section **one**

accounting to trial balance

1

Introduction to accounting—theory and principles

Introduction

The purpose of this chapter is to provide the foundations to accounting theory, including the accounting principles, concepts and terms that will be applied throughout the rest of the text.

This chapter refers to:

The accounting process (Questions 1.1–1.6)
Business ownership (Questions 1.7–1.8)
Source documents—collecting information (Questions 1.9–1.18)
Goods and Services Tax (Questions 1.19–1.26)
Accounting classifications (Questions 1.27–1.33)
Accounting conventions/doctrines (Questions 1.34–1.40)
Accounting standards (Questions 1.41–1.44)
Statements of accounting concepts and the Conceptual Framework (Questions 1.45–1.47)
Ethics (Questions 1.48–1.50)

Illustrative Example 1—shows the calculation of GST at each step as a product passes from a manufacturer, through wholesalers and retailers to the final consumer.

Illustrative Examples 2 and **3**—show the calculation of GST on individual transactions.

Self-test questions (solutions in Chapter 16) appear after questions 1.18, 1.26, 1.33, 1.40 and 1.46.

THE ACCOUNTING PROCESS (QUESTIONS 1.1–1.6)

This book will consider the accounting processes from the point of view of a *sole trader*—a person who operates a small to medium sized business involved with buying and selling goods or services in order to make a profit.

> **Definition**
> Accounting is the process of *collecting, classifying, recording, reporting, interpreting and analysing* the effect of financial transactions on a business or organisation to provide information to owners, management and other interested parties.

The functions of accounting are to:

- communicate financial information
- assist in the decision-making processes
- establish responsibility for various tasks
- provide controls, and
- assist owners, management and other interested parties.

The accounting process is just one operational component of a business. Other operational areas would include:

- purchasing
- sales
- warehousing
- personnel, and
- management.

You should now attempt questions 1.1 to 1.6 on page **20**.

BUSINESS OWNERSHIP (QUESTIONS 1.7–1.8)

The information required by a business partly depends on the type of business ownership structure involved. The types of business ownership include:

- **Sole trader**—a person operating a business on their own and being personally liable for all debts of the business and receiving all the profits of the business.
- **Partnership**—two or more persons operating a business and all the partners are liable for the debts of the business and they share the profits in an agreed ratio.
- **Companies (corporations)**—a business promoted by people, but which has its own legal status under the operation of the Corporations Law. The owners are called shareholders. The company pays its own tax, can sue and be sued in its own name and is legally independent from its shareholders and directors. The profits may be returned to the shareholders, by way of dividends. The liability of each shareholder is limited to the value of the shares they hold.
- **Cooperatives**—owned by members (groups of people with similar interests) and entitled to special rates or services from the cooperative (for example marketing cooperatives or fishing cooperatives).
- **Clubs and societies**—generally non-profit organisations that provide services for the benefit of their members (for example sports clubs, Rotary, Lions Club etc.).
- **Government, semi-government, local government and statutory authorities**

The advantages and disadvantages of the first three types of business ownership are outlined below:

Type of business ownership	Advantages	Disadvantages
Sole trader	• easy and inexpensive to set up and operate • easy to change to another legal structure • independence and full control • no sharing of profits • little government interference and regulatory restrictions • no need to have the business name registered • minimal formal reporting requirements	• unlimited liability for business debts • limited resources available • limitations on growth • no sharing of workloads, risks or losses • narrow skill base • owner's death will terminate the business • income sharing is difficult • loneliness and isolation • limits on borrowing capacity
Partnership	• easy and inexpensive to set up and operate • greater access to capital • wider skill or knowledge base • not all partners need to be active in the business • easy to change to another legal structure • little government interference and regulatory restrictions • workloads, responsibilities, risks and losses can be shared • income splitting with family members can reduce taxation	• each partner has unlimited liability for business debts • possible disagreement between partners • danger of a bankrupt or insolvent partner acting carelessly • profits must be shared as agreed in the partnership agreement • death or bankruptcy may terminate the business
Company	• shareholders have limited liability for company debts • private companies can have up to 50 shareholders, whilst public companies can have thousands or even millions • provides a larger potential capital base • greater ability to borrow funds • can hire shareholders as employees • company has a life of its own and not dependent on the continuation of any one shareholder • a clear distinction exists between the company and its management • financial interests in the company (shares) can be disposed of by sale • potential for more skilled management, by hiring professional managers	• more complex to set up, operate and terminate • companies are strictly regulated by the Corporations Law and their own constitutions • the actions of the directors are more closely monitored and subject to severe penalties in cases of neglect and fraudulent actions • reporting requirements are greater and more extensive • reporting requirements reduce the confidentiality and privacy of the company's activities and results

Figure 1.1 Advantages and disadvantages of business ownership structures

You should now attempt questions 1.7 to 1.8 on page **20**.

SOURCE DOCUMENTS—COLLECTING INFORMATION (QUESTIONS 1.9–1.18)

Business activity usually involves five basic activities or transactions:

- selling goods or providing services for either cash or on credit (including returns of goods by customers)
- purchasing goods or services for either cash or on credit (including purchase returns)
- cash receipts
- cash payments, and
- other transactions, usually internally generated.

The first record that a business has of a transaction actually occurring is called a *source document*. Source documents record the details of the transaction and start the recording process of the transaction in the records of the business. Some source documents are initiated by the business entity, whilst others are initiated by external parties (such as suppliers). However, the source document is usually retained by the business for recording. Once the source document has been checked or validated according to the business entity's organisational procedures, the details from the source document are used as input to the accounting system within the business entity.

The most common types of source documents and the transaction that they detail are:

Source document	Prepared by	Business transaction
Tax invoice (copy retained by business)	Business entity	Sale of goods/service on credit
Tax adjustment or Credit note (copy)	Business entity	Return of goods sold on credit
Tax invoice (original received by business)	Supplier	Purchase of goods/service on credit
Credit note (original received by business)	Supplier	Return of goods purchased on credit
Receipt (copy retained by business)	Business entity	Receipt of cash
Cheque butt (retained by business)	Business entity	Payment of cash
Internal memorandum	Business entity	Internal adjustments

Figure 1.2 Source documents and business transactions

Sale of goods or services on credit

A business entity, in accordance with its organisational policies and procedures, may sell goods or supply services to customers without being paid for those goods or services at that time. The customer will take advantage of a period of 'free' credit before making payment. At the time of the sale transaction, the business will issue a *tax invoice* to the customer. The tax invoice will be prepared with multiple copies. The original is given to the customer and the copies are retained by the business for a number of purposes, including entry into its accounting records.

The tax invoice will include the following information (as a minimum):

- must include the words '**Tax Invoice**' (this is the document title)
- the business name and address
- the business **ABN** (Australian Business Number)
- the customer's name and address
- the transaction date
- the invoice number (pre-numbered)
- details of the goods or services supplied
- the amount of the sale or service, and
- details of any GST included in the invoice amount (GST may be shown separately or included in the total).

Office Supplies

TAX INVOICE

ABN 47 852 963 654

Invoice No **OS471**
123 Paper Rd
Worktown 2000

Date: 6 February 20X3

To: ***Freeman Sporting Goods***
500 Chapel Rd
TOPTOWN 8888

Quantity	Description	Price	
1	Computer	1650.00	1650.00
1	Printer	220.00	220.00
3	Printer cartridges	27.50	27.50
TOTAL			$1952.50

The total price includes GST

Figure 1.3 Tax invoice

Purchase of goods or services on credit

A business entity may also buy goods or obtain services from suppliers without paying for those goods or services at that time. At the time of the sale transaction the business will receive the *original tax invoice* that is issued by the supplier. This original tax invoice is the source document that the business uses to enter the transaction details into its accounting records.

Purchase or sales returns

The goods purchased by a business may not be accepted by the business. The business may return some or all of the goods. When these goods are returned to the supplier, the supplier will issue a *tax adjustment note* or *credit note* to recognise this business transaction. Similarly, a customer may return goods to the business entity and request a tax adjustment or credit note be issued to them to recognise this return.

The tax adjustment or credit note is issued to record an agreed reduction in the amount still owing by the customer to the supplier. This reduction in amount owing may arise for numerous reasons and not only from a return of goods. Other reasons may include incorrect price, incorrect invoice details, or short delivery.

The tax adjustment or credit note will include the following information (as a minimum):

- the document title—Tax Adjustment or Credit Note
- the business name and address
- the business **ABN** (Australian Business Number)
- the customer's name and address
- the transaction date
- the adjustment or credit note number
- details of the goods or services returned or being adjusted
- the amount of the adjustment, and
- details of any GST included in the tax adjustment or credit note amount.

Office Supplies **CREDIT/TAX ADJUSTMENT NOTE**

ABN 47 852 963 654

123 Paper Rd
Worktown 2000

Date: 10 February 20X3

CREDIT NOTE: CN347

Freeman Sporting Goods
500 Chapel Rd
TOPTOWN 8888

Description of adjustment/refund
Refund for damaged goods purchased on Invoice 471 dated 6 February 20X3

AMOUNT ADJUSTED/REFUNDED (including GST) $11.00

Figure 1.4 Tax adjustment or Credit note

Receipt of cash

For a business, receipts of cash include physical cash, cheques or credit card transactions and any amounts directly deposited to the business bank account. These receipts could occur for many reasons. A receipt may relate to income from investments, from a cash sale (including credit cards) or a payment from a debtor (customer) resulting from an earlier credit sale.

Cash receipts

Any money received by a business should be recorded on a *receipt*. The original of the receipt is given to the payee and the business retains the copy—this is the source document.

The receipt will include the following information (as a minimum):

- the document title—Receipt
- the business name and address
- the business **ABN** (Australian Business Number)
- the customer's name (only if required)
- the transaction date
- the receipt number (pre-numbered)
- details of the receipt (i.e. Cash sale, Payment of account etc.)
- the amount of the receipt
- method of receipt (i.e. cash or cheque), and
- a signature of the person receiving the money.

Cash sales

Sales made for cash may result in an individual *cash sale docket* or could be recorded on the *cash register tape*. These documents are the source document for a cash sale and replace the tax invoice. However, many of the information requirements for a tax invoice must also be included on the cash sale source document. This includes:

- the words '**Tax Invoice**'
- the business name and address
- the business **ABN** (Australian Business Number)
- the transaction date
- the cash sale number (may also be an invoice number)

Office Supplies

RECEIPT

123 Paper Rd
Worktown 2000

ABN 47 852 963 654

Date: 28 February 20X3

RECEIPT NO. 12345

Received From: Freeman Sporting Goods
The sum of: *One thousand nine hundred and forty-one dollars 50 cents*
$1 941.50
By: ~~Cash~~/Cheque
For: Payment of account

(Signed)……..
for Office Supplies Ltd

Figure 1.5 Receipt

- details of the goods or services supplied
- the amount of the sale or service, and
- details of any GST included in the invoice amount (GST may be shown separately or included in the total).

Credit card sales

Credit card sales should not be confused with sales made on credit with a Tax Invoice. A credit card sale is a form of cash sale. In this case, the source document is the credit card voucher or copy of the receipt. When a payment is made by credit card in person, this payment is made when the recipient of the goods or services (customer) signs the docket, or enters PIN, to authorise the transaction. If the voucher is manually prepared, the customer and supplier details are impressed onto the voucher mechanically. If the credit card transaction is electronically processed, these details are printed on the receipt voucher. When a payment is made remotely (for example, by telephone or through the internet), the payment is authorised and completed when the customer or cardholder gives the card number and other required details.

Under the usual arrangement for credit cards, once the cardholder signs the credit card voucher or provides the card number and other details, the liability to pay the supplier is unconditionally discharged.

Credit card services are provided by a number of credit card organisations. The total of the credit card transactions with each credit card service provider is recorded on a *merchant summary* at the end of each day and then included on the bank deposit slip for that day.

EFTPOS sales

EFTPOS (electronic funds transfer at point of sale) is another method of payment for a cash sale transaction. In this instance, the customer electronically authorises the direct transfer of funds from their bank account to the business's bank account to pay for the sale transaction. This payment will be recorded on the cash register tape or cash sale receipt.

Recipts from debtor (customers)

When the business makes a sale to a customer on credit, payment will be received at a later date. When payment is received, a receipt will be issued to provide evidence of the payment.

Bank deposits

All receipts, whether by cash, cheque or credit card need to be deposited to the business bank account. These deposits are usually made daily by the business. EFTPOS transactions do not need to be deposited to the business bank account because the direct deposit transfer has already been authorised by the customer. To deposit money to the bank, the business will prepare a *bank deposit slip*. Preparing accurate bank deposits involves entering and balancing all the different types of payments received. The bank deposit slip will include:

- the title—Bank Deposit
- the date of the deposit
- the name and address of the bank branch where the deposit is being made
- the name of the account to which the deposit is being made
- the account number
- details of any cheques being deposited (including drawer, bank and amount)
- totals of any cash being deposited
- name of the person who deposits the money, and
- a space for the bank (specifically the teller) to stamp and initial the deposit slip to acknowledge the deposit.

Banking should be prepared on a daily basis. The bank deposit slip accompanies the money for banking. Businesses usually have a *deposit book* with the bank account details pre-printed on the form. The size and type of deposit book depends on the size of the business. For instance a larger organisation may have a specially designed and pre-printed deposit book whereas a smaller organisation may use a standard, bank-supplied deposit book.

A bank deposit slip records all the amounts which make up the deposit. In addition the bank deposit slip has the business's account details, date and deposit total. The person making the deposit, usually the cashier, signs the deposit slip on behalf of the business.

Whilst many businesses will use credit card transactions which are carried out electronically (so that the funds are automatically transferred to the business's bank account, similar to an EFTPOS transaction), some businesses may still use manual credit card transactions. These are normally banked

Deposit for account at		$100			**DEPOSIT**	
One Stop Bank		$50				
Where this deposit is lodged at a bank or branch other than shown below it will be transferred under the Bank's internal procedures. One Stop Bank is not to be responsible for delays in transmission to branch or transfer to nominated bank. Proceeds of cheques etc. will not be available till cleared.		$20			**Date:**	
		$10				
		$5			Cash	
		Coins			Cheques	
Branch: (where account is held)		Cash Total			Visa/Bankcard/ Mastercard	
Paid in by: (Signature)		Teller:		No of Chqs:	Less Charges	
Credit A/C Name and No.					**Total $**	

along with the other takings of the day. Credit card vouchers are sorted into batches by card type (e.g. Mastercard, AMEX, Bankcard, Visa etc.) and a cover sheet or *merchant summary* form is completed for each batch. The merchant summary total is then recorded on the bank deposit slip.

All particulars of cheques are shown on the reverse side of the deposit slip and are completed by the depositor:

Drawer	Bank	Branch	Amount
1			
2			
3			
4			
5			
6			
		Carried forward	

Example of a Merchant Summary Form

BANKCARD			**Date:**	
Merchant Summary				
List Sales Vouchers or attach machine tape			Amount	
1			Sales Vouchers	
2			Less Credits	
3				
4				
Total			**TOTAL $**	

Payment of cash

When a business pays for its goods or services, it usually prepares a *cheque*. However, the cheque is given to the supplier and not retained by the business. Therefore, the business uses the *cheque butt* (or sometimes a carbon copy of the cheque or a computer produced cheque register) as the source document to record the payment in the company's accounting records.

The cheque will require the following information:

- the name and branch of the bank on which the cheque is drawn
- the cheque number (pre-numbered)
- the date
- the name of the payee
- the amount of the payment in words and figures
- the name of the drawer
- the signature of the drawer, and
- the mica encoded details of the cheque number, bank and branch and account number.

The cheque butt will record:

- the cheque number
- the date
- the name of the payee
- a brief description of what the payment is for, and
- the amount.

	…../…../20….	One Stop Bank		…../…./20….
To:	……	Toptown		
	……	PAY	……	OR BEARER
For:	……	THE SUM OF	……	**$**…….
	……		……	
	$……..	Freeman Sporting Goods	……..	
	321654	**9871/654 091 091 321654**		

Figure 1.6 Cheque and cheque butt

A business entity may make cash payments for many reasons, including:

- cash purchases of goods
- cash purchases of assets
- payments for expenses (for example telephone, rent etc.), or
- payment to a supplier for goods originally purchased on credit.

Internal adjustments

Some business transactions do not involve buying or selling goods or services, nor do they involve the actual movement of cash into or out of the business. These transactions are called *internal adjustments*. These transactions are initiated by an employee of the business and usually are authorised in accordance with the organisation's policies and procedures. The transaction advises the accounting department that some event has occurred that will change the value of one or more accounts within the business accounting records. Examples of an internal adjustment would include writing off a bad debt, recording depreciation on equipment, or the store's manager advising that some stock is missing or damaged.

The source document for internal adjustments is called an *internal memorandum*.

Checking, authorising and filing source documents

Because the source document records the business transaction and is used as the primary record of that transaction, it is important that the information it contains is valid. If the business receives the source document from an outside party (i.e. a supplier), then that document must be carefully checked. The organisation will have a set of policies and procedures that set out how the checking is to be done. For example, if an invoice is received from a supplier, the following checks may be required before that invoice is paid:

- Have the goods been received?
- Were they in good order and condition (i.e. not damaged)?
- Were they the actual goods that the business ordered (i.e. same colour, type etc.)?
- Did we receive more than we ordered (or less)?
- Is the price correct?
- Has the invoice been correctly calculated?
- Is it a valid invoice (i.e. does it provide the required detail as outlined earlier)?

If it is a receipt, then you may want to check that:

- the name of the payer is correct
- the total amount is correct
- the GST component of the amount is correct
- the payment type (cash, cheque or credit card) is correct, and
- if the payment is by cheque, the drawer of the cheque (if different from the payer) should be recorded on the receipt.

These are not exhaustive lists of the checking procedures and each business may have additional requirements that must be met before it pays an invoice.

If the source document is prepared by the business there will also be established policies and procedures that outline the steps that must be covered to check the accuracy of these documents. This will often include authorisation procedures. For example, the payment of a cheque will require appropriate authorisation to ensure that the cheque being prepared is accurate and for a valid reason. Authorisation and checking procedures will help prevent errors (both accidental and deliberate) from occurring.

A source document may still be required to be reviewed again, even after it has been checked, authorised and recorded. There may be many reasons that the document needs to be retrieved at a later date. There may be a dispute regarding some detail on the document or it may be needed for a legal matter. Regardless of the reasons, the document still needs to be retrieved. To make it easy to retrieve, the document must be filed in a manner that makes retrieval easy. It may be filed in document number order, date of processing order, or batch order. Batch processing will be covered later in this book.

Cash or accrual accounting

Cash accounting concerns the recording of transactions that have been finalised by the purchaser paying the supplier an amount in *cash* (and *cash* can include cash, cheque, credit card or EFTPOS). These transactions have been outlined earlier.

Accrual accounting is involved when the transaction concerned does not involve the actual payment by *cash*. Therefore, sales or purchases on credit represent accrual accounting. Accrual accounting also involves the recording of end of period adjustments. These accrual accounting techniques will be covered in more detail in a later chapter.

You should now attempt questions 1.9 to 1.18 and self-test question 1A on pages **20–21**.

GOODS AND SERVICES TAX (QUESTIONS 1.19–1.26)

The Goods and Services Tax (GST) was introduced in 2000 to replace a number of indirect taxes that were operating up until 30 June 2000. The GST is a broad-based consumption tax on the supply and consumption of most goods and services within Australia.

A business entity will pay GST on its acquisitions (purchase of goods, services and assets). The business entity is also required to collect GST on the sale of any goods or services made by the business.

Certain goods or services may be *GST free* or *input taxed*—which means that they do not have GST added to the value of the goods or services at the point of sale. All other purchases or sales are *taxable supplies*. An example of supplies not subject to GST include:

- financial supplies such as bank interest
- dividends paid
- wages
- rent on residential properties, and
- rates and taxes.

Calculating GST

The current rate of GST is 10%. This means that an extra 10% of the value of goods or services being supplied must be added to the invoice total. Another way of saying this is that 1/11th of the total value of the invoice represents the GST component of the supply.

GST is not an expense of the business. GST is actually collected by the business on its sales or supplies of goods or services. The amount collected is then passed on to the Australian Taxation Office (ATO) when the business submits its *Business Activity Statement (BAS)*. GST paid by the business on its acquisitions of goods or services can be claimed back from the ATO when the BAS is due. If the amount collected by the business is greater than the amount paid by the business, then the difference is paid to the ATO. If the amount collected by the business is less than the amount paid by the business, then this difference can be claimed back from the ATO. Thus the business is merely acting as a collection agent for the ATO.

1 Illustrative Example

This example shows how the GST amount that is eventually paid by the final customer is calculated and added on at each stage of the goods being produced and sold. The total amount of the GST is paid by the final customer. However, each business involved in the process does not bear the cost of this GST.

Transaction	Calculation of GST		Payment of GST	
Manufacturer produces goods at a cost of $500 and sells these goods to a wholesaler for $1 000 plus GST	Value of goods sold	1 000.00	Collected from wholesaler	100.00
	Plus 10% GST	100.00	Paid to ATO	(100.00)
	Total invoice value	1 100.00	Cost	0.00
Wholesaler sells goods with a profit of $500 to a retailer, plus 10% GST	Value of goods sold	1 500.00	Paid to manufacturer	(100.00)
	Plus 10% GST	150.00	Collected from retailer	150.00
	Total invoice value	1 650.00	Paid to ATO	(50.00)
			Cost	0.00
Retailer sells goods with a profit of $750 to consumer, plus 10% GST	Value of goods sold	2 250.00	Paid to wholesaler	(150.00)
	Plus 10% GST	225.00	Collected from customer	225.00
	Total invoice value	2 475.00	Paid to ATO	(75.00)
			Cost	0.00
Consumer buys goods for $2 250 plus 10% GST	Value of goods sold	2 250.00	Paid to retailer	(225.00)
	Plus 10% GST	225.00	Collected	0.00
	Total invoice value	2 475.00	Paid to ATO	0.00
			Cost	225.00
	Total amount paid to ATO by manufacturer, wholesaler and retailer			$225.00

Figure 1.7 Calculation and payment of GST

2 Illustrative Example

How much GST does the business need to pay to the ATO with its Business Activity Statement if it had the following transactions during the month?

- the business buys a computer valued at $5 000
- the business pays rent valued at $750
- the business sells goods valued at $40 000 during the month
- the business buys stock worth $25 000, and
- the business pays its electricity account, totalling $1 100, including GST.

Solution

Transaction	Calculation of GST	GST paid to or claimed from ATO
Buys computer with value of $5 000	$5 000 × 10% claimed from ATO	(500)
Pays rent valued at $750	$750 × 10% claimed from ATO	(75)
Sells goods valued at $40 000	$40 000 × 10% paid to ATO	4 000
Buys stock valued at $25 000	$25 000 × 10% claimed from ATO	(2 500)
Pays electricity invoice totalling $1 100	$1 100 divided by 11 and claimed from ATO	(100)
	Total GST paid	$825

3 Illustrative Example

How to calculate GST on individual transactions—do we add 10% or divide by 11?

Transaction	Calculation of GST	GST amount of transaction
Cheque paid for goods—$770	$770 divided by 11	70
Sold computer for $300 **plus** GST	$300 × 10%	30
Paid rent for business premises $1 320	$1 320 divided by 11	120
Paid wages of $660	Wages are GST free	nil
Received tax invoice for $1 980	$1 980 divided by 11	180

Accounting for GST

GST collected on sales or supplies of goods or services (because it must be passed on to the ATO) is treated as a liability. GST paid on acquisitions by the business can be claimed back from the ATO and is therefore treated as an asset of the business.

There are different techniques that may be used for accounting for GST. The most common accounting treatment is to maintain two separate accounts for GST. One account is used for the GST collected on sales or services provided by the business. Another account is maintained for the payments of GST on any purchases or services used by the business. The naming of these accounts may vary from business to business. The table below shows some of the common naming conventions used for GST. For our purposes, we will use *GST collected* and *GST paid* throughout this textbook.

GST included on payments made by the business for acquisitions or services	GST included on receipts of the business from sales or services provided
GST paid	GST collected
GST receivable	GST payable
GST input tax credit	GST payable
GST clearing	GST clearing

The last option shown above is where the business elects to use one single account to record all GST transactions and is called *GST clearing*. When using a GST clearing account, all GST collected on sales is recorded in this account and then any GST paid on acquisitions is offset against the amounts collected, in the same account. You will cover more on the operation of accounts in later chapters of this textbook.

You should now attempt questions 1.19 to 1.26 and self-test questions 1B and 1C on pages **22–23**.

ACCOUNTING CLASSIFICATIONS (QUESTIONS 1.27–1.33)

Our definition of accounting (in section 1) included classification as part of the process. The five broad classifications used in the accounting process are *assets*, *liabilities*, *owners' equity*, *income* and *expense*.

Assets—are things that the business owns which are of benefit to future periods. They can be items that you can see and touch such as cash and equipment or intangible items such as the promises to pay by people who owe money. These are known as accounts receivable.

Liabilities—are amounts owed by the business or enterprise. These are sometimes called debts owed. A bank loan is an example of a liability.

Owners' equity/Proprietorship—represents the amounts owed to the owner(s) after taking into account amounts put into the business, profits earned and amounts taken out of the business by the owner(s).

Income/Revenue—are earnings of the business such as sales and fees received.

Expenses—are costs of earning income such as wages and advertising expenses.

The net result of a business entity's activities involving income and expense will be either a *profit* or a *loss*.

Profit—the business makes a profit when the income earned is greater than the expenses.

Loss—the business makes a loss when the expenses are greater than the income earned.

You should now attempt questions 1.27 to 1.33 and self-test question 1D on pages **23–25**.

ACCOUNTING CONVENTIONS/DOCTRINES (QUESTIONS 1.34–1.40)

Accounting conventions are accepted customs followed by the accounting profession. Listed are six accounting conventions:

Business entity convention

This convention states that the business exists separately from the owner. The owner's assets or liabilities must not be included with the business assets and liabilities (also known as the *accounting entity convention*).

Going concern convention

This convention states that the life of a business will continue to exist for the foreseeable future. The financial statements of a business are prepared on this basis.

Accounting period convention

The life of the business (seen as indefinite as per the going concern convention) is divided into equal periods, usually of one year. Financial statements are prepared for each of these annual periods.

Historical cost convention

This convention states that the value of an asset, liability, income or expense will be recorded at the actual amount that the business pays or receives (historical cost), regardless of any changes in potential value since the transaction occurred. This convention ignores any changes due to inflation. Under this convention, all financial transactions are recorded in the accounting records of the business in Australian dollars.

Monetary convention

Under this convention, any laws relating to the business and its accounting records must be followed. This includes following the approved accounting standards (see next section).

Accounting doctrines refer to generally held beliefs or principles. Listed are three doctrines:

Doctrine of consistency

This requires the business to follow the same accounting principles or methods from one accounting period to the next. For example, the valuation method used for inventory at the end of one financial year should be the same as that used at the end of the previous financial year. If there is some valid reason to change the valuation method, this reason and the financial impacts of the change should be disclosed in the financial statements.

Doctrine of disclosure

Under the doctrine of disclosure, the financial statements should be prepared at a sufficient level of detail to allow the owner (or any other interested party) to understand what has occurred in the reporting period and the current financial position of the business.

Doctrine of materiality

This doctrine states that all *significant* items relating to the operations of the business or its current financial position must be disclosed. This doctrine also extends to the level of accuracy in the financial statements in relation to reporting to the nearest dollar or the nearest 1 000 dollars. The size of the business will be the main determinant of this level of accuracy.

You should now attempt questions 1.34 to 1.40 and self-test questions 1E and 1F on pages **25–26**.

ACCOUNTING STANDARDS (QUESTIONS 1.41–1.44)

Generally Accepted Accounting Principles GAAP—Financial statements are required to be prepared in accordance with generally accepted accounting principles so that quality and consistency of information is provided. However, there is not a comprehensive definition of what GAAP means and as a result there has been inconsistency in accounting practice over the years.

Accounting Standards—are an attempt to formalise GAAP into firm rules and codes of accounting practice. The Australian Accounting Standards Board (AASB) was established under the *Australian Securities Commission Act 1989*. The AASB now provides published standards, the purpose of which is to establish requirements for the recognition, measurement and disclosure of transactions and other events in financial reports. In 2004, the AASB adopted the equivalent international standards, replacing the then existing Australian standards, in an attempt to harmonise accounting standards internationally.

Under the Corporations Law standards issued by the AASB are legally enforceable for companies only. However, all members of the professional accounting associations, under their membership rules, must observe them.

These standards are constantly being reviewed by the accounting profession. You can view the current standards by visiting the Australian Accounting Standards Board's website.

You should now attempt questions 1.41 to 1.44 and self-test question 1G on page **26**.

STATEMENTS OF ACCOUNTING CONCEPTS AND THE CONCEPTUAL FRAMEWORK (QUESTIONS 1.45–1.47)

Statements of Accounting Concepts (SAC) (the Conceptual Framework) are also an attempt to establish general concepts and principles to be followed in the preparation and presentation of financial reports. They do this by defining the reporting entity, defining the objectives and characteristics of financial information and of assets, liabilities, owner's equity, income and expenses.

There were four statements developed by the professional accounting associations. With the adoption of the international equivalent standards in 2004, only SAC1 and SAC2 have been retained. These are:

SAC1 Definition of the Reporting Entity—the purpose of this statement is to define the concept of a reporting entity and to set out the 'benchmark for the minimum required quality of financial reporting'.

SAC2 Objective of General Purpose Financial Reporting—this SAC identifies the users of general purpose financial reports as including resource providers, recipients of goods and services and parties performing a review or oversight function. It also outlines the common information needs of these users and the types of information that should be provided to the users.

SAC3 and SAC4 have been replaced by the *Framework for the Preparation and Presentation of Financial Statements*. The framework, like the statements of accounting concepts which it replaced, sets out the objectives of financial reports, the qualitative characteristics (understandability, relevance, reliability and compatibility) that determine the usefulness of financial reports and the definition, measurement and recognition of elements of financial statements. The elements of financial statements are our five major classifications of assets, liabilities, equity, income and expenses.

More information on these statements and the framework can be obtained from the AASB website or the members' handbook published jointly by the Institute of Chartered Accountants in Australia and CPA Australia.

You should now attempt questions 1.45 to 1.47 on page **27**.

ETHICS (QUESTIONS 1.48–1.50)

Ethics are codes of moral behaviour which are acceptable to the wider community. Ethically unacceptable behaviour would be such things as cheating (in all its forms), fraud, embezzlement,

deceptive advertising or defrauding owners, shareholders, companies or the Tax Office. Most of these activities are also illegal.

The accounting bodies have set out seven areas where their members must act in an ethical and professional manner. These areas are:

- to ensure that the public interest does not conflict with their need to look after the interests of the business owners
- to act with integrity (honesty and sincerity) in their professional work
- to be objective in their approach (fair and unbiased)
- to respect confidentiality with regard to their knowledge about the business gained through their privileged position
- to conform to the technical and professional standards in their work
- to perform their work with professional competence, due diligence and care, and
- to conduct themselves at all times in an ethical manner and not to bring discredit to the profession.

You should now attempt questions 1.48 to 1.50 on page **27**.

QUESTIONS

- **1.1** Name five individuals or organisations that would receive information from the accounting process.

- **1.2** List three reasons why people or enterprises that lend money to a business would be interested in accounting information.

- **1.3** What is a business transaction?

- **1.4** What are the activities in the accounting process?

- **1.5** What are the functions of accounting?

- **1.6** Who needs accounting information?

- **1.7**
  - **a** What are the three main alternative forms of business ownership?
  - **b** List the advantages and disadvantages of the three main alternative forms of ownership.

- **1.8** What forms of business ownership involve unlimited liability for the owners?

- **1.9** What are the five main groups of transactions for a business?

- **1.10** What source document is used for the following transaction:
  - **a** a customer pays cash for a purchase
  - **b** the business pays rent to the building owner
  - **c** a customer buys goods and agrees to pay at a later date
  - **d** the store's manager informs the accounting department that some inventory has been damaged or destroyed
  - **e** the business receives a cheque from a customer
  - **f** the business makes a payment to the owner of the business, and
  - **g** goods are returned by a debtor (accounts receivable)?

- **1.11** Why is it important to document business transactions? How may these documents be useful in the event of disputed transactions? Illustrate your answer with an example.

- **1.12** Why is it important that certain business documents are accountable? How is this accountability practised by a business entity?

- **1.13** What would normally appear on the following documents:
  - **a** sales tax invoice
  - **b** credit note
  - **c** cash sale docket
  - **d** sale made by credit card
  - **e** receipt, and
  - **f** cheque butt?

■ **1.14** For each of the following transactions:

a name the source document which records the transaction, and

b describe the data included on the document:

i sale of goods on credit

ii cash paid to a creditor (accounts payable)

iii goods returned by a debtor (accounts receivable), and

iv cash received from a debtor (accounts receivable).

■ **1.15** Is it necessary to record the tax invoice number in the accounting records? Why?

■ **1.16** Prepare source documents, suitable for a wholesaling company, for the following business transactions:

a sale of goods on credit, and

b amount received from a debtor (accounts receivable).

■ **1.17** Explain the difference between cash and accrual accounting.

■ **1.18** Which of the following transactions would be included on the bank deposit slip:

a received a cheque from a customer for $950

b made cash sales for the day totalling $1 925

c sold goods on credit for $880

d EFTPOS sale totalling $750

e credit card sale for $220?

SELF-TEST QUESTION 1A (answer Chapter 16)

What source document is used for the following transactions:

a the business purchases goods for cash

b the business pays council rates

c the business buys a motor vehicle and agrees to pay at a later date

d a customer buys goods from the business for cash

e the business returns damaged goods originally purchased on credit

f the credit manager informs the accounting department that one of its customers is no longer able to pay its debts

g the business makes an instalment payment on the motor vehicle previously purchased on credit

h the business sells goods to a customer on credit

i the business receives a cheque from a customer

j the owner withdraws cash from the business

k goods are returned by a customer, and

l the business sells some furniture for cash?

QUESTIONS

■ **1.19** What is GST?

▨ **1.20** How do you calculate GST if:

a you know the cost of the goods or service but not the total of the invoice, and

b you know the total of the invoice but not the value of the goods or service?

■ **1.21** **a** If a business buys goods valued at $1 200 before GST, what is the total amount payable on the invoice?

b If a business pays $990 for electricity including GST, how much GST is paid?

c If a new car costs $35 000 plus GST, how much is paid in total?

▨ **If you paid $781 for a new desk including GST, how much is the GST portion?**

e If the invoice total is $110, how much is the GST?

f If the invoice total is $1 980, how much is the GST?

g If the invoice total is $137.50, how much is the GST?

h If the invoice total is $83.38, how much is the GST?

■ **1.21** **a** If a business sells a computer valued at $2 500 plus GST, how much GST is charged?

b If a business collects revenue of $780 excluding GST, how much did they receive including GST?

c If a business receives $1 320 in cash sales including GST, what is the GST portion of this amount?

d The total of the tax invoice is $2 145. How much is the GST?

e If the GST is $95, what is the value of the invoice?

f If the GST is $189, what is the value of the invoice?

g If the GST is $12.50, what is the value of the invoice?

h If the GST is $322.55, what is the value of the invoice?

■ **1.23** A business buys a computer valued at $2 000 (excluding GST), pays their commercial rent valued at $1 500 (excluding GST) and buys stock valued at $5 000 (excluding GST). How much GST have they paid?

■ **1.24** You receive a tax invoice totalling $1 650 for the purchase of goods. What is the value of the goods and how much GST have you paid?

■ **1.25** You are selling goods to a customer valued at $2 260 excluding GST. What is the total amount of the tax invoice that the customer receives?

■ **1.26** A business buys a motor vehicle valued at $25 000 excluding GST, pays their telephone account valued at $850 excluding GST, and buys stock valued at $3 000 excluding GST. The business also sells goods valued at $35 000 excluding GST during the month. How much does the business need to pay the ATO with their next Business Activity Statement?

SELF-TEST QUESTION 1B (answer Chapter 16)

- **a** If a business pays $1 760 for repairs including GST, how much GST is paid?
- **b** If a new fork lift vehicle costs $42 000 plus GST, how much is paid in total?
- **c** If a business receives $1 210 in cash sales including GST, what is the GST portion of this amount?
- **d** If the total of the tax invoice is $3 278, how much is the GST?
- **e** If the invoice total is $1 562, how much is the GST?
- **f** If the invoice total is $195.80, how much is the GST?
- **g** If the GST is $56.20, what is the value of the invoice?
- **h** If the GST is $541.50, what is the value of the invoice?

SELF-TEST QUESTION 1C (answer Chapter 16)

Calculate the payment to the ATO that will accompany the BAS if the company had the following transactions during the month:

- **a** owners commenced business with $10 000 cash
- **b** business buys inventory on credit for $10 000 (excluding GST)
- **c** business sells goods valued at $5 000 to customer for cash (excluding GST)
- **d** business gives a tax invoice to customer totalling $6 600 (including GST)
- **e** business buys goods for cash and is invoiced $3 850
- **f** business pays rent of $990 including GST
- **g** business pays wages totalling $1 500
- **h** business sells goods for cash totalling $4 950 inclusive of GST
- **i** business receives $6 600 from customer who earlier bought goods on credit
- **j** business pays a supplier invoice totalling $16 500 for goods purchased on credit, and
- **k** business pays telephone account—invoice was for $220.

■ **1.27** Identify those items that are assets to a business:

- **a** land
- **b** amounts contributed by the proprietor
- **c** an employee's motor vehicle
- **d** computer equipment
- **e** GST collected
- **f** cash at bank
- **g** accounts payable (amounts we owe)
- **h** accounts receivable (amounts owed to us)
- **i** cash withdrawn by the owner to pay personal debts
- **j** factory machinery
- **k** mortgage loan
- **l** warehouses
- **m** owners' contribution to business
- **n** buildings
- **o** office furniture, or
- **pinterest income.**

■ **1.28** Identify those items that are liabilities to a business:

- **a** loan to sales manager
- **b** interest on bank loan
- **c** loan from JLW Finance Company
- **d** bank overdraft
- **e** amounts due to suppliers
- **f** debtors (accounts receivable)
- **g** cash at bank
- **h** mortgage
- **i** GST collected
- **j** factory equipment, or
- **k** accounts payable.

■ **1.29** Classify the following as either asset (A), liability (L) or owners' equity (OE):

a capital
b plant
c loan from Sun Bank
d GST paid
e creditors
f premises
g petty cash
h mortgage on premises
i land
j inventory, and
k investments.

■ **1.30** Define the following terms:

a accounts receivable
b accounts payable
c inventory
d GST collected
e capital
f drawings
g income
h expense
i mortgage
j profit, and
k bank overdraft.

■ **1.31** Circle the correct answer for each of the following that is an asset, liability or owners' equity to the business. Some items may not be an asset, liability or owners' equity, so leave them blank.

a	stock	asset	liability	owners' equity
b	A. Reubens (a debtor)	asset	liability	owners' equity
c	advertising	asset	liability	owners' equity
d	owner's interest in the business	asset	liability	owners' equity
e	payroll clerk's personal computer	asset	liability	owners' equity
f	loan from Blue Bank	asset	liability	owners' equity
g	cash at bank	asset	liability	owners' equity
h	consulting fees received	asset	liability	owners' equity
i	GST collected	asset	liability	owners' equity
j	G. Greig (a creditor)	asset	liability	owners' equity
k	cash withdrawn from the business by the owner for personal use	asset	liability	owners' equity
l	plant and equipment	asset	liability	owners' equity
m	an employee's video camera	asset	liability	owners' equity
n	loan to finance manager	asset	liability	owners' equity
o	morning tea supplies	asset	liability	owners' equity
p	staff training course	asset	liability	owners' equity
q	motor vehicles	asset	liability	owners' equity
r	rent received	asset	liability	owners' equity
s	building	asset	liability	owners' equity
t	cash in petty cash tin	asset	liability	owners' equity

■ **1.32** Classify the following items as either an asset (A), liability (L), owners' equity (OE), income (I) or expense (E):

a delivery costs
b sales
c dividends received
d cash
e shares in other companies
f rent
g loan from ACB Finance Company
h repairs and maintenance
i equipment
j bank overdraft
k interest received
l sales commission paid
m salaries
n commission received, and
o bank charges.

■ **1.33** Classify the following items as either an asset (A), liability (L), owners' equity (OE), income (I) or expense (E):

- **a** shares in Optecom Ltd
- **b** rent received
- **c** accounting fees paid
- **d** insurance
- **e** GST collected
- **f** mortgage
- **g** telephone
- **h** fees received
- **i** capital
- **j** shop fittings, and
- **k** bank.

SELF-TEST QUESTION 1D (answer Chapter 16)

Classify the following items as either an asset (A), liability (L), owners' equity (OE), income (I) or expense (E):

- **a** cash at bank
- **b** inventory
- **c** mortgage loan
- **d** sales
- **e** rent paid
- **f** interest received
- **g** accounts receivable
- **h** GST collected
- **i** land
- **j** premises
- **k** telephone expenses
- **l** plant and machinery
- **m** rent received
- **n** drawings
- **o** insurance
- **p** fees received
- **q** capital, and
- **r** wages.

■ **1.34** What is the difference between an accounting convention and an accounting doctrine?

■ **1.35** Explain your understanding of the:

- **a** business entity convention
- **b** accounting period convention
- **c** going concern convention, and
- **d** monetary convention.

■ **1.36** Explain your understanding of the:

- **a** doctrine of consistency
- **b** doctrine of disclosure, and
- **c** doctrine of materiality.

■ **1.37**

- **a** What does the historical cost convention assume?
- **b** What are some of the problems associated with historical cost accounting in times of inflation?

■ **1.38** Is the preparation of income tax returns the sole reason for the importance of the period convention? Discuss.

■ **1.39** What conventions/doctrines can be mainly associated with providing for employee benefits such as long service leave?

■ **1.40** What conventions/doctrines are breached if:

- **a** sales are recorded in units and not dollars, and
- **b** the private house of a business proprietor is included in the business assets?

SELF-TEST QUESTION 1E (answer Chapter 16)

Which of the accounting conventions or doctrines applies to the following events or circumstances:

- **a** a business prepares financial statements each year
- **b** the owner's motor vehicle is not included as an asset of the business
- **c** the business uses the same inventory valuation method each year
- **d** the company's financial statements are rounded to the nearest $1 000
- **e** the purchase of equipment is recorded in Australian dollars, and
- **f** the business meets the requirements of the GST legislation?

SELF-TEST QUESTION 1F (answer Chapter 16)

Which accounting convention or doctrine is being used if the business reports the following information:

- **a** the purchase price of land acquired in 1991 is recorded as the cost in the financial statements
- **b** the business reports that it is changing the method of valuation for inventory and the financial impact of the change is shown
- **c** the financial statements are recorded in whole dollars
- **d** the business reports the loss on the sale of motor vehicles as separate from the usual running costs
- **e** the business prepares its financial statements in accordance with the requirements of the Corporations Law
- **f** the business has been preparing financial statements since commencing business in 1991 and expects to continue to do so, and
- **g** the financial statements are presented for the year ended 30 June 2010?

- **1.41** What are statements of accounting standards?
- **1.42** What authority do statements of accounting standards have with the accounting profession?
- **1.43** Does the AASB series of accounting standards apply to all organisations? Discuss.
- **1.44** What are possible outcomes for accountants who breach the AASB series of standards?

SELF-TEST QUESTION 1G (answer Chapter 16)

Which accounting standard covers the following aspects of accounting or financial reporting:

- **a** recording income
- **b** recording stock on hand
- **c** recording the costs associated with borrowing funds
- **d** reporting items that are significant
- **e** reporting assets, liabilities and owners' equity
- **f** disclosure of information relevant to the business financial operations, and
- **g** reporting income and expenditure.

■ **1.45** What is the difference between statements of accounting concepts and statements of accounting standards?

■ **1.46** What are the qualitative characteristics outlined in *Framework for the Preparation and Presentation of Financial Statements*? Give one example of how each may be used in the reporting of financial information relating to a business.

■ **1.47** Which convention or doctrine is applied for the following transactions or events:

a the company prepares financial statements annually

b the business owner does not include a personal motor vehicle in the list of business assets

c the business has been preparing annual financial statements for the last 12 years and expects to continue to do so

d the business follows the AASB accounting standards to produce the financial statements

f the business records the profit on sale of motor vehicles in a different account to the motor vehicle running costs

g the business used a 'first in–first out' inventory valuation method last year and will use the same method this year

h the business rounded its financial statements to the nearest $1 000, and

i the business acquired its land and building 10 years ago and still records the value at cost despite land values doubling over this time?

■ **1.48** Some economists would say that the most important aim of a commercial organisation is to maximise its owners' wealth. Others suggest that commercial organisations must also exercise social responsibility, for example they must not pollute the environment with industrial waste. Discuss each of these points of view.

■ **1.49** Some large business corporations experience financial collapse. How do you think accountants may assist in avoiding these corporate failures?

■ **1.50** **a** A local business asks you to prepare its accounting records. The proprietors want two sets of books, one for themselves and the other for the preparation of the tax return. The books for the tax return preparation are not to disclose significant profits from one section of the business. What will be your decision and why?

b You are an expert in a particular professional field. A book publisher approaches you to write a chapter on your particular field of expertise for a book soon to be published. The publisher advises that payment to you will be made by 'cash placed in a brown paper bag'. Discuss the possible accounting and social implications that may arise for both parties.