for reporting purposes.
Full Disclosure Principle	Requires all circumstances and events that could make a difference to decisions users might make are fully disclosed.
Going Concern Principle	Assume entity will continue to operate in the foreseeable future unless the business will cease trading or go into liquidation.
Accounting Entity Concept	Only information about transactions, not personal transactions, relating to an entity is involved in financial statements.
Monetary Principle	Only things that can be expressed in monetary terms can be in accounting records.
Cost Principle	G + S should be recorded at historic cost.



Normal balance:
DR: assets, drawings, expenses.
CR: liabilities, revenue, equity.

Accrual Accounting Concepts

Recording Process:

1. Analyse each transaction in terms of its effects on accounts,
2. Enter transaction into a **journal** (chronological record).
3. Post journal information into appropriate accounts in the **ledger** (running balance, T account (cross-referenced))
   Balance each ledger account – accumulates effect of journalised transactions in individual accounts and closes the books.
4. Prepare **Trial balance** – list of all accounts and their balances at a given time to prove DR = CR.
5. Journalise, Post and trial balance for Adjusting entries. (periodically done)
6. Prepare Financial Statements
7. Journalise, Post and Trial balance for post-closing entries. (done at EOFY)

Worksheets are optional devices which are spreadsheets that assist in the preparation of adjusting entries in financial statements.

Accounting Information System: system of collecting and processing transaction data and communicating financial information to interested parties.

Accrual accounting: record expenses and revenue at the time incurred (when they meet the recognition criteria) – double entry system.
Cash-based accounting: revenue is recorded only when cash is received and an expense is only recorded when cash is paid.

Adjusting entries are needed to ensure recognition criteria are followed for A, L, revenue and expenses and to produce accurate and up to date financial statements. Effect an income statement and balance sheet account but never affect cash flow.

- **Prepayments:** pay before consumption/use.
    - Prepaid expenses (cash outflow precedes receipt of G/S; either recorded as asset or expense), revenue received in advance (cash inflow precedes supply of G/S; commonly recorded as liability).
- **Accruals:** pay after consumption/use.
    - accrued revenue (supply precedes cash inflow – revenue is unreceived and unrecorded), accrued expenses (receipt precedes cash outflow – not paid or recorded).

Post-closing entries close all temporary accounts to a balance of zero.
1. Debit revenues, credit expenses and opposite effect on P/L Summary account. Balance is the P/L.
2. Close P/L Summary to Retained Earnings.
3. Close Dividends to Retained Earnings. (done after because dividends are a distribution of retained earnings).
4. If sole proprietorship close capital and drawings accounts – debit capital, credit drawings.

Temporary accounts: relate only to one accounting period (revenue, expenses, dividends).

Permanent accounts: carried forward to future accounting periods (A, L, OE).

Analysing Financial Statements

Highlights relationship among items of financial statement data, provide insights into underlying conditions and help in evaluations that may not be apparent from simply viewing financial statements.

Profitability	Liquidity	Solvency
Ability of a firm to generate financial return. ROA = Profit/Total assets Profit Margin = Profit/Net sales **GPR = GP/Net sales** *GP = sales revenue – COGS* *NP = GP - expenses* **Operating expenses to sales ratio** = Operating expenses/net sales	Short term ability to meet current obligations. 3 useful measures: **Current Ratio = CA/CL** **WC** = CA – CL **Quick Ratio** = cash + marketable securities + Net receivables/CL Better indication of liquidity because looks at liquid CA.	Measures ability of an entity to survive over a long period of time. **Debt to Total Assets Ratio: TL/TA** **Times interest earned** = profit before income tax + interest expense/interest expense See if business can make fixed interest repayments as they fall due.

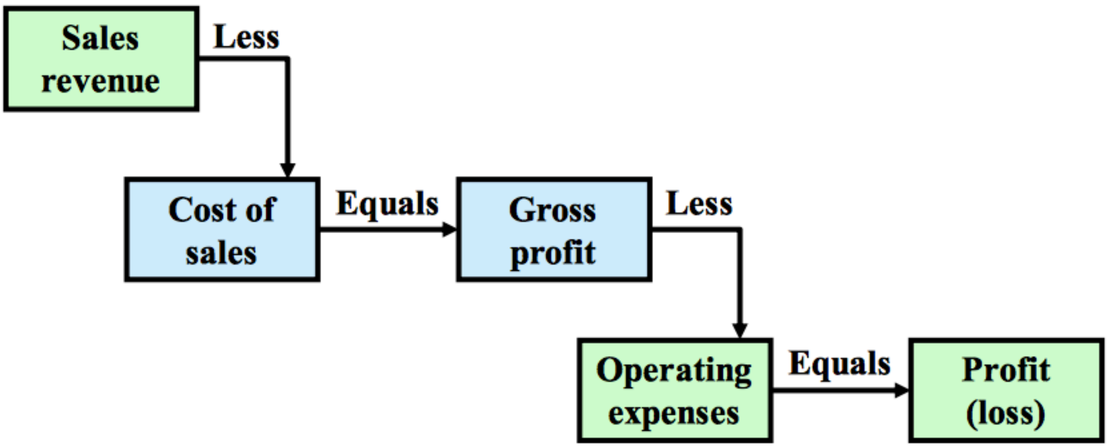
Cash return on sales ratio = net cash provided by operating/net sales	**Current cash debt coverage** = net cash from operating/average CL	**Cash debt coverage** = net cash from operating/average TL

Merchandising Operations & Inventories

Merchandising operations

- Merchandising businesses purchase inventories for re-sale to generate sales revenue.
- Expenses of merchandising include **Cost of Sales (COGS)** (total cost of inventory purchased and sold in the period – freight cost, transport costs, etc.) and **Operating Expenses** (selling, administrative, financial).
  Cost of Sales = Opening Stock + Purchases – Purchase Returns and Allowances - Closing Stock
- Credit purchases should be supported by a supplier's invoice and credit sales should be supported by a sales invoice as evidence.
- **Cost of goods purchased** (COGP): (***net purchases [gross purchases – costs] + freight charges***).
- Gross Profit Ratio and Operating expenses to sales ratio are important for merchandisers.
  - Higher value or increasing percentage of operating expenses = cost cutting should be investigated.
  - Too high profit margin can drive customers to competitors.
- No gross profit in a service business.

Profit Measurement – primary objective of accounting for inventory to evaluate a business' financial return.



AASB 102 – Inventories

- Para 1: primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised.
- Para 6: inventories are assets – held for sale in ordinary course of business, in process of production of in form of material or supplies to be consumed in production or in rendering of services.
- Para 34: when inventories are sold, the carrying amount of those shall be recognised as an expense in the period in which the related revenue is recognised.