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CHAPTER 1: Elements in the Conceptual Framework; Capital Maintenance Measurement; The recording process

GENERAL NOTES

Accounting regulation

There are **three** main sources of accounting regulation, including:

1) **Companies legislation**
2) **Stock exchange listing regulations**

} Apply the broad principles to the **many & varied** transactions, events and circumstances that arise in practice

3) **Accounting standards** → Generally only deal with principles of accounting measurement and disclosure at a **broad** level

In Australia, a Conceptual Framework (see below), as well as an Australian Accounting Standards Board (AASB) regulate the practice of accounting. The **CONCEPTUAL FRAMEWORK** is comprised of the following elements:

PART 1: ***SAC*** **(Statement of Accounting Concept) 1 - Defining a reporting entity**

In determining whether a business is a reporting entity, and thereby obligated to propose general purpose reports, the following factors must be considered:

- **The existence of dependent users who rely on financial information and reports for decision-making purposes –** includes the owner and shareholders, who rely on financial information in reaching decisions as to whether, for example, they should invest in the business or not.
- **Separation of the owner from the entity/management –** the greater the separation between the owners and management, there more likely it is that there exists users who are dependent upon general purpose financial reports as a basis for decision-making purposes.
- **Economic/political influence –** the greater the economic/political influence of an entity, the more likely it is that there exists users who are dependent upon general purpose financial reports as a basis for decision-making purposes.
- **Financial characteristics –** the larger the size/indebtedness of the entity, the more likely it is that there exists users who are dependent upon general purpose financial reports as a basis for decision-making purposes.

PART 2: ***SAC 2*** **- Objectives of financial reporting and a reporting entity**

The objective of financial reporting and the reporting entity is to provide users with decision-useful information by collecting and collating financial information into general purpose reports, including the:

- Income Statement
- Statement of Financial Position (Balance Sheet)
- Cash Flow Statement
- Statement of Changes in Equity

PART 3: <u>THE AASB FRAMEWORK</u>

Brief history of regulation

Over time, 'Generally Accepted Accounting Principles' (GAAP) have developed to guide the practice of accounting. But as entities grew in size and complexity, more formal rules were required – resulting in the standards formed by the AASB (Australian Accounting Standards Board). These standards are mandatory to many entities nowadays in the preparation of financial statements.

As part of these standards, a **CONCEPTUAL FRAMEWORK** was developed to base these standards upon. A set of inter-related concepts outlining the *nature, scope & content* of accounting and reporting, this framework covers the general theory of accounting in developing specific accounting rules and regulations in determining how information should be presented in financial statements.

Need for the Conceptual Framework

The Conceptual Framework:

- Provides a logical and consistent outline and understanding of the *nature, purpose* & *methods* of financial accounting.
- The complexity of businesses in today's world requires in-depth guidelines for their proper management and reporting to dependent users.
- Resolves conceptual disputes with regards to accounting practice, outlining clearly how items should be measured, recorded and disclosed.

The **CONCEPTUAL FRAMEWORK** covers many areas of accounting, including (as well as SAC 1&2):

PART 3a: ***Assumptions underlying financial reports***

- **Going-concern principle –** the life of the business is assumed to be continuous with an undetermined lifespan.
- **Accrual assumption –** income and expenses are recognised in the period in which they are earned/incurred, which is not necessarily when, or in the same period, as when money changes hands.

PART 3b: ***Qualitative Characteristics***

The two most essential characteristics of financial reports are:

- ✓ **Relevance –** to be useful, information must be relevant to the decision-making needs of users. Information is deemed relevant when it <u>influences the economic decisions of users</u> by helping them evaluate past, present or future events or confirming/correcting their past evaluations.
- ✓ **Reliability –** information is deemed reliable when it is <u>free from material error and bias</u> and can be depended upon by users to <u>faithfully represent that which it purports</u> to represent, or could reasonably be expected to represent.

PART 3c(i): ***Key elements – definitions***

The various elements of financial reports include:

<u>Assets</u>

- **A resource <u>controlled</u> by the entity** – control regulates the capacity of the entity to <u>benefit from the asset</u> in pursuit of its objectives while <u>denying/regulating</u> the access of others to that benefit.
- **As a result of past events** – brought about through a previous economic event/transaction
- **From which future economic benefits are expected to flow <u>into</u> the entity** – the capacity of assets to provide economic benefits, which can then be used to provide goods/services for exchange in generating *positive* cash flows.

<u>Liabilities</u>

- **A <u>present obligation</u> of the entity** – includes both legally enforceable obligations, such as contractual agreements, as well as equitable (i.e. moral/social/constructive) obligations.
- **Arising from past events**
- **The settlement of which is expected to result**
- **In the <u>outflow of resources</u> from the entity embodying economic benefits**

<u>Equity</u>

- **The residual interest in the assets of the entity** – subtracting liabilities from assets
- **After deducting all its liabilities –** resulting in a net amount which constitutes the claim/right owners have over the net assets of the entity.

NOTE: Equity is <u>increased</u> by <u>profitable</u> operations (i.e. income exceeds expenses, owner contributions), and <u>diminished</u> by <u>unprofitable</u> operations (i.e. expenses exceed income, owner distributions)

<u>Income</u>

- **Increases in economic benefits** – derived from the definition of assets
- **During the accounting period** – under the accrual accounting system, income is only recognised within the period when it occurred, being closed off at the conclusion of the period.
- **In the form of a) inflows/enhancements of assets, or b) decreases in liabilities**
- **That result in increases to equity**
- **Other than those relating to contributions from equity participants** – owner's contributions do not constitute revenue

<u>Expenses</u>

- **Decreases in economic benefits** – derived from the definition of liabilities
- **During the accounting period** – same concept as income (see above)
- **In the form of a) outflows/depletions of assets, or b) incurrences of liabilities**
- **That result in decreases in equity**
- **Other than those relating to distributions to equity participants** – owner's, shareholders drawings/dividends do not constitute an expense

PART 3c(ii): ***Key elements – recognition***

Under the CONCEPTUAL FRAMEWORK two additional criteria are required for the recognition of assets, liabilities, income and expense items, and thereby, their presentation within general purpose financial reports:

- ✓ **It is <u>probable*</u> that any future economic benefit associated with the item will flow to/from the entity**
- ✓ **The item has a cost/value that can be <u>reliably measured</u>** (i.e. in dollar figures)

*__Probable__ refers to the notion of 'more likely than less likely' i.e. more than 50% chance of occurring. Has caused controversy as it contravenes the principle of *conservatism,* which requires income and/or assets be recognised only when there is a *<u>high degree</u>* of cash being received.

This notion could lead to unscrupulous businesses adopting a level of probability which is too high, leading to business-wide occurrences of bad and doubtful income and assets.

PART 3c(iii): ***Key elements – measurement***

'Measurement' refers to the process of determining **monetary amounts** at which assets and liabilities, and hence income and expenses, should be recognised and carried in financial reports. The valuation methods adopted have an impact on the capital, and therefore wealth, of an entity (next topic). Valuation methods include:

Historical cost:

- ***Assets –*** recorded at the amount paid, or their fair value, at the time of their purchase/acquisition.
- ***Liabilities –*** recorded at the amount of proceeds received in exchange for the obligation, or in some cases, the amount expected to satisfy the liability.

Current cost:

- ***Assets –*** are carried at the amount that would have to be paid if the same/equivalent assets were purchased currently.
- ***Liabilities –*** are carried at the undiscounted amount that would be required to settle the obligation currently.

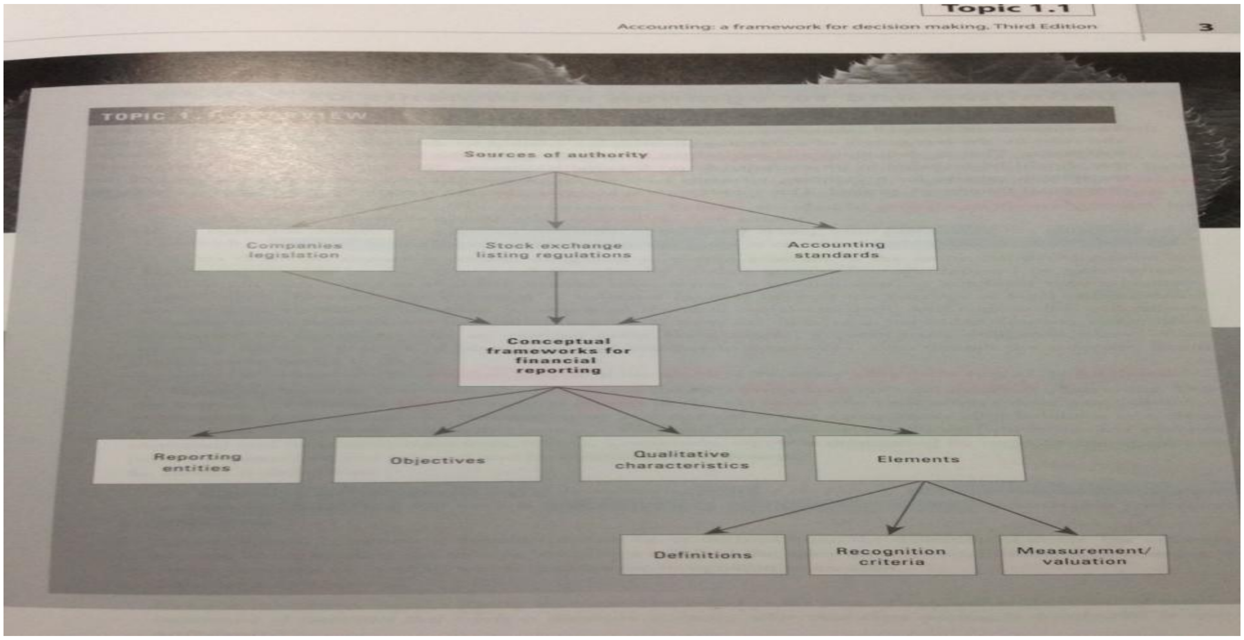
Realisable (settlement) value:

- ✓ ***Assets –*** are carried at the amount that could currently be obtained by selling the asset.
- ✓ ***Liabilities –*** are carried at their undiscounted amounts expected to be paid to satisfy the liabilities.

Present value:

- ***Assets –*** are carried at the present <u>discounted</u> value of <u>future net cash inflows</u> that the item is expected to generate.
- ***Liabilities –*** are carried at the present <u>discounted</u> value of <u>future net cash outflows</u> that are expected to be required to settle the liabilities.

A summary of Topic 1.1 is below:



Topic 1.2: Capital Maintenance Measurement

GENERAL NOTES

People start businesses in order to earn a profit and gain wealth. The wealth of a business is determined by its capital, the **net worth** of the business which is also the residual claim the owner has over the entity's assets. It is assumed that business owner's want their entity's, and therefore their wealth and profits to grow from period to period, but if not, to at least **maintain** their wealth and level of profits. This is the idea behind **capital maintenance** – the desire for a business to be as well off, if not better off, at the end of the period as they were at the start of the period.

There are **two** forms of capital maintenance:

- ✓ **Maintaining monetary capital** – a business is said to have maintained its monetary capital if it is in the same financial position in dollar terms *at the end of the period* as it was *at the start of the period*, once contributions from/distributions to the owner have been excluded.
- ✓ **Maintaining physical capital** – a business is said to have maintained its physical capital if it is able to remain in the same operating capability at the end of the period as it was at the start of the period, once it has re-purchased assets sold and expensed during the year, and contributions from/distributions to the owner have been excluded.

Capital is calculated by deducting liabilities from assets. Hence, the valuation method applied to assets will have a direct effect on the determination of net capital, and the overall net worth of firm. There are several ways in which to value assets (facing page):

All Forms Of Physical/ Adaptive Capital Maintenance

Method of Valuation	Description	Strengths	Weaknesses
Historical cost (**Maintenance of monetary capital** use historical cost valuation as its basis) If a business distributes all of its profit as dividends/drawings, maintaining the monetary wealth at the start, but the price of sold/expensed assets have risen, the business will be unable to purchase the same quantity the following period. Thus they have **maintained monetary capital** but **eroded physical capital**.	Valuing assets at the cost incurred to purchase them at the time of the original transaction.	Facilitates **reliability** – the cost of the asset can easily be referenced back to source documentation, verifying that maintained cost faithfully represents the cost of purchase.	Assumes money holds a **constant buying power.** Due to inflation, the value of money changes over time, making the historical cost a fair representation of the assets value at a particular point in time, only (at time of purchase). Makes the practice of adding assets purchased in different periods together, as those assets were purchased with dollar of differing buying power.
Current replacement cost/Current cost Involves valuing monetary assets at replacement cost i.e. away from historical cost, which will inevitably rise due to inflation	Valuing assets at the amount that would have to be paid at **today's prices** to purchase a similar/same item.	Facilitates **relevance –** valuing at current prices is very useful for users of financial reports in their decision-making.	It is assumed that the owner wants the asset replaced – sometimes isn't the case with very valuable assets. Current cost accounting lowers profit, making businesses look bad compared to competitors
Economic value/Present value	Value of the expected earnings from the item, discounted to give a present-day value.	This would be the most ideal and accurate measure of value and wealth if calculated correctly.	Valuation implies knowledge of what is going to happen. Societal changes can make the estimation problematical. Discounting rate can become very subjective, especially when manipulated to make current capital seem better than it really is.
Net realisable value	Estimated proceeds from selling the asset, less all costs incurred in marketing, selling and distributing it to customers.	-	Can be a very subjective form of valuation, as different assumed costs may be predicted by different people. It is assumed there is a buyer for the asset – otherwise, it is essentially worthless.
Fair value/Exit value	The amount that a willing buyer and seller are prepared to exchange for an item in an arm's length transaction.	Is an **adaptive** method of valuing assets, changing along with current selling prices. No need for arbitrary cost allocations for depreciation, as depreciation is based on changes in exit price.	When the asset is sold, no profit or loss is recognised, as the gain was recognised as the difference between retail price and actual cost at time of purchase. As such, exit valuing requires a **fundamental shift in revenue recognition,** and has not been widely adopted. Specialised assets are considered to have no value, as they cannot be separately disposed of. Fair valuing ignores the 'value in use' of an asset.

As part of the calculation of capital, **profit** has to be calculated. There are two methods of doing so:

1) ***Stocks approach***

Profit is measured as the increase in wealth that occurs over time after taking into account changes in capital investment and drawings.

Formula:

$$\boldsymbol{Profit} = [\text{OE(end)} - \text{OE(start)}] - \text{Capital contributions(end)} + \text{Drawings, Dividends(end)}$$

Thus, the **stocks approach** measures profit *indirectly* i.e. away from the traditional measure of profit as a function of income less expenses, as a result of changes in wealth.

2) ***Flows approach***

Profit is measured as in the increase in wealth brought through the day-to-day earnings & activities of the business i.e. taking income and expenses into account.

Formula:

$$\boldsymbol{Profit} = \text{Income(end)} - \text{Expenses(end)}$$

Thus, the **flows approach** measures profit *directly* i.e. through the traditional measure of profit as a function of income less expenses.

Generally, the flows approach is preferred because it provides **detailed records of income & expenses** which help with:

- The administration of business eg. wage records
- Decision-making measures, such as actions to increase profits.
- Internal reporting and providing detailed information to the tax offices.

NOTE: If there is no detailing of income & expenses, the stocks approach needs to be adopted. However, both approaches must, by definition, yield the exact same result. This is because assets, a part of the stocks approach, is used to provide economic benefit in the form of income, just like liabilities are obligations which result in the outflow of economic benefit in the form of expenses.

Topic 1.3: The recording process

GENERAL NOTES

The recording system

The complete accounting recording system is as follows:

Source documents → *Journals* → *Ledgers* → *Trial Balance* → *Financial statements*

Source documents are recorded in **journals,** followed by recording in the **ledger.** All accounts are then checked to see whether debits equal credits (more to follow) in the **trial balance,** followed by these items's transferral and recording in their various **financial statements.**

A recording system has to fulfil **three** requirements:

- ✓ **Efficiency –** must be able to process transactions with minimum recording procedures. Otherwise, the likelihood of errors would be increased by inserting more steps to the chain, which would in turn make the process more cumbersome and costly.
- ✓ **Control –** the system should provide checks against routine errors, such as faulty additions or misclassification. This ensures that the eventual reports are consistent with the original evidence records, and that no interference has occurred in the process.
- ✓ **Accessibility –** records and reports must be easy to attain and follow. Therefore, records and reports require enough detail so that management can read, interpret and make decision thereof.

The Accounting Equation & Double-entry Recording

The accounting equation is recognised as:

Assets = Liabilities + Owner's Equity (Income – Expenses + Contributions – Drawings)

This equation **must always** remain in balance i.e. equal. To achieve this, each transaction has at least two effects on it – a *debit* & *credit* effect – which are recorded on either one of the two side of the ledger, preserving the equality of the equation:

- ✓ **Debit** refers to the left-hand side of the ledger account, trial balance and/or balance sheet. Accounts which are *increased* via a debit include **assets, expenses** & **drawings** items, as well as contra-revenue and contra-liability accounts.
  - Likewise, the above is *decreased* via a credit.
- ✓ **Credit** refers to the right-hand side of the ledger account, trial balance and/or balance sheet. Accounts which are *increased* via a credit include **liabilities, income** & **capital** items, as well as contra-asset and contra-expense accounts.
  - Likewise, the above is *decreased* via a debit.

PART 1: Source documents

To ensure financial statements are consistent with original evidence of transactions, all entries in the journals and ledgers are traceable back to evidence. This is facilitated by standard business documents such as *invoices* (to customers), *bank records, cheque butts* and *receipts.* When an entry is not based on one of the aforementioned documents, it must be authorised by an officer of the organisation.

PART 2: Recording in the Journals

All transactions are initially recorded in journals. Journals help to ensure all like-entries are kept together, so that a sequential and logical record of all transactions is kept. There are various types of journals, including:

Part 2a: *The General Journal*

Format:

Date	Account name	Debit	Credit
DD/MM/YY	Debit account	$$$$	
	Credit account		$$$$
	Narration – source doc.		

As shown above, the General Journal has a fairly simple format:

- ✓ Debit account(s) are listed first, along with their amounts.
- ✓ Credit account(s) are indented, along with their amounts.
- ✓ A **narration** i.e. a brief description of the transaction usually follows, with *reference to the source document.*

NOTE: The narration enhances control over a business' transactions, allowing it to have another point of reference to the original transaction and its documentation.

There are, however, many difficulties associated with the general journal:

1) It is time-consuming to enter every transaction within it, and therefore is costly to maintain.
2) Recording becomes very repetitive and monotonous for like-transactions.
3) The volume of transactions transferred to the general journal is very high.
4) There is a limited scope for segregation of duties i.e. maintaining only one journal does not provide enough duties to every accounting personality within the firm, and can also lead to errors.

Therefore, in practice, the general journal is a once-off/infrequent journal, used for *balance-day adjustments, reversals of BDAs, contributions from owners* (other than cash) & *asset purchases on credit.*

Therefore, there are various other types of journals, known as **special journals**, shown below:

Part 2b: *The Sales Journal*

Date	*Inv #*	*Customer Name*	*Post Ref*	*Sales*	*GST Collected*	*Accounts Receivable*

Used to record **credit sales.**

At end of month, columns are totalled are recorded in general ledger as:

Dr Accounts receivable
Cr Sales
G.S.T. collected

NOTE: Under the *periodic inventory system*, a column titled **inventory/CoGS** is added to the end, with the following transferred to the ledger:

Dr Accounts Receivable, **Cr** Sales/GST collected
Dr Cost of Goods Sold, **Cr** Inventory

Part 2c: ***The Purchases Journal***

Format:

Date	Supplier Name	Inv. #	Post Ref	Purchase	GST Paid	Other Expenses	Accounts Payable

Used to record **credit purchases.**

At the end of each month, the journal columns are totalled and transferred to the general ledger as:

Dr Purchases/Inventory
Expenses
GST paid
Cr Accounts payable

Part 2d: ***The Cash Receipts Journal***

Format:

Date	Account	Rec #	Post Ref	Bank	Disc Exp	Cash sales	GST Coll	Accounts Rec	Other

Used to record **cash receipts.**

At the end of each month, the journal columns are totalled and transferred to the ledger as:

Dr Bank, Discount expense

Cr Sales, GST collected, Accounts receivable, Revenue

Part 2e: ***The Cash Payments Journal***

Format:

Date	Account	Chq #	Post Ref	Bank	Disc Rev	Wages	GST Paid	Accounts Payable	Other

Used to record **cash payments.**

At end of the month, columns are totalled and transferred to general ledger as:

Dr Wages, Accounts payable, GST paid, Expenses

Cr Bank, Discount revenue

Benefits of recording in separate journals include:

- Reducing excessive detail in general ledger
- Improvement in efficiency of recording
- Improvement in speed of recording

PART 3: Posting to the ledgers

A ledger account is made for each individual account. There are two formats of the ledger account, including:

1) **The T-ledger**
2) **The running balance ledger** (see below) – involves determining a new balance after each individual transaction

Format:

Account name **Account no.**

Date	*Account name*	*Debit*	*Credit*	*Balance*
DD/MM/YYYY	XXXX	$$$$	$$$$	$$$$

As stated previously, each transaction has to have a **dual-effect** i.e. affect both the debit and credit sides of the ledger in order to keep the accounting equation balanced. This provides for both ***control*** over the accounts of the business, and makes the recording process more ***efficient*** and easy to understand. Further, by placing the date, and the two (or more) account names, ledgers are made more ***accessible*** to users of financial information, allowing for comprehension of the activities of the business in making their decisions.

Part 3a: Subsidiary ledgers

Different levels of information are needed by different managers. Managers responsible for a certain area of the business require very detailed information, while other managers may only need summary information of business activities. However, if **all** ledger accounts are recorded in the general ledger, it becomes very large and excessively detailed. Therefore, ***subsidiary ledgers*** for individual accounts receivable, accounts payable and inventory are used, whose added totals are then transferred to the ***accounts receivable/accounts payable/inventory control accounts.*** This enables more summary information to be maintained in the general ledger and trial balance. An example follows:

Trial Balance

Account name	*Debit*	*Credit*
Bank	10, 000	
Inventory	20, 000	
Debtor: A	**5, 000**	
Debtor: B	**3, 000**	
Debtor: C	**100**	
Debtor: D	**12, 500**	
Debtor: E	**690**	
Debtor: F	**458**	
Debtor: G	**1,200**	
Plant & equip.	90, 000	
Acc. Dep'n.		500

Account name	*Debit*	*Credit*
Bank	10, 000	
Inventory	20, 000	
Accounts receivable control	**22, 498**	
Plant & equip.	90, 000	
Acc. Dep'n		500

As shown above, all 7 individual (subsidiary) debtor ledger accounts are cross-referenced and totalled to add up to the **accounts receivable control** account. The same procedure would be followed for individual creditor accounts, as well as accounts of different types of inventory

In terms of recording the above in the **special journals:**

- Individual debtors would be recorded in the sales journal
- Individual creditors would be recorded in the purchases journal

In terms of recording the above in the **general ledger:**

- Individual debtor/creditor transactions are recorded *in summary* in the ***accounts receivable/accounts payable accounts***, and *in detail* in the individual debtor/creditor account in the ***subsidiary ledger***

PART 4: Recording in the Trial Balance

The **trial balance** is a list of all accounts and their balances at a *specific point in time*; that is, after all transactions have been recorded in the general ledger, but prior to the preparation of the financial statements.

Accounts which usually have **debit balances** (assets, expenses, drawings) are posted to the left-hand i.e. 'debit' side of the Balance, while accounts which usually have **credit balances** (liabilities, income, capital) are posted to the right-hand i.e. 'credit' side of the Balance. These two columns **should equal.** Format follows below:

Account name	**Debit**	**Credit**
XXXX	$$$$	$$$$

If the Trial Balance's debit and credit columns don't balance, it could be due to a variety of reasons, including:

- ✓ **Errors in preparation –** incorrect addition of totals, recording account balance on wrong side of Trial Balance
- ✓ **Errors in recording in ledger –** incorrect calculation of a ledger balance, recording a balance on the wrong side of the account.

But even if the Trial Balance columns <u>do</u> balance, there could nevertheless still be errors in the statement, including:

- ✓ Completely omitting transactions
- ✓ Entries being recorded twice
- ✓ Wrong amounts entered in both accounts
- ✓ Debit and credit entries were reversed

PART 5: Recording Closing Entries

Under the accrual accounting system, income and expenses are earned and/or incurred in the period which they occur, but not necessarily when cash has exchanged hands. Therefore, *on the last day of the period*, income and expense items need to be **closed to 0** in a) preparation for the next reporting period, as well as b) to calculate profit for the current period to disclose in reports, aiding users in their decision-making.

Income and expense accounts, as well as drawings to capital, are disclosed in the following manner (to a temporary ledger account known as the **Profit & Loss Summary** account):

General Journal

Account name	**Debit**	**Credit**
Income 1	$$$$	
Income 2	$$$$	
Income 3	$$$$	
Profit & Loss Summary		$$$$
Profit & Loss Summary	$$$$	
Expense 1		$$$$
Expense 2		$$$$
Expense 3		$$$$
(**If profit realised**):		
Profit & Loss Summary	$$$$	
Capital		$$$$
(**If loss realised**):		
Capital	$$$$	
Profit & Loss Summary		$$$$
Capital	$$$$	
Drawings		$$$$

PART 6: Preparing the reports

Several reports are prepared at the conclusion of the period, including the **Income Statement, Balance Sheet** (Statement of Financial Position) and **Cash Flow Statement**.

Format: *Income Statement* (only income and expense accounts closed to Income Statement):

Item	**Value**
Sales	$$$
Less Sales Returns	$$$
Net Sales	$$$
Less Cost of Sales	$$$
Gross profit	$$$
Add Discount revenues	$$$
Adjusted gross profit	$$$
Less Other expenses	$$$
Net profit	$$$

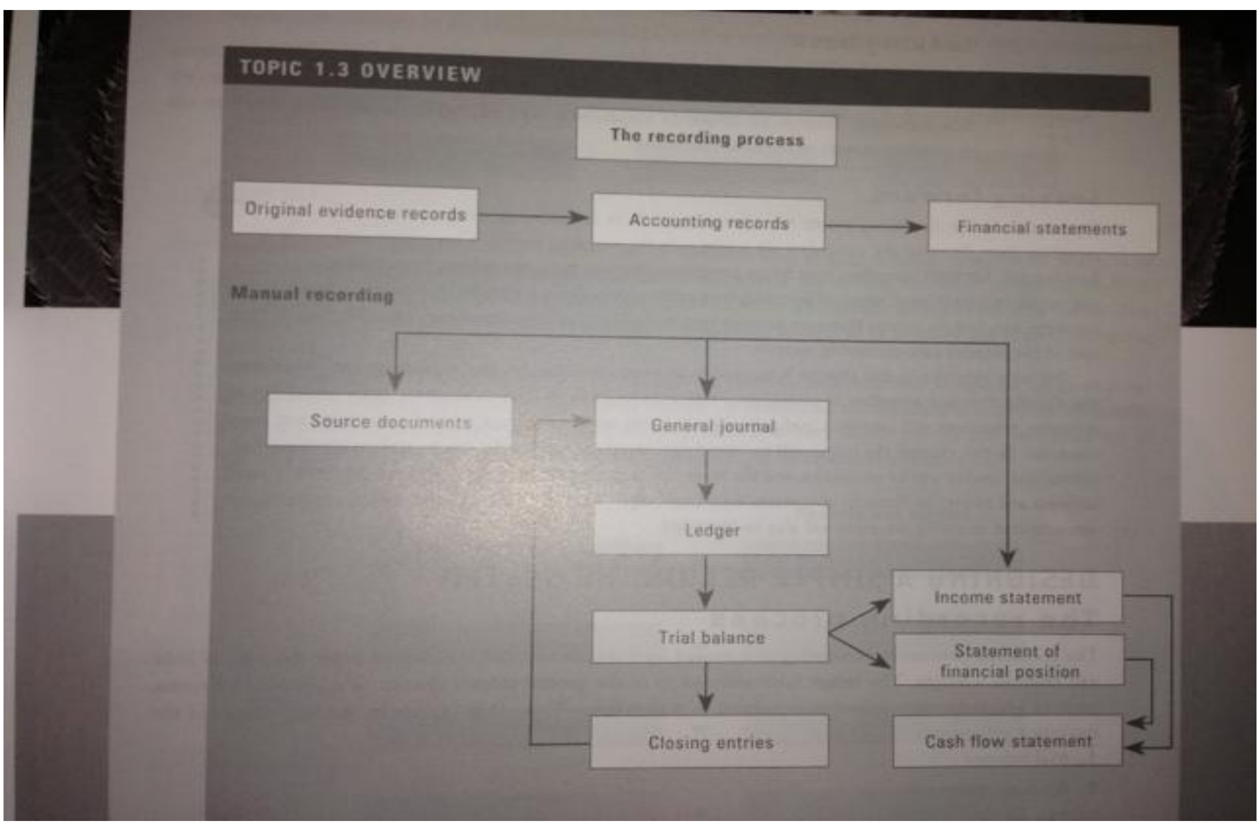
NOTE: The income statement contains the same information in the **P+L Summary,** but in a more readable and comprehendible way for its users.

Format: *Statement of Financial Position/Balance Sheet* (only assets, liabilities, capital and drawings disclosed):

Current Assets	**Value**	**Current liabilities**	**Value**
Current asset 1	$$$	Current liability 1	$$$
Current asset 2	$$$	Current liability 2	$$$
Total current assets	$$$	**Total current liabilities**	$$$
Non-current assets		**Non-current liabilities**	
Non-current asset 1	$$$	Non-current liability 1	$$$
Less Acc. Dep'n	($$$)	**Total non-current liabilities**	$$$
Non-current asset 2	$$$	**Owner's Equity**	$$$
Less Acc. Dep'n	($$$)	Capital	$$$
Total non-current assets	$$$	*Add* net profit	$$$
			$$$
		Less drawings	($$$)
			$$$
Total assets	$$$	**Total Equities**	$$$

NOTE: The Balance Sheet represents the ledger accounts remaining open after closing entries have been completed.

A summary of **The Recording Process (Topic 1.3)** is shown below:



CHAPTER 2: Internal control, cash management and incomplete records

Topic 2.1: Incomplete Records

GENERAL NOTES

Most businesses maintain adequate records of all transactions and process them by the double-entry system, based on the **accounting equation** (see above). However, due to a variety of reasons, financial records at the end of a period may be incomplete, reasons being:

- ✓ **Inappropriate recording** – some small businesses do not maintain a double-entry accounting system, as it takes up lots of time and money.
- ✓ **Loss of records due to carelessness or misadventure** – the recording system may break down, deleting a portion of the records in the process. Further, a large amount of records could be destroyed in a fire.
- ✓ **Fraud**
- ✓ **Lack of knowledge –** that is, with regards to the book-keeping process.
- ✓ **Poor internal control –** results in a lack of info, thus requiring a reconstruction of the transaction analysis.

Yet whatever the unique circumstances of the business, it still has to prepare reports and determine profit at the end of the period, using the records it has available. The extent to which these records can be recovered from incomplete records depends on the extent of the information lost. Generally, there will be some record of cash receipts and payments, as well as debtors and creditors, so it is just a matter of working around the remaining figures to determine the lost records.

There are **two methods** of completing incomplete records and determining profit: The *Comparison method*, and the *Analysis method.*

Comparison method

This method uses a comparison of owner's equity at the start and end of the period to determine profit i.e. uses the change in the accounting equation (OE = A – L) over the period to determine profit/loss

****Refer to notes for example****

Profit can also be attained by <u>rebuilding</u> the capital account. Assuming we know the opening and closing balances, and no additional investments were made, the change in capital is given by the **profit/loss.** In most cases however, capital will be affected by withdrawals and/or investments.

****Refer to notes for example****

Analysis method

Many small businesses maintain a system of **single-entry accounting** as their normal recording procedure. This involves recording all transactions either in a cash or credit book. At the end of the period, the information is sufficient to analyse the records, and prepare various reports, including the Income Statement and Balance Sheet.

However, in some businesses, these single-entry records may be *incomplete*, in which case the accountant gathers the information available; that is, for example, cash info from cheque butts and receipts, credit info from information relating to debtors and creditors. Through the available information, the accountant is then able to **reconstruct** the accounts receivable and accounts payable accounts, thereby divulging the value of *credit purchases & sales.*

Note: A similar situation could exist in double-entry recording businesses, but due to circumstances out of their control, such as a computer malfunction or fire, records become incomplete. It is then the role of the accountant to work with the remaining information to prepare reports. In order to do so, a **keen knowledge** of items in certain accounts is required. Examples follow:

EXAMPLE 1: B Goddard unfortunately had a computer malfunction that destroyed a large section of past credit sales history. From various sources including customers the following information was found. B Goddard wants to you to determine the entity's credit sales for the period.

Accounts Receivable 1\7\2010	**-**	**$30,500**
Accounts Receivable 31\12\2010	**-**	**$38,800**
Cash received from debtors	**-**	**$27,500**
Sales returns	**-**	**$2,400**
Bad Debts	**-**	**$560**
Contra-Set Off *	**-**	**$950**

Contra-Set Off: This phenomenon occurs when we owe money to a creditor, who in turn owes us i.e. is both a debtor and creditor, in which we cancel the accounts out by recording on decreasing sides on both the debtors (CR) and creditors (DR) control accounts*.

Accounts receivable

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
1/7/'10	Balance	30, 500	31/12/'10	Cash	27, 500
31/12/'10	**Credit Sales**	**39, 710**	31/12/'10	Sales returns	2, 400
			31/12/'10	Bad debts	560
			31/12/'10	Creditors control*	950
			31/12/'10	Balance	38, 800
		70, 210			70, 210

EXAMPLE 2: **The book-keeper of Monash R & D disappeared and left the AIS in a mess. You are asked as part of the process of preparing financial statements to reconstruct the following accrued and prepayments to determine revenues and expenses; as well as determining the proposed dividend. You were able to determine the following from various sources:**

1/1/2011

Prepaid Insurance	**160**
Accrued Salaries	**600**
Prepaid Rental Rev	**500**
Dividend Payable	**200**

30/6/2011

- **Prepaid Insurance** **120**
- **Accrued Salaries** **800**
- **Prepaid Rental Rev** **1000**
- **Dividend Payable** **175**
- **Receipts – Rent Rev** **3,500**
- **Payments – Salaries** **43,000**
- **Payments – Insurance** **520**

Payments – Dividend (amnt. owing to shareholders) **200**

Prepaid Insurance expense (A)

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
1/1/2011	Balance	160	**30/6/2011**	**Insurance exp.**	**560**
30/6/2011	Bank	520	30/6/2011	Balance	120
		680			680
1/7/2011	Balance	120			

Accrued salaries (L)

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
30/6/2011	Bank	43, 000	1/1/2011	Acc. Sal. Beg.	600
30/6/2011	Acc. Sal. Bal.	800	**30/6/2011**	**Salaries exp.**	**43, 200**
		43, 800			43, 800
			1/7/2011	Acc. Sal. Bal.	800

Dividends Payable (L)

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
30/6/2011	Bank	200	1/1/2011	Balance	200
30/6/2011	Balance (end)	175	**30/6/2011**	**Dividend paid**	**175**
		375			375
			1/7/2011	Balance	175

Prepaid Rent Revenue (L)

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
30/6/2011	**Rent revenue**	**3, 000**	1/1/2911	Balance	500
30/6/2011	Balance	1, 000	30/6/2011	Bank	3, 500
		4, 000			4, 000
			1/7/2011	Balance	1, 000

EXAMPLE 3: Account balance 30 June 2011

- Machinery **$250,000**
- Accumulated Dep'n – machinery (ALL machinery) **($160,000)**

Account balances at 30 June 2012 were:

- Machinery **$230,000**
- Accumulated depreciation **($120,000)**

Additional Information

Machinery was sold during the year. The machinery sold originally cost **$100,000**.

Depreciation expense for machinery for the year was **$35,000** (not total acc. Dep'n)

Cash Receipts from sale of old machinery **$32,000**

Required

A) How much if any was outlaid on the purchase of a new machine? **- $80, 000**

B) What was the gain or loss on the sale of the machinery? **- $7, 000 Gain**

A, B)

Machinery (A)

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
1/7/2011	Balance (start)	250, 000	30/6/2012	Cost of Machinery sold	100, 000
30/6/2012	**Cash Purchase**	**80, 000**	30/6/2012	Balance (end)	230, 000
	330, 000				330, 000
1/7/2012	Balance	230, 000			

Accumulated Depreciation (-A)

DR **CR**

Date	*Account*	*$$*	*Date*	*Account*	*$$*
30/6/2012	**Depn. Asset sold**	**75, 000**	1/7/2011	Balance	160, 000
30/6/2012	Balance	120, 000	30/6/2012	Depreciation	35, 000
		195, 000			195, 000
			1/7/2012	Balance	120, 000

Sale of Machinery (-A)

DR

Date	*Account*	*$$*	*Date*	*Account*	*$$*
30/6/2012	Machinery	100, 000	**30/6/2012**	**Acc. Depn. Asset sold**	**75, 000**
30/6/2012	**Gain**	**7, 000**	30/6/2012	Cash	32, 000
		107, 000			107, 000

Topic 2.2: Internal Control

<u>GENERAL NOTES</u>

Accounting information provides the *framework* in which the recording and summarising of data produced by business transactions occur, and is hence used for **decision making.** However, in order to be used for decision-making purposes, accounting information must be *reliable;* that is:

1) Free from material error
2) Reflect reality (faithfully representing what it purports to represent)
3) Free from bias

As such, businesses need to implement procedures and structures to not only ensure information is reliable, but also to allow for **accurate recording** of financial information, and **protect its assets** from fraud and theft (**Note:** The above is crucial for larger businesses, but are required in smaller businesses as well).

<u>Internal control</u>

'Internal control' refers to the system by which management implements procedures and structures to ensure that a) *business activities are monitored and controlled*, b) *assets are safeguarded,* and c) *accounting records are accurate & complete,* and therefore **reliable** (see above). Failure to properly implement internal control processes, on the other hand, can cost firms large amounts of money in potential errors, fraud and theft, which will reduce cash available to pay accounts.

There are **2** types of internal control:

1) **Management/Administrative controls**
2) **Transaction/Accounting controls**

Management/Administrative controls

Consists of all those controls designed to promote <u>efficient operations</u>, including:

- Encouraging staff to follow the organisation's principles.
- Quality control over goods produced in the production line.
- Policies of hiring efficient staff.

In general, **management controls** focus on the overall *effectiveness & efficiency* of the business.

Transaction/Accounting controls

Consists of those controls designed to ensure that accounting records and reports are <u>accurate & reliable,</u> and to prevent loss/theft of assets. It does so through the following:

- Use of the double-entry system means that each transaction has two entries, which, through use of a trial balance, can determine whether possible errors have occurred in recording.
- Keeping a list of assets and their locations, with periodic inspections of the same.

In general, **transaction controls** focus on the reliability of accounting information, and compliance with business rules and regulations.

Characteristics of Internal Control

- **Controls to monitor and minimise business risks –** eg. Implementing Human Resource Department policy for an employee who leaves.

- **Clear lines of authority and responsibility –** management should ensure that any member of staff who has the *authority* to carry out certain operations understands the associated *responsibility* over that task. This means that lines of authority must be clearly defined, so as to ensure staff members are not confused as to what they have authority over in the organisation.

- **Proper segregation of duties –** duties are divided up into three categories: *custody, authorisation* and *recording* (C.A.R.).None of these duties should overlap. This is because, by separating tasks and making them the responsibility of different employees, errors are more easily detected. Further, this negates the possibility of fraud, as fraud needs collusion between two people, which is less likely to occur if responsibilities are spread. *VITALLY IMPORTANT!*

- **Proper procedures for authorization**

- **Adequate documents and records –** documents must be adequately designed to enable data to be accurately entered and extracted, and to ensure all transactions are accurately recorded. A simple procedure of *pre-numbering purchase orders* can assist in ensuring that all purchase transactions are recorded properly in the accounting system.

- **Physical control over assets –** safeguards must be employed to ensure the protection and control over assets. For example, cash, which is a prime asset for fraud, should be held in cash registers, banked daily, and if left on the premises, should be locked in a safe.

- **Internal and external verification and checks –** closely related to the *separation of duties,* this is where the performance of an employee is evaluated by another who is independent of the original's subject and function. For example, this could include two responsible officers signing each cheque, leaving bank reconciliations to an employee who is **not** involved with the receipt/payment of cash. *VITALLY IMPORTANT!*

- **Competent and trustworthy staff**

Limitations of Internal Control

- Controls are not always cost-effective.
- Most controls are set up for **routine** transactions, but should cover non-routine transactions as well.
- Human error can still occur in recording, verification, etc.
- Collusion can still occur between two employees in cahoots.
- Internal controls can become **out-of-date** as the business and its dynamics change.

Topic 2.3: Cash Management – Bank Reconciliation

GENERAL NOTES

Cash is the most negotiable of all assets, and therefore, is the most susceptible to fraud and theft. It is for this reason that rigorous internal control procedures should be implemented. Such procedures could include:

- Banking all cash **daily.**
- All payments being made by **cheque.**
- Cheques should be signed by two independent staff.
- *Separation of duties* – those who are responsible for collecting and handling cash should not have access to the recording system, or be responsible over ***bank reconciliations****

BANK RECONCILIATION

One of the unique features of cash control is that there is a system of *external verification* of the organisation's records; that is, all receipts and payments are not only recorded by the business, but by the bank as well. The bank sends businesses **bank statements** to businesses, typically at the end of the month, with a copy of their cash details present on it. The business is then able to cross-check its own records with that of the bank, verifying whether the two are in agreement. But often they aren't, obliging businesses to prepare *bank reconciliation statements.*

Reasons for discrepancies between Bank Statement & Internal Records

TIMING discrepancies often occur between the two sets of records:

- ✓ **Unpresented/outstanding cheques –** the business may enter cheque payments in their records immediately after they are drawn, but will only appear in the bank's records after it has been presented by the payee i.e. business and cleared by the bank for payment. This delay may involve several days, or even weeks.
- ✓ **Deposits not credited/deposits in transit/outstanding deposits –** the business may make an entry into their records immediately after deposits are lodged with the bank. However, this deposit may not appear on the bank statement prepared at the end of the day, but only on the following day's statement.
- ✓ **Service and bank charges** – for maintenance of the account by the bank.
- ✓ **Charges for dishonoured/'bounced' cheques –** negative entry recorded in CRJ.
- ✓ **Interest –** the bank may deduct charges due on bank loans, taxes, direct debits
- ✓ **Direct deposits made to the bank by external party –** payment of salaries/wages, where the business ('external party') is making a direct deposit in the employee's account.
- ✓ **EFT transactions**
- ✓ **Errors –** errors by banks are rare, due to their high standards of internal control (**note:** but is never assumed to always be correct!). Therefore, it is more likely that the businesses records will be inaccurate due to errors made.
    - **If our error:** *Write down difference as new entry in CRJ.*
    - **If bank's error:** 'List' error i.e. deduct difference from balance as per bank statement

Procedure for reconciliation of cash records

Through the process of bank reconciliation, the business tries to bring into agreement their records with those of the bank.

STEPS & EXAMPLE:

Step 1: Gather the following data;

- *Previous bank reconciliation statement* – starting balance divulged from here.
- *Cash receipts and payments since that date*
- *Bank statement received since the previous reconciliation*

Cash receipts Journal

Particulars	Rec. No.	Folio	Debits		Credits		
			Bank	Disc. Exp.	A/c. Rec.	Sales	Sundries
Capital			20,000				20,000
	16		6,200			6,200	
Liberace	17		11,070	1,230	12,300		
	18		1,500			1,500	
Price	19		4,500	500	5,000		
	20		2,000			2,000	

Cash payments Journal

Particulars	Chq. No.	Folio	Credits		Debits		
			Bank	Disc. Rev.	A/c. Pay.	Rent	Sundries
	101		600			600	
Wages	102		400				400
Strad	103		16,150	850	17,000		
	104		600			600	
Wages	105		400				400

Bank Statement

AUSTRALIA BANK
GOLDEN MUSIC STORE BRANCH - MONASH UNIVERSITY

Date		Cheques and other debits	Deposits and other credits	Balance
March 1	Brought forward			20 000 Cr
5	C/C		6 200	26 200 Cr
6	101	600		25 600 Cr
6	102	400		25 200 Cr
8	Cheque		11 070	36 270 Cr
10	C/C		1 500	37 770 Cr
15	103	16 150		21 620 Cr
	Cheque		4 500	26 120 Cr
16	105	440		25 860 Cr
18	Bank fee	22		25 658 Cr
19	Cheque returned	4 500		21 158 Cr

Step 2: Match items in the bank statement with items in the **previous bank reconciliation**/cash records/journals, identifying timing discrepancies (i.e. unpresented cheques and deposits not yet credited), unexplained items on the statement, and possible errors.

Step 3: For each item matched, a *tick* is made on both the cash records and bank statement.

Step 4: Enter any *unmatched items* in the **bank statement** into the appropriate cash journal, and then tick both entries (**Note:** Don't follow procedure for bank errors. Business cannot adjust bank errors. For general errors, place a correcting entry i.e. difference between error and actual amount in **business'** records).

Cash Receipts Journal

Receipts Journal Pg. 23

	Particulars	Rec. No.	Folio	Debits		Credits		
				Bank	Disc. Exp.	A/c. Rec.	Sales	Sundries
1	Capital			20,000				20,000
5		16		6,200			6,200	
7	Liberace	17		11,070	1,230	12,300		
9		18		1,500			1,500	
14	Price	19		4,500	500	5,000		
19		20		2,000			2,000	
0	*Price-Dish.Chq*			*(4,500)*	*(500)*	*(5,000)*		
				40,770	*1,230*	*12,300*	*9,700*	*20,000*
				DR +	*DR =*	*CR +*	*CR +*	*CR*
				Cash at bank	Disc exp	A/c Rec	Sales	Capital

Cash Payments Journal

Payments Journal Pg.27

	Particulars	Chq. No.	Folio	Credits		Debits		
				Bank	Disc. Rev.	A/c. Pay.	Rent	Sundries
3		101		600			600	
6	Wages	102		400				400
10	Strad	103		16,150	850	17,000		
15		104		600			600	
16	Wages	105		400				400
0	*Wages error*	*105*		*40*				*40*
0	*Bank fees*	*-*		*22*				*22*
				18,212	*850*	*17,000*	*1,200*	*862*
				CR +	*CR =*	*DR +*	*DR +*	*DR*
				Bank	*Disc. Rev*	*A/c pay.*	*Rent*	*individ. a/cs*

Step 5: Update the ledger accounts

GENERAL LEDGER OF GOLDEN MUSIC STORES LTD.

CASH AT BANK No.11100

Mar 20	*Sundry recs.*	*CRJ23*	*40770*	*Mar 20*	*Sundry pay*	*CPJ 27*	*18212*
				20	*Bal.*		*22558*
			40770				*40770*
Mar 21	*Balance*		*22558*				

Step 6: Items remaining *unticked* in cash journals/ledgers and the previous bank reconciliation statement represent items that business **has recorded,** but which the bank **has not.** These include unpresented cheques, receipts not yet deposited.

Step 7: These items are now recoded in the new bank reconciliation statement (made by the business).

Bank Reconciliation Statement

Bank Reconciliation Statement of Golden Music Stores Ltd. as at 20 March 20X2

Balance as per bank statement		*21 158*
Plus : Deposits not yet credited		*2000*
		23 158
Minus : Unpresented cheques		
Chq 104	*600*	*600*
Balance as per bank ledger a/c		*$22 558*

Step 8: After including the unpresented cheques and deposits not yet credited in the bank reconciliation statement, the bank statement's figure **should match up** with firm's cash at bank account.

<u>Points to note:</u>

- Cheques *will not* appear on the bank statement in the same numeric order that the business issued them. Nevertheless, ensure that the cheque numbers and amounts in CPJ correspond with those on the bank statement.
- Receipts **should be** in the same order on both records.
- From the bank's perspective, customers are liabilities as they have the present obligation to pay them whatever funds they place in the bank. Therefore, on the bank statement, a **credit balance** equates to **debit balance** on the business' records, and, by extension, the debit column of the bank statement relates to cash payments and credit column to cash receipts.

As a general rule, when deposits are acknowledged by the bank, the bank's records will increase. Likewise, when cheques are acknowledged by the bank, the balance in the bank's records will decrease. After allowing for these differences and assuming there are no errors by the bank, the business records should be reconciled with the bank's records.

HOWEVER, if a business is in *overdraft* i.e. has an unfavourable balance, the procedure of adding deposits and deducting unpresented cheques is **reversed:** Unpresented cheques will increase overdraft, and therefore should be <u>added</u> to the bank statement, while deposits not yet credited will reduce overdraft, and therefore should be <u>subtracted</u> from the bank statement, to arrive at the organisation's balance.

Weaknesses of Bank Reconciliation

- Bank reconciliation only provides control over cash recorded in the business records – it cannot reveal any unrecorded or misappropriated cash.
- Bank Reconciliation will not reveal unauthorised payments eg. Forged signatures, stolen cheques. Therefore other measures of internal control are still required, such as requiring that employees always record cash receipts in the cash register, instead of just leaving it on the counter.

IN SUM, the bank reconciliation statement is one of the most important verification controls in a business, allowing for reliance on the bank's records as an independent check of the business' records.

APPENDIX: ***The Imprest Petty Cash Method***

A petty cash fund facilitates the payment of small amounts. A small fund of cash is kept in a secure cash tin, box or drawer, with an authorised person controlling it, making payments, and organising reimbursement of funds periodically and as needed.

To **establish** a petty cash fund: **DR** Petty Cash Advance, **CR** Bank

To **request cheques** for reimbursements of the fund: **DR** Relevant Expense, **DR** G.S.T Paid, **CR** Bank.

Expenditures are first recorded in **Petty Cash Vouchers,** which represent the original source document relating to disbursements of cash, and then recorded in a Petty Cash Book (see below) as well as in the **Cash Payments Journal**:

					Payment Analysis			
Date	**Details**	**Vch No.**	**Receipts**	**Payments**	**Postage**	**Amen**	**Travel**	**Other**
19XX								
Jan 2	**Petty Cash Adv. (CHQ 102)**	**-**	**50.00**					
4	**Tea & Coffee**	**1**		**14.00**		**14.00**		
	Milk	**2**		**5.00**		**5.00**		
6	**Stamps**	**3**		**10.00**	**10.00**			
8	**Bus Fare**	**4**		**7.00**			**7.00**	
10	**Cleaning Fluids**	**5**		**8.00**				**8.00**
	Total Payments			**44.00**	**10.00**	**19.00**	**7.00**	**8.00**
	Balance c/d			**6.00**				
10	**Balance b/d**		**50.00**	**50.00**				
	Reim (Chq 133)		**6.00**					
	Stamps	**6**	**44.00**	**6.00**	**6.00**			